ELSEVIER

Long Range Planning 45 (2012) 1—15

LRP long range planning

http://www.elsevier.com/locate/lrp

Winning Strategies in China: Competitive Dynamics Between MNCs and Local Firms

Sea-Jin Chang and Seung Ho Park

This paper presents frameworks about the competitive structure and dynamics between local and multinational firms in China. Based on an extensive fieldwork we identify technological complexity and market heterogeneity as important drivers that determine the nature and extent of competitive dynamics. Our framework illustrates different advantages and disadvantages of multinationals over local firms depending on the nature of competitive dynamics. We then discuss generic strategies for multinational firms and the ways to implement them in each competitive dimension.

© 2011 Elsevier Ltd. All rights reserved.

Introduction

The collapse of the US property bubble caused a global financial crisis that reversed the growth of economies around the world. The effect of the financial meltdown varied depending on the particular economy, with advanced economies most significantly impacted and emerging economies able to weather the storm more successfully. In particular, Asian economies remained unaffected by the crisis, as banks operated more conservatively, government stimuli worked effectively and domestic markets remained vibrant. Now, as the world economy attempts to recover, China is leading the way with over 9 per cent growth in 2011.

Yet China, now the de facto locomotive of the world economy, has witnessed noticeable changes in the competitive environment for multinational firms in recent years. Since implementing the "reform and open door policy", China experienced a skyrocketing inflow of foreign investments, amounting to $1098bn between 1979 and 2010; this figure is more than three times the investment flow into Japan during the same period. There are currently almost 660,000 foreign investment projects in China from over 150 countries, contributing to almost one-third of China's industrial outputs and 56 per cent of its total exports. China's vast market, often captured by the phrase "1.3bn potential customers", strongly attracted foreign investors.

0024-6301/$ - see front matter © 2011 Elsevier Ltd. All rights reserved.
doi:10.1016/j.lrp.2011.11.002

China, however, can be challenging to navigate for unprepared foreign multinationals. Several early entrants have already experienced costly failures and retreated from the market. For instance, the brewers Carlsberg, Bass and Foster's — unable to maintain their market positions against the onslaught of strong domestic competitors such as Tsingtao and Yanjing, as well as larger and richer foreign competitors such as Anheuser-Busch InBev — opted to exit China (Meyer and Yen, 2006). Major shakeouts and exits of foreign companies also occurred in capital-intensive industries, such as mobile handsets, that were formerly occupied by foreign firms until the late 1990s. Local firms expanded quickly and captured more than half of the market by the middle of 2003. Several foreign firms, such as Siemens and most Japanese companies, were unable to withstand such competition and eventually left the market (Park, 2004).

Local competitors challenge multinationals with low costs, managerial flexibility and extensive distribution networks (Hexter and Woetzel, 2007). Despite their superior brands and technology, foreign companies experience difficulty competing against strong local competitors. Winning competition against local firms does not necessarily imply winning only in the Chinese market. Given the possibility that these local contenders will challenge foreign rivals in the global market — e.g., Lenovo in personal computers, Haier in consumer electronics and Geely in cars — it is critical to understand the competitive dynamics to sustain global dominance. A manager at LG Electronics says: "China is a place like an Olympic game. The best players from all over the world are here and fight to win. Chinese local firms are strong in the domestic market. They are also global players, exporting goods to all over the world. The global competition with them begins in China. We will be stronger as we strive hard to match their prices and costs. By being here, we also have an opportunity to learn about local firms that will be our competitors in the global marketplace. If we lose in China, we cannot succeed in the world market."

Many multinational firms remain unable to address the competitive challenges of local firms in China. In this paper, based on extensive fieldwork, we propose frameworks that detail the competitive structure and dynamics between local and multinational firms in China. We first illustrate the change in competitive structure during China's market liberalisation and then identify two important dimensions of competitive dynamics — namely, technological complexity and market heterogeneity — which determine the competitive advantages or disadvantages of multinationals over local firms. The paper also discusses generic strategies for multinational firms and ways to implement them according to the two dimensions of competitive dynamics.

Changes in competitive dynamics

The competitive landscapes in China have transformed drastically since the 1990s. When Deng Xiaoping opened China's gate to foreign companies, the country was in a dire state. Under the communist regime, state-owned enterprises and collectives were responsible for the production of goods and services across the country. The ideological conflict and the risk of a potential war with the Soviet Union led state planners to build duplicative production facilities, e.g., thousands of TV set manufacturers and pharmaceutical firms scattered around the country. Thousands of small-sized plants also flourished, defying the concept of scale economies (Huang, 2008). As a consequence, most local industries were filled with poor-quality products at prohibitive costs, as unmotivated workers relied on decades-old machine tools in run-down factories. There were no concepts of efficiency, cost and quality in these old Chinese industries (Rawski, 1980).

Multinational firms' entry throughout the 1990s was a wake-up call for these Chinese companies. On the one hand, foreign firms posed great competitive threats to local incumbents; on the other hand, they presented opportunities for locals to learn new technologies and skills. During the mid-1990s, most industries were populated with two types of companies. Multinationals entered the Chinese market via product imports or the local assembly of imported parts, targeting primarily the upper end of the market. The high-end players competed on the basis of technology and brand. The other type of competitor was local companies, mostly traditional state-owned enterprises and co-operatives positioned at the low end of the market. Their products were of low quality and made

competitive primarily due to price. Multinationals and local firms were positioned at opposite ends of the market and avoided direct competition with one another.

Over the last decade, however, this somewhat peaceful landscape was significantly disturbed. Some multinationals pursued localisation by relocating production facilities to China. They then penetrated into the mid-priced segment by using localised products. We call them "localised multinationals" as opposed to "conventional multinationals" that continued relying on imports at the high-end market. Localised multinationals took advantage of the high-end segment by localising production and sourcing. In the consumer electronics industry, LG Electronics aggressively pushed localisation, building production facilities in many regions, including air conditioners in Tianjin, washing machines in Nanjing, televisions in Shenyang and DVD players in Shanghai.

