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Developing a China Strategy That Delivers Results



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CONTACT INFORMATION

Edward Tse is managing partner with Booz & Company in Greater China. With twenty years of management consulting and senior corporate management experience, Dr. Tse is one of the most experienced strategy consultants in China. He was the partner-in-charge of the first authorized office in China (Shanghai) among all international strategy consulting firms in the early 1990s. He has advised hundreds of Chinese and foreign companies on their growth strategies, organizations, corporate transformation, M&As and alliances. His experience covers a wide range of industries. He also consults to public sector organizations such as the World Bank, the Asian Development Bank and the Chinese Government on issues related to policies, state-owned enterprise reform and competitiveness. He can be reached at edward.tse@booz.com.

Ronald Haddock is a partner with Booz & Company. He has over 18 years of work experience in consulting and in management, and focuses on assignments in strategy, organizational design, operations restructuring, performance improvement and turnarounds. He can be reached at ronald.haddock@booz.com.

Originally published as:

Developing a China Strategy that Delivers Results,
by Ronald Haddock and Edward Tse, Booz Allen Hamilton, 2005.

DEVELOPING A CHINA STRATEGY THAT DELIVERS RESULTS

China: No longer a question of whether to enter, but of how, and how to succeed over the long term

The emergence of China in the global economy is arguably the most significant economic event in recent history. Headlines in newspapers around the world proclaim the advent of the China century. With economic growth averaging between 8 and 9 percent per annum for the past decade, coupled with a truly massive domestic population, most global companies have long since recognized that China is simply too large a market for them to ignore.

For some companies, the reasons for pursuing China are the potential opportunities for new growth and profits. For others, China is a defensive play, essentially an opportunity to access low labor costs or to build and sustain an advantageous business model before a competitor can do the same and exporting this new model back into the home market. Whatever the reason for pursuing China, most companies are well beyond the question of whether to be in China and are struggling with the question of “how”, and how to succeed over the long term. Indeed, for many Western and even Asian executives, China remains an enigma that is both difficult to understand and in which capturing the true value potential remains elusive.

The real China—massive, diverse, and rapidly changing

So what is the real China? Perhaps the most useful definition is William Graider’s in his book *One World, Ready or Not* where he sums up quite succinctly when he

says: “Diverse and contradictory, China is like a black box where both optimists and pessimists can find proof to support their expectations.” Winners in this marketplace will recognize the real China’s market potential, its diversity, and its speed of change—and will be able to reconcile and make practical business decisions across all three dimensions.

Simplistic generalizations (e.g., “chicken not beef,” “rice in the south, wheat in the north,” “operating in China is low cost,” “guanxi [relationships] is the most important”) do more harm than good in describing the real China. The degree of cultural and geographic diversity in China is perhaps most analogous to the cultural diversity of Western Europe multiplied by the

geographic scale of the United States. Compound this by a pace of change comparable to the Internet age and you will start to get a flavor for the real market in China.

