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'A Crucible of Competition': The Emerging Chinese Company

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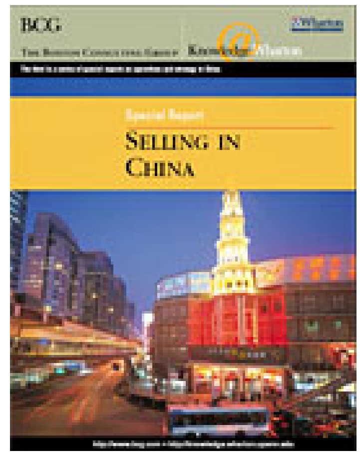

It's hard to believe today, but private companies are still a relatively new phenomenon in modern China. In 1988, the Chinese government began breaking up state-owned enterprises into individually directed, but still largely state owned, companies. At around the same time, some private companies began to form, but only in 1993 did the government pass its first comprehensive law permitting private enterprise.

While collectively these firms have already had an outsized impact on economies worldwide, only a few Chinese firms have yet made their presence felt individually. But they're coming, according to John Wong, a senior vice president with Boston Consulting Group in Hong Kong who works primarily with pharmaceutical and consumer goods companies. Wong says that over the next few years, he believes that a number of Chinese companies will begin to emerge from what he calls "a crucible of competition" in the highly competitive, highly fragmented domestic market.

What will those firms be like? "Any companies that successfully emerge from [China] will be very competitive," Wong says. While the degree of involvement of Western firms in running these companies is yet unclear, Wong and other experts from BCG and Wharton point out that emerging Chinese companies will have distinct advantages that many Western competitors are unprepared to deal with, including steep cost savings in wages and safety requirements, and a widespread lack of concern or clear regulation regarding intellectual property protection.

But, the experts note, rising to the level of global competition will not be easy for Chinese companies. Confucius once said that individuals gain wisdom in three ways: "First, by reflection, which is noblest; second, by imitation, which is easiest; and third by experience, which is the bitterest." The same might be said for organizations, and for Chinese companies in particular as they find their way to the global marketplace.

Learning the Hard Way

In the case of the typical Chinese company, experience has so far been the greatest -- and true to Confucius's words -- perhaps bitterest teacher. The challenges of growing a business in China are pervasive, ranging from the fundamentals of poor infrastructure to the arcane rules that govern competition.

"One challenge is simply that the process of establishing a national presence is not so easy because China is so big and diverse and geographically far-flung," says David Michael, a senior vice president of the Beijing office of BCG. "Many domestic companies emerge out of a certain province or geography in China ... but are challenged in truly growing a national presence and setting up sales and distribution and product coverage nationally."

Fragmentation of sales and distribution has made it extremely difficult to build a brand. Wong says many distributors are still state-owned, and may have their own allied companies to back, making access into particular provinces or cities difficult. Seventy percent of all retail sales are through local "mom and pop" stores, he says, and even the 30% that is considered "modern retailing" often entails locally controlled licensing of bigger store names.

Not that branding was always seen as desirable until recently: Marshall Meyer, a professor of management at Wharton, says that in the past, low quality led to negative brand equity. "You put a label on something, and they were shoddy goods; the next year, you changed the label so no one would know what they were buying. I don't think that's the case today, but a lot of companies operated very short-term -- and manufacturers were quite happy to give their brands new names every year," he says.

Without any brand power, companies have had to compete largely on cost, which has driven them to practices that would be considered out of bounds by Western standards. For example, Oded Shenkar, a professor of international business at the Fisher College of Business of Ohio State University and author of *The Chinese Century* (Wharton School Publishing), notes that this form of competition has led to little investment in safety equipment and salaries of only 60 to 75 cents an hour.

In addition to geographic barriers, Meyer points out that local governments often make it extremely difficult for companies from other provinces to do business in order to favor the products of home-grown companies, where city or provincial government officials often sit on boards of directors. As an example, Meyer recalls that a few ago, "Shanghai threw up tariffs against 'foreign automakers,' meaning non-Shanghai automakers."