Multinational firms are now overwhelmed by the unprecedented pace of change in Chinese markets. Since the economic reform began, the Chinese car industry has grown by over 45 per cent annually, making it the fastest growing and the biggest market in the world. A manager at a major consumer product company stated: "You rarely see anywhere else in the world this pace of change. There have been massive changes in retail chains, customer behaviours and the competitive environments. People in western countries might still have a perception that China is a backward country. You have to throw away such an outdated mindset first before you come to China." (Figure 1).

At the same time, consumers' perceptions of locally manufactured products have greatly improved. One manager at GM described the changes in the car industry as follows. "Not many years ago, there was a perception among Chinese consumers that imported products were of high quality, which was true at the time. Now, the perception gap is narrowed with many new models, including Buick, Accord and Passat, made in China. People started to recognise that locally-made cars are of high quality." He further added: "Chinese customers have become more demanding. On the one hand, people look for the lowest price and a very basic product; on the other hand, you had people looking for the best. For them, price was not a concern and there was nothing in between until a few years ago. Currently, however, the middle market has evolved, looking for value, which poses another set of complexity…"

Substantial changes also took place in the conventional low-end segment with new local players becoming strong contenders. These new breeds of local competitors emerged in two distinctive ways. First, some became strong competitors by learning from joint ventures with multinationals. The Chinese government forced foreign multinationals to establish joint ventures with local firms as

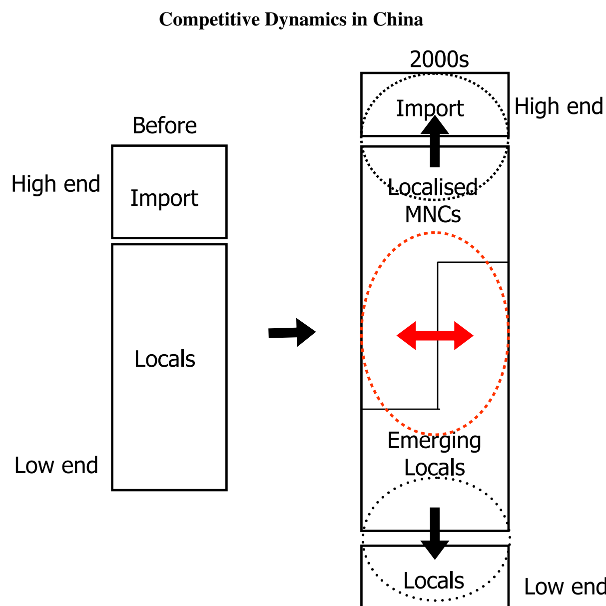

Figure 1.

a condition of market access. The SAIC's (Shanghai Automobile Investment Corporation) joint ventures with Volkswagen and GM are prime examples of such government-designated schemes. Second, some of the new contenders were private entrepreneurial firms or restructured state-owned enterprises. For example, the businessman Zhang Ruimin transformed a small obscure freezer manufacturer in Qingdao into a multinational corporation, now known as Haier (Yi and Ye, 2003). It is a well-known anecdote that he smashed defective products with a hammer in front of factory workers as a form of shock therapy to emphasise quality. Haier expanded by acquiring and transforming other staggering firms. As a step toward becoming a strong global player, it opened a production plant in South Carolina and captured a 20 per cent share of the US freezer market. Similarly, some private companies, run by a cadre of entrepreneurs, emerged. Lenovo, a PC manufacturer, was established by Liu Chuanzhi and 10 other researchers from the Chinese Academy of Science. Liu and his colleagues developed cheap but high-quality PCs for Chinese consumers. Lenovo's market share increased from 6.9 per cent in 1996 to almost 32 per cent by 2011, thus becoming one of the most dominant PC manufacturers in China as well as around the world.

These strong local companies, which we refer to as "emerging local firms", have accumulated technological skills by benchmarking foreign multinationals and hiring engineers and managers away from them. It is not fair, however, to call all local firms successful imitators. In fact, some of them employ cutting-edge technologies. For example, Huawei, a Guangdong-based telecommunication equipment company, established over 20 global R&D centres in the US, Germany, Sweden, Russia and India. Huawei has spent more than 10 per cent of its annual revenue on R&D every year since 2001. Its R&D-related personnel accounted for more than 46 per cent of the company's total employees in 2010.

These local companies have not only cost advantages but they also have greater access to distribution channels. While most foreign multinationals covered only large cities in coastal areas, local firms developed dense distribution networks into rural markets. As these two new types of firms — localised multinationals and emerging locals — continued their market expansion, they began competing head to head with each other in the mid-range market around the country (Gimeno and Woo, 1996). These two new types of firms are bolstering conventional multinationals that rely on imports, while causing problems for conventional local firms that cannot upgrade themselves.

Industry variation in competitive dynamics

The nature and extent of competitive dynamics between local and multinational competitors differ greatly across industries. There have been mounting pressures from emerging local players, while multinational firms engage in strategic moves to hold on to their earlier advantages. Our field research leads to two dimensions, market heterogeneity and technological complexity, as key determinants of industry variation in local-multinational competitive dynamics. Local firms would face higher barriers to challenge multinationals as they deal with complex technologies and face highly diverse consumer needs and market structures (Figure 2).