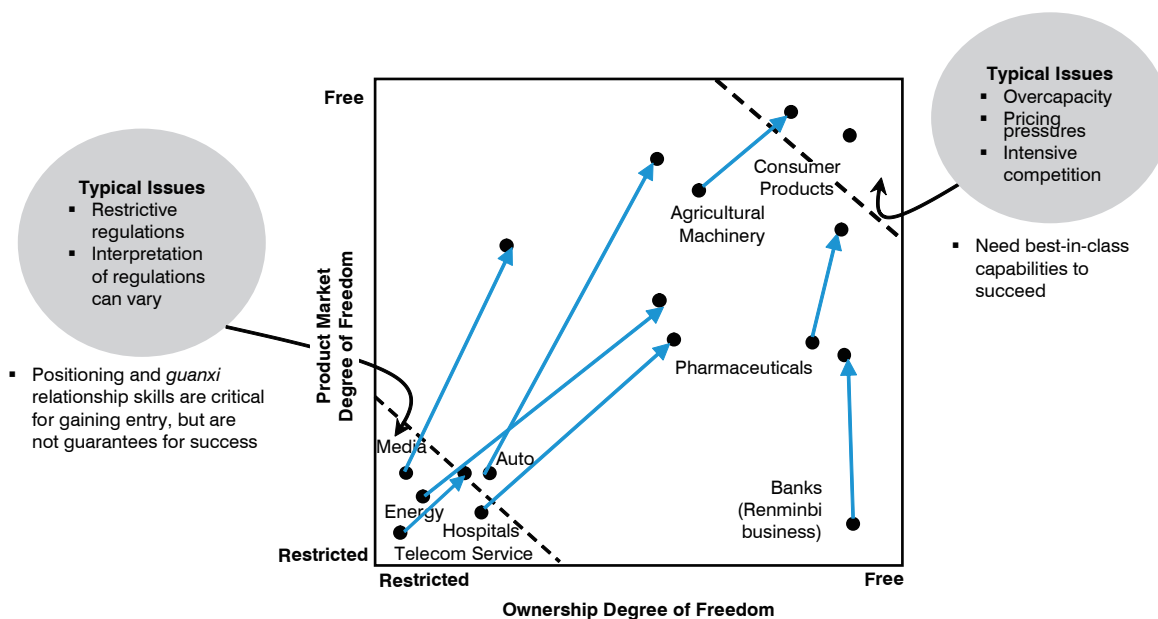
Deregulation, Global Integration, and Darwinian rivalry

Two phenomena are perhaps the most important in characterizing China over the last 15 years: deregulation and global integration. The Chinese government has been gradually deregulating its markets industry by industry. Exhibit 1 shows a simple framework that depicts the trend of de-regulation in China over time. Against a continuum defined by product market degree of freedom and ownership degree

of freedom, industry after industry are moving from the “restrictive” part of framework to the “de-regulated” part. In the early 1990s, the Chinese government started this process—bit by bit in a typical Chinese fashion—and the process has persisted. China’s entry into the WTO in 2001 was merely one step, albeit a giant step, in this process. Clearly, not every industry has become fully de-regulated but many, e.g., fast-moving consumer goods (FMCG) and mobile handsets, already are. While companies engaging in restrictive industries would need to resort to “positioning” or building guanxi as their major source of competitive advantages, those engaging in de-regulated industries would typically find that they are competing in probably