"It's local protectionism," Meyer explains, "due to a whole set of institutional factors in China, which go back way before communism: big country, difficult communications. Any traditional system of authority looks like that. If you go back to 16 th century England, you see the same thing -- local nobility ran it. Queen Elizabeth I could govern, but only with the assent of the privy council, which represented the local interests. And that assent was not guaranteed. The situation is the same today in China. It's a very traditional system."

Outside Advantages

Private companies face another major challenge from state-owned companies, as well, because of what might be called a sustainable *noncompetitive* advantage: The state-owned enterprises don't have to worry about making a profit, because the state won't let them fail, according to Michael.

Small and mid-size private firms also frequently have a hard time getting financing, unlike state-owned companies. "Over the last 10 to 15 years ... state-owned enterprises and the listed enterprises, which are mostly former state-owned enterprises, have been the recipients of most of the loans of the major banks, and the other firms -- the rest of the economy -- have gotten relatively little," notes Wharton finance professor Franklin Allen.

Michael notes, however, that the public-private dichotomy is often not that simple. Many firms exist on both the public and private planes. For example, some may be partly owned by a local or provincial government, but outside the province, receive no special advantages.

Both state-owned and private companies struggle with a variety of managerial challenges. For the state firms, it's a matter of learning to operate as a profit-driven company. Wong says that among the state companies, some old habits are still common. "Big meetings, unclear handoffs, and lack of clear accountability are still quite pervasive."

Many local divisions of state-owned firms operate semi-independently of the parent company, according to Meyer. This can lead to tugs-of-war over company control that would be unthinkable in a Western company. "If you look at the airline industry, for example, the software for integrating the system nationally exists, and the software for yield management exists. But look at China Eastern Airlines: They're based in Shanghai, but they have provincial subsidiaries, and the local folks can say, 'We want the schedules this way; we want to hold seats for the local officials or their friends, etc.' So the cost of running an airline over there becomes much higher than here," he says.

To give the main offices more control, the central government is pressing banks to stop funding locally inspired projects, Meyer says. But local chauvinism remains a problem, and the pet-projects of local boosters have created excess capacity in a variety of different industries. One case in point: Even as the number of major auto manufacturers has decreased to a handful worldwide, Meyers notes that China still has over 150 different car manufacturers.

As state firms struggle to gain greater control over regional fiefdoms, private, entrepreneurial companies, meanwhile, are likely facing the opposite challenge -- how to develop a less-centralized organization that doesn't depend on a charismatic founder for leadership. Michael says that in the entrepreneurial company, there is likely to be a high degree of centralized decision-making that becomes increasingly difficult to sustain as the company grows.

Winning Through Imitation -- But Only for Now

Imitation, Confucius's second mode for gaining wisdom, has been a mixed blessing for many Chinese companies -- at least if defined in terms of copying intellectual property.

On the positive side, the near absence of intellectual property laws or enforcement has helped many companies get started: In the absence of patent and trademark protection, what could be a lower-risk strategy than launching a copycat product? Selective copying also provides specific competitive advantages. For example, when a car manufacturer copies designs that a Western company paid to develop, that can be a significant source of cost savings, says Shenkar.

However, the benefits gained may be offset later on when companies are unable to protect their ideas from being stolen by others. Furthermore, some China business experts argue that all this piracy is harming Chinese companies right now, by reducing their incentives to make investments in product innovation and making it more difficult for them to compete globally as anything but suppliers of low-cost goods.

But Shenkar disagrees with economists who see the lack of intellectual property law enforcement as a net cost for Chinese companies at the moment. "I think that these economists are completely wrong because for now it's extremely helpful to them," he says.

Some regional economies are now so addicted to the production of knock-offs that the government is unlikely to tighten enforcement -- at least in the short term -- even under pressure from the U.S. "Faced with pressure from America against internal pressure that would threaten social stability, guess what they will choose?" Shenkar asks. "...The Chinese will reform when it's in their interests to reform. Right now, I don't think it's in their interests to reform."