When an industry involves complex technologies, it is not as easy for local firms to imitate or to keep abreast with multinationals' product advantages. Quadrants III and IV represent these sectors, e.g., industrial systems and cars, where foreign firms would have sustained advantages over local competitors. In industrial systems that include automation and power systems, multinationals such as GE, ABB and Siemens maintain competitive edges over local rivals. Customers would not be interested in a single isolated product in industrial systems; instead, they would need entire power plants with various components that could run without failure. Multinationals that have the product as well as the process-related advantage would face fewer challenges from local rivals and be able to sustain their leadership positions. The car industry illustrates similar competitive dynamics. Although Volkswagen and other foreign producers have transferred component technologies to local part providers, local manufacturers would still lag in designing a car that normally consists of over 20,000 different components. This is why local firms, such as SAIC and Geely, are actively

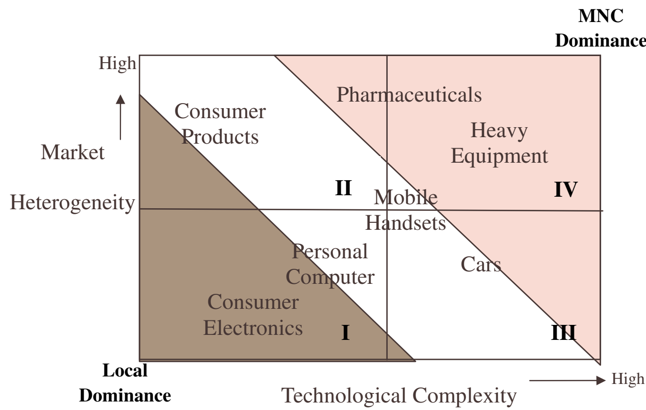

Figure 2.

pursuing foreign acquisitions that would provide the missing links in design and other integrated capacities. SAIC's acquisition of Korea's Ssangyong Motors and UK's Rover and Geely's acquisition of Volvo are driven by these motivations, especially to acquire technologies and brands.

A senior manager in a foreign industrial system manufacturer explains: "Chinese workers are not particularly strong in complex problem solving, which is essential to be successful in this industry. It takes a high level of abstract thinking and co-ordination skills to solve a complex problem. Local competitors may be able to copy a product but they cannot copy a system. At the end of the day, we are able to provide solutions to customers but they cannot." Another manager in the automation business made a similar remark. "Local competitors may buy just a robot from us. It does not do any good to customers unless you provide solution with it. A robot is just a tool. For instance, a customer wants a machine to punch holes. We can design a system according to the customer's specification: how many holes in a minute and what size, etc. We have been providing solutions to customers for many years. We have know-how and solutions for automobile, power generation and many other system-related sectors. Local competitors can manufacture a robot, but they cannot provide the total solutions for customers, which is why they will have difficulty to compete with us."

Likewise, local firms would have difficulty catching up with multinationals in industries with extreme market heterogeneity (Quadrants II and IV). For example, the consumer goods industry is dominated by multinational firms due to their advantages in marketing capabilities, i.e., brand, channel and market segmentation. Global consumer goods producers, such as P&G and Unilever, have extensive knowledge of analysing customer demand and creating brands tailored to specific consumer segments. They also have larger advertising budgets and efficient distribution systems that bring products to the final consumers directly. Local firms would be able to develop a product tailored to regional markets, but they do not have the market research capabilities to develop brands at the national level. This is why P&G and Unilever could defend their market shares in personal care and hair products, despite the threat posed by local competitors. A manager in a consumer goods company explains: "Local companies are learning fast, but I do not think they have gained the appropriate marketing capabilities. In most product categories, the more you go down the learning curve, the bigger the investment in consumer research is required to make the next step forward. It becomes more expensive over time to bring a new product to the market. So, this is where our research could help. We apply our systems and processes to get things done. We have a leading edge process to manage communications, allowing us to develop advertising at a lower cost per consumer. Local firms, on the other hand, apply a shotgun approach. They may try with one advertisement and another if the first trial does not work, continuing the trials without any logic or consistency. This becomes too expensive and ineffective, with lots of capital and marketing effort wasted…" Quadrant IV, with the characteristics of both Quadrants II and III, would present the most difficult challenges for locals to catch up with foreign competitors.

On the other hand, local firms' challenges against multinationals are most severe in industries with less market complexity and technological complexity (Quadrant I). The consumer electronics industry belongs to this category, where local firms quickly overtook multinationals. These local firms are capable of manufacturing even high-end products by purchasing standardised components from overseas suppliers. Chinese appliance manufacturers, e.g., TCL and Haier, can manufacture LCD televisions even when they do not have capacity to manufacture LCD panels. Because LCD panels and graphic controllers are available from independent vendors, it is a matter of designing the case and pushing it through distribution channels.

The mobile phone and PC industries are technologically more complex and require more sophisticated marketing knowledge than the consumer electronics industry. Like consumer electronics, mobile handsets have a short lifecycle and local firms can quickly imitate foreign products by sourcing components from independent suppliers, i.e., mainly original equipment manufacturer (OEM) companies. However, unlike consumer electronics, mobile phones require tight partnerships with network operators. Foreign multinationals such as Nokia own core technologies, and they are also in the infrastructure businesses, while local handset makers are primarily assemblers. At the same time, some key components such as chip sets are sensitive to scale economies. Multinational firms with global sales thus enjoy cost advantages over local firms that are limited to domestic sales.

Strategies for multinational firms

This section introduces the generic strategies for multinational firms across the quadrants, as described above. Each quadrant presents different competitive dynamics between local and multinational companies, where we discuss the interactive process of local firms' challenges and multinational firms' reactions (Figure 3).

Quadrant 1: Leveraging the global scale

Local firms in this quadrant challenge multinational firms based on low cost advantages. Many local competitors are located in rural areas with abundant supplies of cheap labour. Although the labour cost in China has been increasing, it is still below 6 per cent of the US standard in 2010. Local firms do not have to maintain global health and safety standards, which incurs substantial costs for multinational firms. Local firms do not have expensive overheads, as multinationals do, for their headquarters. Furthermore, local companies, many of which are formerly state-owned enterprises, are subsidised by regional governments that have vested interests in maintaining employment rates. As a consequence, these companies often sell their products below cost or at prices most multinationals cannot possibly match.

