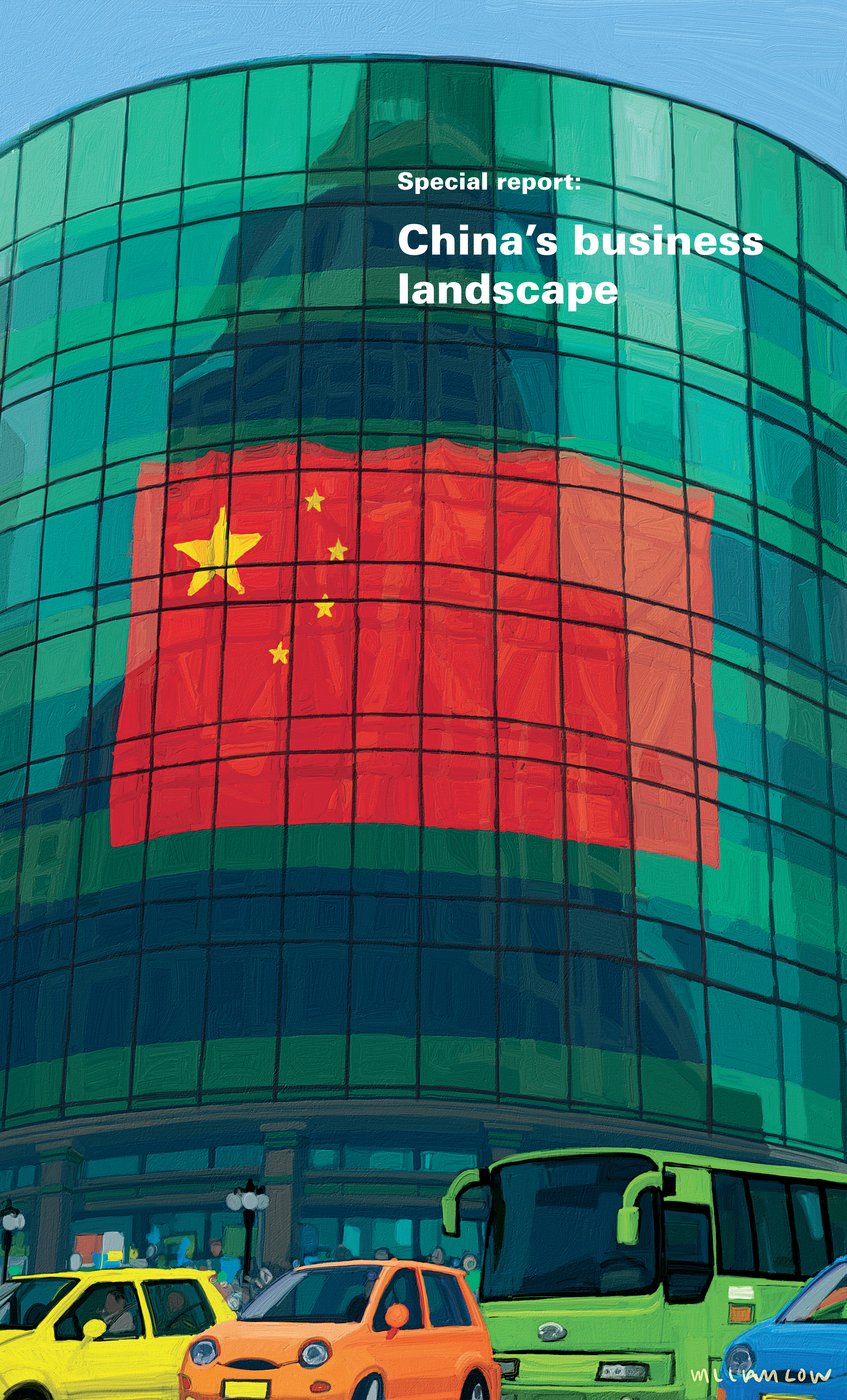
Special report:

China's business landscape



How corporate China is evolving

China's business landscape is changing rapidly. So must the way we comprehend it.

Andrew Grant

Years of rapid economic growth and exposure to global competition are redrawing the boundaries of China's business landscape. In the past, most companies there fell into one of three categories: state-owned enterprises, joint ventures between Chinese and foreign concerns, or wholly owned foreign operations. The new world of Chinese business calls for new ways to describe the playing field.