When it comes to intellectual property, he says, Western companies need to take a radically new view. "Right now, most companies are chasing after the violators once the product has been copied. I tell them, 'Go back to the drawing board.'" What's necessary, he argues, is nothing less than a completely new way of thinking about intellectual property. "Instead of hoping that the Chinese will reform, assume -- at least for now -- that you have no [intellectual property rights] protection."

Some companies have tried to partner with their pirates -- Honda, for instance, has a joint venture with a Chinese company that was making imitation Honda motorcycles -- but Shenkar is not optimistic about the strategy. Instead, he says, companies from advanced economies will need to rely less on the courts and more on designing products that are difficult to copy.

BCG's Michael predicts that in the short run, the continuing lack of intellectual property rights in China will lead domestic companies themselves to make one of two strategic choices: either to focus their research and development on lower-cost production rather than product innovation, or to make "a business case for innovation which is based on the idea that you'll be pretty quickly copied."

He expects, however, that in the longer term, China's approach to intellectual property will come to align with that of the developed world. He says that as Chinese companies venture abroad, they will need to develop a deeper understanding of intellectual property law, and begin to see the advantages of growing their own portfolio of intellectual property.

This is typical for a developing economy, Michael notes. "In the early 1800s, the United States had a less developed IP system than its European counterparts," he says. More recently, Japan and Korea went through a prolonged period of learning how to use intellectual property strategically. Only in 2003, for example, did Japan collect more in intellectual property royalties than it paid out for IP imports.

Indeed, the Chinese government has at least formally indicated it is beginning to take the situation more seriously. Two major planks in the recently released 11th Five-Year Plan concern intellectual property and the need for more corporate innovation. "I think it's pretty significant," Michael says. "One thing you have to respect about this government is that it has put its reputation on the line on this issue. They've made these public promises. They've publicly stated these priorities and made promises to the West that IP practices will be improved."

But even if he is ultimately optimistic, Michael doesn't minimize the challenge Chinese companies face in the short run. He says that Chinese companies will face some large IP challenges as the system matures. "They will risk having Western markets closed to them if they don't either pay the licensee or develop their own intellectual property," he says.

Simply learning about patent law is going to take a surprising amount of effort, Michael predicts. Many Chinese companies today, for example, don't realize that a patent filed in China isn't good outside the country, and they don't have a good grasp of all the paperwork and politics involved.

Chinese companies must also work harder to develop intellectual property to give them some negotiating chips as they try to enter new overseas markets. "If you really want to be competitive ... you better have some IP in your portfolio as well, otherwise you may be boxed out," he advises.

A New Generation of Managers

Reflection, Confucius's noblest route to wisdom, is becoming an increasingly important source of competitive advantage for Chinese companies, as managers gain more education, sophistication and experience.

Both private and public companies now have younger, better-educated managers than even a few years ago, Wong says. He points out that among the top 50 companies in China, the average age of managers has declined in the past five years from around 55 to 45. Many of the managers of the previous generation had their schooling disrupted by the Cultural Revolution, Wong says; these younger managers have had more opportunities for a sustained education, and more chances to travel abroad.

One typical example of this new breed: 42-year-old China Netcom CEO Edward Tian. Far from parochial, Tian has a Ph.D. in resource management from Texas Tech University, and made his first fortune with AsiaInfo, a Delaware-registered telecom software and security products company that Tian took public on NASDAQ in 1999.

Even in state companies where gaining a leadership position once had to do more with party credentials than managerial skills, Wong says, today you seldom see any difference in the quality of managers "except in some egregious situations," such as in banks, many of which are still highly controlled by the state.

But a state company led by executives with Western education and managerial experience still faces challenges quite different from those of a privately owned company. In a recent interview with *BusinessWeek*, China Netcom's Tian, whose company is half owned by state shareholders, said he found that surviving in a large, state-owned enterprise is "a 50% business and 50% politics balance."