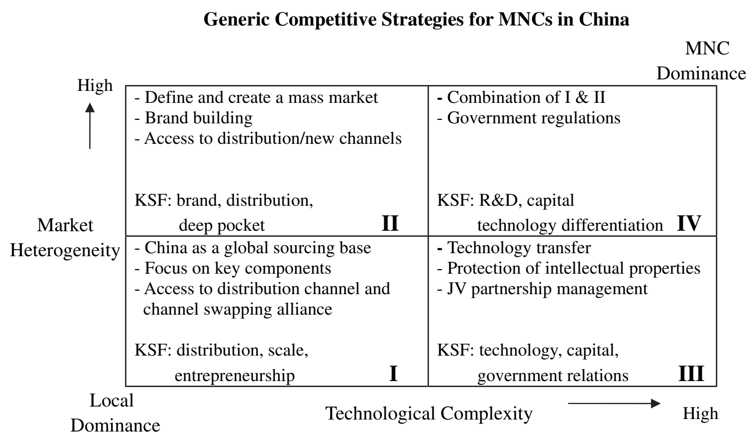

Figure 3.

Given the strength of local firms in this quadrant, multinationals should not pursue a strategy competing head-to-head with local counterparts on price. Our field work suggests that localisation is a key to success in this case. Moving the production base to China and sourcing locally-available parts and materials help multinationals to lower their cost structures to a level parallel to local competitors. Furthermore, offering more decision-making authority to local management enables fast decision making and flexible execution, so that they can respond quickly to local market changes.

A key success factor for multinationals in this quadrant is the ability to leverage global scales in sourcing and production. Local sourcing is a critical starting point to address the cost pressure. According to a manager at GE: "With local sourcing, it can act more like a local company. GE cannot compete against the 50,000 local manufacturers of incandescent light bulbs, whose prices are substantially lower, but it can use them as the basis of sourcing, from which it could establish a global level of cost competitiveness."

Most managers we interviewed emphasised that sourcing should be integrated with the company's overall strategies. First, multinational firms should be able to evaluate sourcing in the context of global strategies, not just local operations. When Hyundai Motors set up its assembly lines in China, it invited many suppliers from Korea who also moved their operations to China. While doing so, Hyundai was keen on exporting parts and finished products, so that it could acquire scale advantages in China. China's policy of waiving import duties and value-added taxes further encouraged sourcing from China. Multinational firms maintain cost competitiveness in both high and low ends of the market, as they are able to exploit the global scale advantages.

Second, multinational firms should source not only from China but globally for China. Since their China operations tend to be smaller in scale, at least during the initial stage, their parts suppliers cannot fully enjoy scale economies. Further, quality materials are expensive in China and, while still improving, the quality of some parts is often below the global standard. Multinational firms are able to recapture scale economies, forgone due to small local operations, by combining local sales with exports. For example, a large portion of the cost for mobile phones is semiconductor chips that are subject to strong scale economies. Samsung is thus able to maintain cost advantages in chip manufacturing for mobile phones by exploiting its global market share.

Third, as products in this quadrant easily turn to commodities, multinational firms should consider making profits by selling key components to local producers rather than by competing solely on finished sets. In the mobile handset market, Nokia, Motorola and Samsung make profits by selling chips to local competitors while they compete with them on final sets. For instance, Motorola provided its semiconductor chip set to Eastcom, its joint venture partner, which then decided to sell its own mobile handsets. Motorola had decided that it would be better for Eastcom to use Motorola's chip rather than someone else's chip, even though the firm would become a direct competitor to Motorola in the handset market. Although Motorola had to compete with local firms in the handset market, it could exploit scale economies in chip manufacturing through this partnership.

Lastly, given the rapid changes in the local context, multinational firms require careful and continuous monitoring of local suppliers and supply chains. They should be able to optimise their supply chains and maintain the highest level of efficiency. A few years ago, Dell moved its global sourcing centre to Shanghai in order to better manage the sourcing functions. It realised that over 85 per cent of the components were from the companies located in East Asia that are also likely to have presences in China. Dell concluded that it was logical to locate its sourcing headquarters in China for a closer relationship with these suppliers.

Quadrant 2: Leading in the mass market

The General Manager of Unilever (China) pointedly summarises the extreme heterogeneity of Chinese customers as follows: "We have to "de-average" any statistics in China. If we try to sell a product to all customers across the country, we are bound to fail. For example, a toothpaste product could be frozen in northern provinces where temperature easily goes down to minus 30 degrees Celsius. On the other hand, the same product could melt down in southern provinces. The average consumer income in coastal areas is two to three times as high as that in western and inner

provinces. Customers in coastal areas generally look for more expensive and sophisticated products while those in inner areas look for more basic products. Therefore, we have to treat every market differently from others."

In industries in this quadrant — e.g., consumer goods — local firms continue upgrading technologies and brands and move up from the low-end towards the high-end market segments. Meanwhile, multinational companies strive to maintain their market leadership by expanding positions into the mid-level while sustaining the dominance in the high-end markets. Repositioning in the mid-level market, however, requires strategies for new product development and distribution.

Our study shows two different strategies that successful multinational firms adopted to expand their positions into the mass mid-tier market. First, when local competitors initiate a price war, they cut prices across the board on existing brands in order to attract more customers. A few years ago, as competition intensified and accordingly prices declined, P&G responded directly by cutting the price of all products by 15 per cent. Price cutting, however, is not necessarily a good strategy in the long run. Successful multinational firms thus take a more elaborate segmentation strategy with multiple brands across different tiers. For example, Unilever developed a Hazeline brand of black-coloured shampoo for the mass market and a Sunlight brand for second-tier markets. Similarly, Henkel, a German consumer products firm, focused on the high-end market with its own global brands, while serving the mid-tier mass market with local brands from its joint venture partners. By doing so, Henkel successfully expanded its market shares by covering broader segments.