As in the past, some giant state-owned enterprises, protected from competition by a thicket of government regulations, continue to dominate their industries. But other companies in that category, now fully exposed to global competition, vie for business against hundreds of domestic and foreign companies targeting the same customers.

Other categories have emerged in recent years. Globalizing companies are stepping beyond China's borders to build substantial businesses overseas, organically or through acquisitions. The "restless adolescents" are operating beneath the radar of most global players but quietly and methodically building the capabilities needed to go global. And the innovators and entrepreneurs are blazing trails inside China by developing new technologies

How Chinese CEOs do business

The outlook and career experiences of the CEOs who head many of today's rapidly growing and increasingly confident Chinese companies are markedly different from those of Western executives. Understanding these differences can help to explain behavior that otherwise might seem curious to the executives of many multinationals—and could also suggest competitive opportunities.

Nowhere is the contrast with Western corporate leaders starker than it is for the chief executives of state-owned Chinese enterprises. Most of these CEOs have spent their careers shuffling between the private and public sectors. A capable leader might start out as a senior provincial-level executive in a state-owned enterprise, then hold a provincial-level Communist Party post, follow it up with a stint as the CEO of the state-owned enterprise, and move back to the party infrastructure to serve as the mayor of a major city or as a provincial governor. A final career step might be attaining a senior position in the central government or the party—for instance, a seat on the State Council or the Politburo.

Because the career of a typical CEO of a state-owned enterprise usually straddles the corporate and political spheres, these chief executives pay careful attention to politics—in particular, to developments in the Communist Party. In fact, it's not unusual for such CEOs to link the timing of long-term strategic decisions to plans outlined in the annual National People's Congress (China's legislature) or to other significant political events, such as trips to China by foreign leaders or the creation of new government agencies. What's more, the symbiotic relationship between the enterprise and the state makes such CEOs sympathetic to corporate social and economic goals beyond maximizing shareholder value.

China Mobile's rural-expansion strategy shows how one major state-owned enterprise has grown while supporting national-development goals. Since 2004, the company has extended mobile service to millions of people in the vast countryside to support the government's rural-infrastructure program, which includes initiatives linking rural areas through a mobile-telecommunications network. Government objectives such as maintaining social stability by keeping China's huge workforce employed and by redressing economic and social inequities are partly responsible for the importance that many CEOs of state-owned companies attach to top-line revenues. In fact, we find that chief executives in both the public and the private sector talk more about revenue growth, market leadership, and competitive advantage than about shorter-term financial objectives, such as higher earnings. The emphasis on driving top-line growth to keep or pioneering new ways of doing business. Multinationals should awaken to the existence of—and the coming competition from—both the restless adolescents and the innovators.

To be sure, the lines demarcating these categories are constantly shifting, and some companies belong in more than one: many of China's most dynamic, competitive companies, for example, retain vestiges of state ownership. Global executives will need a better understanding of Chinese customers, competitors, suppliers, or even business partners, regardless of where they fall along the ownership spectrum—from wholly private sector to wholly government owned (see sidebar, "How Chinese CEOs do business").

factories humming and employees on payrolls often means that Chinese companies are generalists playing in several different business areas and markets.

Foreign players therefore have an opportunity to carve out niches in rapidly growing but underserved segments. Some pharma multinationals, for example, avoid head-on competition with Chinese companies in large product categories, such as antibiotics, which today accounts for as much as 30 percent of the total pharma market but is declining in importance. These multinationals are instead targeting smaller, faster-growing therapeutic areas—for instance, oncology and hypertension.

Perhaps not surprisingly in a rapidly expanding market, Chinese CEOs rely less on rigorous analysis, market research, or a detailed understanding of customer preferences than their counterparts in developed markets do. Instead, many of them make decisions instinctively, feel comfortable with rapid and flexible responses to new industry trends and shifts, and have a keen interest in holding down costs in order to boost competitiveness and to keep companies growing.

These tendencies also create opportunities for multinationals. The dealer strategies of Chinese automakers, for example, emphasize low-cost facilities in favorable locations that pull in customers. Few of these companies have focused on providing a high-quality showroom experience. GM, by contrast, applies to each of its dealerships strict customer service standards—all the way down to details such as how many seconds should elapse before a dealer greets a customer who enters a showroom and how many times a telephone should ring before a dealer answers it.