Often, it's difficult for state companies to reduce headcount to competitive levels. Maintaining a strategic focus can also be difficult because of the haphazard way in which investment often occurred in the past. Tian told *BusinessWeek* that in Beijing alone, his company owns 2,000 buildings -- and even a five-star hotel.

This generation of managers -- both public and private -- understands its domestic markets perfectly, Wong says, but has a lot more to learn about global markets. That won't always be the case, however. According to Wong, the members of the younger generation of executives are "incessant travelers" who are now intent on absorbing as much knowledge as they can about global markets. He expects, however, that it will take some time for them to gain the kind of understanding they'll need to compete on the global stage. "That's okay for now," Wong argues, noting that most companies have their hands full just trying to win over the huge and growing Chinese market.

Acquiring Knowledge

But companies in some industries don't believe that their competitive situation gives them the luxury of slowly-ripening maturity, and they're using other means to gain the knowledge they need in a hurry -- either by hiring new executives with different skill sets, or through acquisitions. While it has been difficult for companies to attract Western executives so far, many firms now see acquisitions as a quick way to integrate Western expertise and, perhaps more importantly, gain greater scale, according to BCG experts.

Michael also notes that acquiring IP is a key driver of M&A work. "Successful developing economies such as Japan have employed it to great effect in the past. During its IP development, Japan completed at least 450 acquisitions of U.S. companies with valuable intellectual property in the computer, biotechnology, advanced materials, chemicals, electronics, semiconductor and other high-tech industries," he says.

However, such acquisitions may be difficult for Chinese companies to execute successfully, experts say. Joseph Wan, a vice president and director for BCG in Hong Kong, says he thinks many companies will be at risk of paying too much for a company. "Deal styles can be very different, and given their lack of experience, Chinese companies will run the risk of not being able to negotiate the best deals for themselves." Also, he adds, their very eagerness to close a deal may work against them.

Timing can also be risky, BCG experts say. Move too early, and you risk losing your domestic market share as you integrate with your Western target. Move too late, and your opponents may eventually outflank you before you can make your move, using their global scale to squeeze you out of your own markets.

Even a deal made at the right time and the right price, however, may prove a kind of Pyrrhic victory, for two reasons. First, Wan says that most of the time, a company sells a division because it's not doing well. As a result, the expertise that comes with the deal may not necessarily be the kind that will help the company get ahead. The team that came up with the deal, after all, is probably made up of "the guys who ran the company into the ground in the first place," he says.

Second, it may open the door for foreign control. While many pundits have seen the growing presence of Chinese bidders in the global M&A market as a sign that China's business sector has come of age, Meyer disagrees. In his view, mergers with Western companies, such as Lenovo's recent purchase of IBM's PC division, are a sign of weakness rather than strength. "Lenovo, the computer company, is no longer a Chinese company. In fact, the company is controlled by Western investors, at least temporarily. Its management is increasingly Western," he says. "It took this path because it had no choice. Dell was challenging it severely in its home territory, and it had to play global chess."

"My guess would be that other companies in China will take the same path, unless the problems of logistics, localism and fragmentation ... can be addressed very, very swiftly," Meyer says.

For Western companies looking east, opinions vary on the seriousness of the threat Chinese companies may pose. While Meyer believes that many of today's firms will eventually be controlled by Westerners, Shenkar thinks that the companies that begin to emerge from this market are likely to present a tremendous new source of competition. He argues that the threats are of a magnitude that many U.S. companies are unprepared to face, especially the Chinese cost advantages that come with low wages, lack of requirements for safety equipment, and the general lack of regulation for intellectual property.

Already, he sees U.S. auto parts manufacturer Delphi Corp.'s controversial Chapter 11 bankruptcy proposal (in late 2005) that its workers take a 60% pay cut as a sign that such cost pressures from China and other emerging markets are beginning to take a toll on companies that can't adapt quickly enough to the new environment. "When was the last time that you overheard an employer putting on the table, even under Chapter 11, a proposal to workers to take more than a 60% wage cut?" he asks.