Successful multinationals also developed low-priced products specifically tailored to Chinese customers. Johnson & Johnson introduced a low-end version of its Stayfree feminine hygiene brand that is 55 per cent cheaper than the premium version. It requires ingenuity and hard work to develop a "lite" version of premium products without sacrificing the original quality and performance. The general manager of Johnson & Johnson stated: "We had a hard look at the napkin. And we figured out how to make it shorter and thinner while removing some unnecessary bells and whistles… But, we were careful to make sure that the products met consumer needs and their performance was still satisfactory. We cannot afford the risk of damaging our brands with a poor-quality product. Although the low-priced version cannibalises our premium brands, we believe it is better to do so by us than by our competitors." Siemens' medical division also developed a low-priced CT scanner, called SMILE, especially for the Chinese market by keeping only crucial functions. This is an essential strategy for multinational firms operating in emerging markets, so that they tap into mass customers at the bottom of the pyramid (Prahalad, 2004).

While addressing the cost disadvantages through localisation and segmentation, multinationals should also leverage their strengths to compete with local players. The critical success factors for multinationals in this quadrant are their brand management capabilities and amounts of capital to sustain large-scale brand-building efforts. P&G sustained its dominance in the complex consumer goods sector by utilising its advanced marketing capabilities and large-scale investments in advertising. It has been one of the biggest buyers of commercial times from CCTV, the most influential national TV station in China. It also applies a highly effective brand-building strategy that highlights the source of a problem, followed by testimonials from experts and consumers.

Targeting mass markets in China is accompanied by other challenges, such as managing distribution channels. A critical competitive advantage of local companies is their ability to penetrate deeply rural markets through their own channels. Multinational firms often rely on local distributors for national sales and focus primarily on large cities and wealthy coastal areas. In the mobile handset industry, local manufacturers have distribution networks in rural markets. For example, Ningbo Bird, a leading local manufacturer of mobile handsets, maintained 30 branch offices, 400 site offices, 15,000 sales agencies and 2,400 repair centres to cover every province, city, county and town in China during the mid-2000s (Park, 2004). It is too costly and impractical for multinational firms match such an extensive distribution network.

Since multinational firms target primarily the premium segment, they must restructure distribution channels to penetrate the mid-tier mass markets. Successful multinational firms apply various

tactics to expand their reach without incurring prohibitive costs. First, multinational firms often utilise strategic alliances — in particular, channel-sharing alliances — with local firms to serve remote rural markets, while they maintain direct sales networks in strategic locations. A manager at Philips explained: “The top three players in the TV market are local companies and I am sure they will be in similar positions for a while mainly because of the huge distribution base they have built from the beginning. They have moved into rural markets with extensive distribution networks. We cannot build such networks because the cost is too high for us and we are not flexible enough like the local firms in adapting our products to demand in rural areas. It requires flexible and sometimes not-so-transparent approaches to expand into the second and third-tier markets.” This is why multinational firms seek local alliance partners. For example, Philips depended on TCL’s rural networks to distribute its products. The manager further emphasised: “If we cannot penetrate on our own, we’d better take someone with us and build the necessary critical mass. TCL has been picking up lots of sales activities, which was not possible on our own. At the same time, TCL outsourced from us advanced technology components, such as flat panel display. We use TCL’s distribution networks; in return, TCL taps into our technologies to a certain extent, which is a win-win situation.” Sanyo also established a comprehensive co-operation alliance with Haier to tap into the latter’s direct-selling stores, sales centres and service centres. Haier was also able to gain a foothold into the Japanese market through Sanyo’s channels.

Second, multinational firms embrace evolving modern retail outlets, such as category killers and discounters. There has been a revolutionary change in China’s retailing, with specialised stores replacing conventional channels, e.g., department stores and traditional “mom-and-pop” shops. The emergence of these new distribution channels has changed the way of doing business and the margin requirements for multinational firms. GOME became the biggest retailer in household electronic appliances through its rapid expansion strategy. It has been able to lower final retail prices substantially by eliminating middlemen and building on its size advantages (Morgenstern and Shu, 2006).

Lastly, our study also suggests that multinational firms should not be stretched too thin in distribution. It is easy to lose focus when trying to cover the entire market, which results in significant distribution costs and losses. After their initial ambitious expansion, many multinational firms faced the challenge of managing such complex and large distribution channels. For this reason, Unilever had to make a significant change in its distribution system. It upgraded the logistics system to move products easily from production to distribution centres. It could thus concentrate production operations in fewer locations. Roche, a leading multinational pharmaceutical firm, also realised that its distribution channel in China had a lot of room to increase productivity. Its sales team was visiting too many clients — i.e., hospitals — across too many cities, incurring huge costs. Roche was able to increase sales at a lower cost by focusing on a smaller number of hospitals and cities.

Quadrants 3 & 4: Sustaining and leveraging technological superiority

Multinational firms in these quadrants faced challenges from local firms, as local firms started narrowing the design and technology gaps. Most expatriate managers we interviewed were amazed by the abilities of the Chinese companies and workers to learn advanced technologies and management knowledge. The world has witnessed the fast-growing indigenous technological capabilities of various industries in China, including telecommunications, railroads, alternative energy, aircraft manufacturing and so on. While multinational firms are fearful of bringing advanced technologies and know-how for China’s operations, which would result in involuntary technology spillover, they are in a race to access local markets and favours in exchange for their technologies. It is also necessary to bring the newest products to win over the intense market competition. Volkswagen had dominated the passenger car market for over a decade with an outdated Santana model. However, it was compelled to introduce its newest models, such as the Passat and Polo, when GM and other foreign carmakers entered the Chinese market with their latest models.