To be sure, such strategies aren't a silver bullet for multinationals: local pharma companies continue to hold a 70 percent market share in China, and GM is locked in tough competition with other foreign carmakers and with Chinese ones as well. But unless multinationals use such approaches, success will be even more elusive. A better understanding of Chinese companies and of the executives who lead them is an important starting point when multinationals decide how to compete.

Andrew Grant and Richard Zhang

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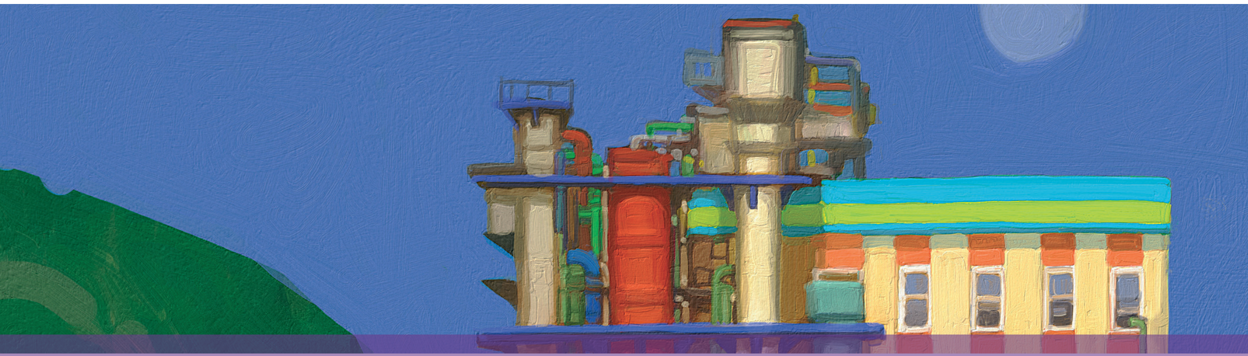


Revitalizing state-owned enterprises

Most people who think about Chinese state-owned enterprises associate them with massive institutions such as PetroChina, the world's most valuable company by market capitalization; State Grid Corporation of China (SGCC), the world's largest electric utility; and China Life Insurance, one of the largest of all insurance companies, with 60 million customers.

The revenues and profits of these organizations, which operate in highly regulated, highly concentrated industries, are largely protected by the government. Such giants often play a quasigovernmental role, pursuing national strategic interests on behalf of China. They also have a broader social role—for instance, providing employment or extending products and services to customers in China's underdeveloped regions. Their CEOs have career pathways and structures that intermingle with the structure of the Communist Party and of politics more broadly.

China's largest state-owned institutions, no longer content to remain tied to the home market, are making their initial forays into global ones—witness SGCC's winning bid to manage the electricity network of the Philippines and China Mobile's acquisition of the Pakistani mobile operator Paktel.

These Chinese companies are making progress in addressing many tough-to-fix issues, such as corporate governance, risk management, and performance management. They have massive scale on their side but in general also face huge productivity challenges and, with few exceptions, have a long way to go before they will be truly world-class organizations. Although they are increasingly open to foreign capital and ideas, it will take them some time to extract all the value from applying international best practices and hiring world-class talent.

Not all of the enterprises owned by the government are in this position; in fact, the companies in one fast-emerging category, while still state owned, function like modern private-sector concerns: they compete head-to-head with multinationals in global markets and are quite often global themselves in operations, organization, and management. China National Chemical Corporation (ChemChina) is an example of this new breed. Through a program of overseas and domestic acquisitions, its management has turned the company into a credible global chemical player that has attracted a large investment stake from the private-equity firm Blackstone (see "A growth strategy for a Chinese state-owned enterprise: An interview with ChemChina's president," in this report).