Local firms in these quadrants focus on grafting multinational firms’ technologies via various means, such as imitation, joint ventures and alliances, and foreign acquisitions. Thus, a critical issue

for multinational firms is how to guard against technology spillovers to local and other multinational competitors. Involuntary technology leakage also happens often from their suppliers. Protecting technologies through supply chains is thus an important issue for multinational firms. When Volkswagen established production facilities, it also developed its own supplier network that requires sharing blueprints, arranging joint ventures with its foreign suppliers and certifying parts with acceptable quality. It took Volkswagen more than a decade to increase the local procurement ratio to over 80 per cent for all models (Chen and Wang, 2008). Once a supplier network was established, Volkswagen continued to work with suppliers to reduce costs. As a late entrant, GM could easily tap into this well-established supplier network through the assistance of its joint venture partner, SAIC. SAIC is a government-owned entity and had joint ventures with both Volkswagen and GM. SAIC helped Shanghai GM recruit managers and engineers – including the general manager, who was with Shanghai Volkswagen for 11 years – from Shanghai Volkswagen. GM was able to establish its China operations rather quickly and to achieve the same level of local contents in a short time due to its access to the human resources and supplier networks developed by Volkswagen.

Shanghai GM and Shanghai Volkswagen entered a competitive race to introduce advanced technologies to China. When GM established an R&D centre in Shanghai, Volkswagen responded with two new R&D centres: Shanghai Automotive Engineering Institute and PanAsia Technical Automotive Center. Such competition among multinational firms helps them to increase the distance from local competitors, although it may result in unexpected technology spillover.

Speedy and flexible execution

The previous section presented generic strategies for multinational firms in China across four quadrants. However, there are common organisational elements for multinational companies to implement their China strategies successfully, wherever they compete along the four quadrants. Two of the key competitive advantages of emerging local competitors are speed and flexibility. Led by entrepreneurial managers, several private enterprises and restructured state-owned enterprises surprised multinationals with their substantially upgraded products at an incredible speed. New entrepreneurial companies enjoy organisational flexibility without being constrained by any structural or institutional inertia. With no organisational heritage, these new companies typically follow a down-to-earth, execution-orientated culture, which enables quick decision making. Local firms' strengths in their rich understanding of local markets and deeply penetrating distribution networks also help them better adapt to unpredictable market changes and opportunities. Xu Lihua, general manager of Ningbo Bird, a leading local company in mobile handsets, said: "You know that Chinese local companies grab the opportunity when the whole market is under such a big expansion. In the booming period of the colour TV industry, Changhong and Konka succeeded. Similarly, Chunlan, Haier and Kelon became successful in the air-conditioner sector. In the PC market, we have Lenovo, Hisense and the Great Wall. The mobile handset industry repeated the same history in early and mid 2000s, including Lenovo, ZTE, Bird, Amoi, Gionee, Haier, etc. The common experiences we generalised is that, though none of us can compete with foreign brands in funding, brand reputation and technology, we have to capitalise on the booming China market based on our speed and market access. Our culture also encourages us to do things quickly. Compared with Nokia, Motorola and other big brand names, we have no other advantages. If we cannot beat them in being quick, we cannot succeed in all other ways." Xu further emphasised that a "[p]lan is important, but the market never goes according to the plan… decision making accounts for only 20 per cent and execution accounts for 80 per cent". Such organisational mentality and practices by local Chinese companies result in tremendous speed and flexibility in their operations, which enable them to compete against much larger foreign multinationals. For these reasons, managers in local companies often comment that they feel more threatened by their local peers than by foreign competitors. A senior manager in a leading local firm revealed that "we have full competence in facing foreign brands because they are somewhat fixed in their strategy and tight management style. But local

companies do not have any fixed strategy. They often use strange tactics that are very difficult for us to predict." Multinational firms should thus find their own ways of responding to local firms' rapid and flexible approaches.

Flexible execution

Multinational firms are often criticized for being slow and bureaucratic. Before we denounce them as slow adapters, however, we must be careful to identify what actually slows them down. We may also want to ask whether it is always good to be so nimble or whether we want multinational firms in China to be as speedy as local firms are. In fact, we advise against this. We instead argue that multinational firms should achieve speed and flexibility in different ways than local firms do.

One of the main reasons for multinational firms' slowness is the control from headquarters. In particular, western multinationals are under great pressure to show profitability on a quarterly base. They cannot take losses for too long as they are sensitive to reporting quarterly earnings for impatient shareholders. It is, however, difficult to meet the required rate of returns in the short term. For instance, Dell constantly evaluates managers based on their business unit profitability. They cannot lower prices to a level that would undermine their bottom lines. When local competitors, including Lenovo and Founder, initiated a price war, even below their costs, Dell simply opted to quit. A Dell manager mentioned that, if local vendors engaged in endless price wars, Dell would simply leave China. Focusing on quarterly earnings also limits the range of product offerings. For instance, a request to develop a product tailored specifically to Chinese customers would undergo internal competition with proposals from other countries because the headquarters selects only proposals that could perhaps cover the internal rate of return.

Another often quoted source of inflexibility is the requirement to comply with the business processes set by headquarters. Multinational firms have elaborate business processes that all subsidiaries should follow to maintain quality and reduce risks. For instance, Motorola has the so-called M-Gate, which specifies detailed processes in new product development. It is easy to label such detailed processes as cumbersome or bureaucratic, given that local competitors run by entrepreneurial founders are quick to take advantage of opportunities and to make deals overnight. Multinational managers often feel that they are handicapped by rigorous procedures and ethical compliances.

We, however, believe that emphasising profitability or following the standard procedures is in fact helpful for multinationals. Some multinational firms can easily be fooled by the conventional belief that China is a "strategic" market, and they should be prepared to take extended losses to develop this market. While such a strategic pricing practice may help to establish a beachhead initially, prolonged strategic pricing can be dangerous because it may result in a perennial price war with local firms. At the same time, emulating local firms is not necessarily a good idea. Local firms may be fast, but they may be wrong in doing so in the long run. Local firms may simply cut corners to act rapidly. While multinationals may be slow, adherence to the appropriate business processes ensures quality and reduces risks. In other words, when local firms adopt a shotgun approach, relying on random experimentation, multinationals should take a well-aimed single shot. Local firms may sometimes perform exceedingly well, but this is not a sustainable strategy.

Multinationals should devise other ways to improve their speed and flexibility. For example, according to a manager at Honeywell: "Customers in China demand speed. When we say we need to conduct several tests to stick to the Honeywell global standards, they tell us to skip those tests and deliver products immediately. We cannot, however, compromise on quality. We therefore try to develop procedures to hasten the product launch, for instance, by conducting different processes in parallel rather than sequentially. By doing so, we can reduce the response time…" In addition, the ability to work as a team speeds the process. A manager in the consumer goods sector stated, "When there is an issue, people tend to wait for decisions from other departments and senior managers. It slows down the process, which would substantially delay launching a new product. We can manage the process efficiently without waiting for others to complete their own task along the whole process; for instance, we can do lab testing and marketing test at the same time."

Such a flexible implementation by subsidiary management requires substantial latitude of freedom. Decentralisation and empowerment of subsidiary employees also give a sense of ownership. People tend to move faster with a sense of ownership.

Leading the change

A few years ago, Samsung Electronics decided to supply its most advanced phones on an OEM base to local manufacturers, who were in short supply of high-end mobile phones. Its rationale was that, even if Samsung refused to do so, another foreign firm might do so. If that were the case, Samsung would rather be the party to initiate the change rather than to be affected by the inevitable change. Thanks to Samsung, local firms captured large market shares at the expense of Nokia and Motorola. Samsung also enjoyed a surge of OEM sales. Samsung's decision sparked similar responses from other multinationals. When Eastcom and Shanghai Radio, two main joint venture partners of Motorola, expressed their wishes to enter the mobile handset business, Motorola helped them to develop the business by providing key semiconductor chip sets. Motorola's rationale was the same: if it did not do this, somebody else would. The company would rather initiate the change than react to it.

Examples of such a voluntary cannibalisation of their own businesses can be found in other industries. When Johnson & Johnson, a leader in the premium sector, developed a low-price version of Stayfree to target the mid-level market, P&G also hurried to launch low-price versions of its products. A GE manager nicely expressed it thus: "There are two groups. One is going to watch the change happen and react to it. Another group is going to participate in the change and be part of it. So, the former is reactive and the latter proactive. If you are always in a reactive mode, you have to be always slow. We view our role as being a proactive part of change in that we help drive the change. We bring the newest and the best power generation technology to China. We will not bring 10-year-old technology. We will bring the newest technology, which will help our customers in China change faster. In other words, we are the main driving force for change."

Being an insider

Since the government is a critical source of uncertainty in China, multinationals should be an insider in its decision-making process in order to act quickly. Otherwise, they will be completely caught off-guard by any sudden shift in policy directives. A manager at Hyundai Motors, one of the fastest-growing foreign carmakers in China, attributed its success to being an insider during the process of the government's decision making. Hyundai built its factory in China in six months, a process that normally requires two to three years, once it received the government's approval. It attributed its fast entry to understanding policymaking procedures in China in order to prepare itself for the changes ahead of its competitors. Even six or seven years prior to its venturing into China, Hyundai developed a pool of talented expatriate managers for future operations in China. These managers learned Chinese, and some were sent to study at major local universities, where they made connections with important stakeholders in Chinese society.

In industries where regulations change frequently and unexpectedly, it is critical to maintain continuous conversations with government officials. It is simply imperative for multinationals to learn and to fully immerse themselves in the local context and the government's guidelines. GE emphasises the importance of government relationships, with 20 of its lawyers working in the organisation for government affairs and local compliance. A senior manager at GE explained: "I am not worried about the transparency in China, not about the transparency of the accounting book, but I am worried about the process — how things get done and how to work successfully with customers in Shanghai versus customers in Chongqing. Their processes are different. Local firms are in an advantageous position since they know the differences. They have literally grown up in them. I am proud of saying this. Two years ago, we had only one lawyer in China. Today, we have 20 lawyers. Every business has a lawyer and every function — HR, environment, health and safety — has a lawyer. We have lawyers not to defend GE in the court but to understand the law and processes, so that we could move forward expeditiously. If you are in a reactive mode, you will always be slow. When we say understanding a process, we mean the process within the government.

Then, we can understand the needs of a certain regional market. For example, Chongqing needs a lot of infrastructure projects. We discussed with the Chongqing municipal government and signed a memorandum of understanding [MOU], saying that Chongqing will source from GE and GE will source from Chongqing, and that, if GE is to move any manufacturing operation into China, we give a priority to Chongqing. This kind of MOU provides a very good umbrella; sourcing people can refer to it; sales people would refer to it; Chongqing government would refer to it. If we did not set up this process, it would be hard to do business in China. GE would easily have 11 businesses knocking on doors in the government. With this MOU, both sides feel free to visit each other. We not only know the process but we invent the process."

Conclusions

In this paper, we addressed the competitive dynamics between localised multinationals and emerging local firms. Chinese markets are undergoing structural changes. Backward local firms are being restructured, while several strong local firms have emerged as champions. Lured by the potential huge markets, foreign multinationals are increasing investments. Besieged local firms engage in a survival game by continuously undercutting prices, leading to vicious price wars. Foreign and local firms are subsequently experiencing huge losses.

Market structures in most Chinese industries pose huge threats to foreign multinationals. Unlike other countries, China does not present a single market; instead, it consists of vastly heterogeneous regional markets with different tastes, income levels and business practices. Furthermore, markets change rapidly and new competitors emerge from all directions without warning. The high level of unpredictability and complexity that is typical in most emerging markets poses great challenges to incumbent and newly entering multinationals in the Chinese market. Based on extensive fieldwork, we introduce a framework of generic strategies for multinational firms that vary depending on local firms' resources and market positions. In particular, we identify two important dimensions in understanding the competitive dynamics in China. Technological complexity and market heterogeneity are two such dimensions that determine the relative advantages and disadvantages of multinational firms vis-à-vis local firms. We further identify generic strategies for multinational firms according to the combination of these two dimensions. The paper then highlights speedy and flexible execution as a critical organisational capability for all multinational firms operating in China. Competition in the Chinese market continues to intensify as local firms gain more experience and accumulate managerial and technological capabilities, while multinational firms expand their positions locally. Multinational firms must become better aware of the competitive context and apply proper strategies in timely and flexible ways.