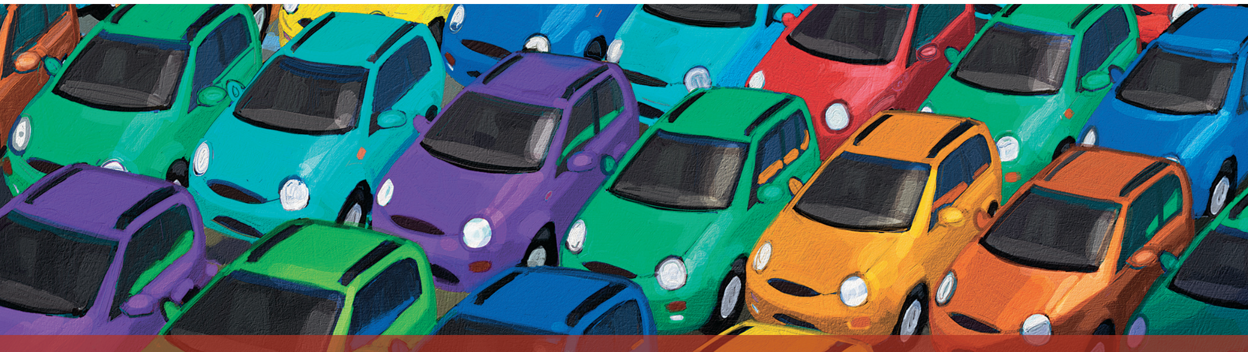
Globalizing players

Many of the enterprises in another group of companies—the globalizing players—started out as state owned but have evolved into a mix between the public and private sectors. Regardless of ownership structure, the one thing that clearly defines these companies is their scale and growing global reach. Through their own brand-building efforts or acquisition programs, they are no longer merely serving as OEMs for large overseas brands. Today, the globalizing players are affixing their own brands to products they move through their own overseas sales and distribution networks.

These companies have grown strong not only by establishing entrenched positions in their rapidly growing domestic markets but also by building competitive advantages that help them succeed elsewhere. They already generate a large part—as much as 30 to 50 percent—of their revenues overseas and have firmly established businesses and brands in the major developed markets, including Europe and the United States.

More often than not, such companies have an inspirational founder who moved beyond the autocratic management style characteristic of many Chinese CEOs and aggressively procured international expertise and capital. Companies of this kind have an incredible appetite to learn and adapt and are generally far more nimble and open to change than their state-owned counterparts.

One company falling squarely in this category is the shipping-container business CIMC (China International Marine Containers), which aspires to capture the global number-one or -two position in each of the markets in which it competes. CIMC now holds a global market share of more than 50 percent in shipping containers and serves all of the world's 20 largest shipping companies (see "A pioneer in Chinese globalization: An interview with CIMC's president," in this report).



Restless adolescents

Another group of companies—some owned by the state, others privately held—could be characterized as restless adolescents. While still middling in size, they are growing very quickly and already rank among the leaders in their respective fields within China. Their brands are not yet well known to the wider world, however, and they are still experimenting to find the best model for overseas expansion. For the present, they are pushing volume through distributors in target markets rather than building their own sales and distribution organizations. In many cases, their technology and know-how are commodities.

Unlike the more established globalizers, these companies primarily target developing markets, such as the Middle East, Russia, and Southeast Asia. While they are not yet established in developed markets, they hope to compete there, so they will have to invest in product development, quality control, brand building, and, eventually, their own sales and distribution networks.

Such a company is Chery Automobile, which currently targets developing markets but aspires to be a truly global player in developed ones. Chery's management team, like that of many restless adolescents, is still by and large very local, but the company is making a concerted effort to hire more international talent to help it achieve its global aspirations. If the experience of Lenovo, Huawei, and Haier over the past five to ten years is any indication, there is little reason to believe that it will take companies like Chery longer than that to reach their global aspirations (see "Selling China's cars to the world: An interview with Chery's CEO," in this report).

Emerging innovators and entrepreneurs

Another up-and-coming kind of Chinese company is what we call the emerging innovators and entrepreneurs. Although not yet globally relevant or well known, they have come up with unconventional business models and take an innovative approach to developing products, bringing them to market, and engaging customers.

China's biggest real-estate development company, China Vanke, is an example: it provides a soup-to-nuts real-estate service, from design to construction to property management. By covering the entire value chain, China Vanke can offer a more standardized product while exercising better control over quality—an issue that bedevils China's rapidly growing real-estate-development industry.

Other innovators are creating new kinds of products and services. ENN Group, known primarily for its publicly listed subsidiary XinAo Gas, started out in municipal gas distribution but is now moving into clean energy. Entrepreneurs like Wang Yusuo, the group's founder and chairman, are not new to China but their numbers are growing fast; the companies they have created are increasingly important to the Chinese economy (see "Cleaner energy for China: An interview with the chairman of ENN Group," in this report). We expect this group of companies to grow vigorously because getting capital to small and midsize enterprises is now a policy imperative. In the past, the Chinese banking system largely starved them of capital.

These companies are also fertile M&A territory for multinationals wishing to build up their presence in China. Many are having difficulty acquiring larger Chinese enterprises, so some instead buy a handful of smaller players and stitch them together—a relatively inexpensive but powerful way to assemble competitive capabilities.

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