Appendix

The research design

This research is based on our field-based work on leading multinationals and local firms in China. We initially selected three to five leading multinationals and one to two local firms in seven industries — consumer electronics, consumer goods, pharmaceuticals, mobile handsets, computers, heavy electric equipments and cars — where multinationals and local firms are actively competing against each other. In total, 35 firms were included from these industries for our field study. We deliberately chose at least one multinational firm from each major economic region, i.e., the US, Europe and Asia (Japan and Korea), to reflect the diverse strategic orientations and different sources of competitive advantages from the country of origin. For example, in the consumer products industry, we include Unilever and Henkel from Europe, Johnson & Johnson from the US and Kao from Japan. As for local firms, we selected White Cat and Jahwa, which are rapidly emerging local challengers.

We made the initial contact with each firm through various sources to arrange interviews. Often, the authors' former executive MBA students proved to be useful contacts to collect basic information on firms and to schedule interviews with high-level managers. In other cases, authors' personal

contacts and introductions proved to be helpful. In each firm included in our fieldwork, we attempted to schedule meetings with at least four key managers in marketing, HR and strategy, as well as with a CEO. By conducting interviews with several key managers, we were able to cross-validate the interviews and cover broad functional areas. We prepared a full list of questions in advance and performed semi-structured interviews, while we tried to be flexible and to let interviewees choose the sequences of answering our questions. Both authors participated in interviews, taking turns while asking questions and making notes. All conversations were, however, recorded and transcribed for review later. In some cases, we followed up our interviews with phone calls or emails to clarify certain points and to request additional information.

In-depth interviews are helpful in collecting rich information on a specific firm in a particular industry. Since we are interested in generalising our major findings from the fieldwork with a broader set of firms, we complemented it with a detailed survey instrument. We designed a 16-page questionnaire targeting multinational firms, which covers market conditions and changes, descriptions of local firms' challenges and their sources of competitive advantages and how multinational firms are responding to such challenges. The questionnaire was pre-tested with senior managers from 15 different multinational firms who were attending an executive MBA programme in China. The initial sample was drawn from the List of Foreign-Invested Enterprises in China (China Statistical Bureau) and the Directory of Foreign-Invested Enterprises (Ministry of Foreign Trade and Economic Co-operation). The companies were then directly contacted by telephone to confirm their operations, CEOs or GMs and addresses. The mailing included 730 multinational firms, of which 122 responses were used in our study, resulting in a response rate of approximately 17 per cent.

References

Hexter, J., Woetzel, J., 2007. Operation China: From Strategy to Execution. Harvard Business Press.

Huang, Y., 2008. Capitalism with Chinese Characteristics: Entrepreneurship and the State. Cambridge University Press.

Meyer, K.E., Yen, T.T., 2006. Market penetration and acquisition strategies for emerging economy. Long Range Planning 39, 177—197.

Morgenstern, I.B., Shu, C., Sep., 2006. Winning the battle for the Chinese consumer electronics market. McKinsey Quarterly.

Competitive rivalry becomes more intense as firms' resource similarities and market overlap increase. See M. Chen, Competitor analysis and interfirm rivalry, *Academy of Management Review*, 1996. See also, J. Gimeno and C. Woo, Hypercompetition in a multimarket environment, *Organization Science*, 1996.

S. H. Park, Ningbo Bird, Co., CEIBS case (CC-304—027), 2004.

Prahalad, C.K., 2004. The Fortune at the Bottom of the Pyramid. Wharton School Publishing.

Rawski, T.G., 1980. China's Transition to Industrialism: Producer Goods and Economic Development in the Twentieth Century. University of Michigan Press, Ann Arbor. L. Lau, Y. Qian, G. Roland, Reform without losers: an interpretation of China's dual track approach to transition. Journal of Political Economy. 108(1), 120—143 (2000).

Volkswagen plans to have 100 percent local procurement in near future and its first model, Santana, has reached almost 95 percent. See X. Chen and H. Wang, Winfried Vahland: Volkswagen breakthrough in 2008, http://auto.sina.com.cn/news/2008-01-19/1102342932.shtml (2008).

Yi, J., Ye, S., 2003. The Haier Way: The Making of a Chinese Business Leader and a Global Brand. Homan & Sekey.

Biographies

Sea-Jin Chang is Provost's Chair Professor of Business Administration, National University of Singapore. He also taught at Korea University and NYU Stern School. His research interests include diversification, corporate restructuring, foreign direct investment, and comparative management studies of Japan, Korea and China. His recent book, *Sony vs. Samsung: The Inside Story of the Electronics' Giants Battle for Global Supremacy* (2008) was selected as

one of the best books for the year by BCG. *NUS Business School, National University of Singapore, 119245 Singapore, Singapore. tel: +65-6516-7854. email*: schang@nus.edu.sg

Seung Ho Park is President of the Skolkovo Institute for Emerging Market Studies and Chair Professor of Strategy at the Moscow School of Management. He was previously President of Samsung Economic Research Institute China and BAT Chair Professor at China Europe International Business School. His research focuses on competitive strategies, firm growth, and high performance organizations in emerging markets. *Skolkovo Institute for Emerging Market Studies, Moscow School of Management SKOLKOVO, Unit 1608, North Star Times Tower, No. 8 Beichendong Road, Beijing, 100101, China. tel: +86-10-64981634. email*: spark@skolkovo.org