Exhibit 1
De-regulation and Its Implications

Regulatory Framework Changes from Mid-1990s to Today



Source: Booz Allen Hamilton

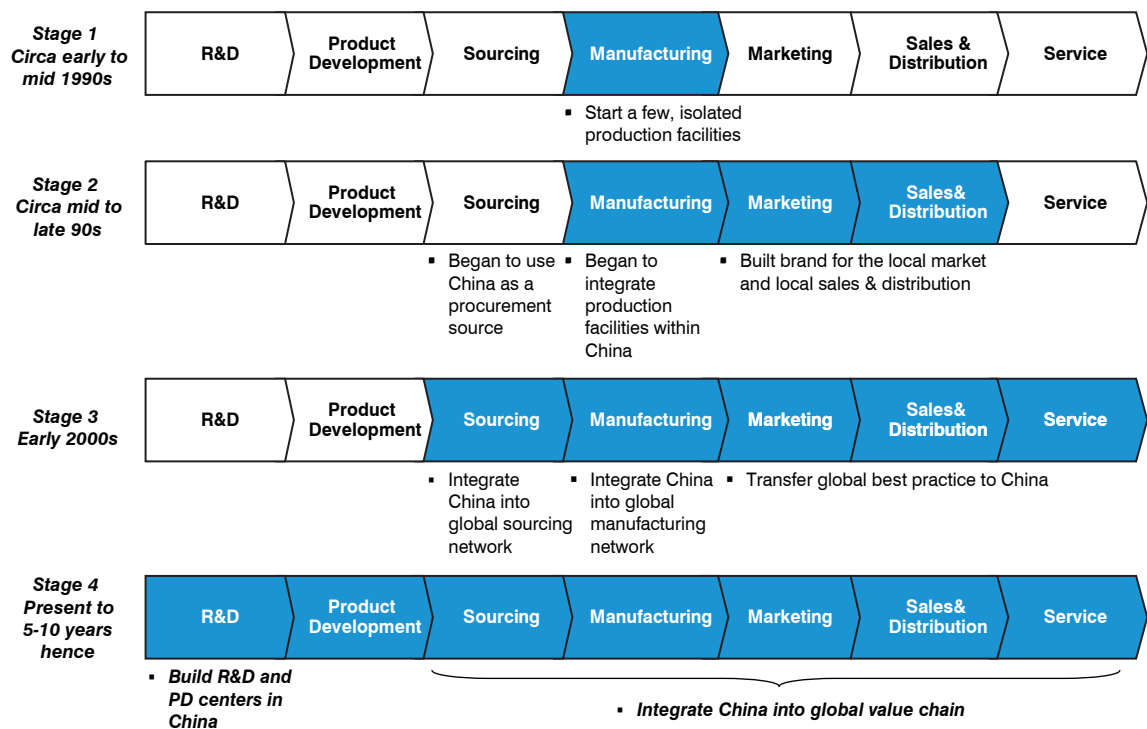
one of the most, if not the most, competitive markets in the world. Competition in the de-regulated industries in China can and will be highly intensive as competitors from all over the world, including those from overseas Chinese along with local domestic Chinese, all strive to get a piece of the action. This type of intensive competition often drives overcapacity inducing severe price pressures and ultimately consolidation among players. Prime examples of this are what happened to the white goods and the brown goods industries several years ago. The passenger car industry, having seen growth rates as high as 75 percent a year ago, is now also beginning to exhibit some of these symptoms.

Companies competing in these industries, be they foreign or local, must bring the best capabilities and business model to bear in order to succeed in this intensively competitive marketplace.

In parallel to the de-regulation process, many MNCs have been integrating their China operations into their global business systems (Exhibit 2). While early investments by foreign companies were focused on establishing isolated production facilities, perhaps by different business units with different local partners, technology licensing, or simple import/export operations, the extent of the value chains of many foreign companies' operations in China has been expanding

both upstream and downstream. Manufacturing plants in China are being considered as part of a company's global manufacturing footprint. Many MNCs are integrating their China sourcing with their global sourcing initiatives and some are in fact recruiting and instituting Chinese suppliers into their global sourcing pyramids (e.g., the automotive parts suppliers industry). At the same time, many MNCs are bringing their marketing and sales best practices to China and some are building China-specific brands and leveraging their global branding expertise and resources to create new superbrands in China. Perhaps, most importantly over the long-term, many MNCs

Exhibit 2
Companies will need to integrate China into their global operations



Source: Booz & Company

are building their research and development and product development centers in China as one of the few, but important nodes of their global R&D and product development system. Not only are technology companies doing this, but also traditionally “low-tech” companies such as FMCG. These companies are investing in China for the critical upstream activities because competitive pressures are forcing them to get closer to the huge or potentially huge Chinese market and to leverage relatively low cost but high quality technical and research capabilities along with human resources.

The combination of de-regulation and global integration make China an incredibly challenging place to compete. The bars for success are very high but the rewards are similarly high for winners. On a positive note, foreign companies’ financial performance in China has been improving. A 2003 survey conducted by the American Chamber of Commerce (AMCHAM) indicated that 75 percent of companies surveyed made money in 2002, and all but 2 percent of them are at least breaking even. Over 40 percent have higher operating margins in China than in other markets around the world, and over 80 percent plan to expand their operations in China. This is also consistent with our first-hand experiences in helping numerous foreign companies in China. In fact, previous reports of financial performance of many

foreign companies in China have often been distorted and sometimes under-reported by the use of mechanisms such as transfer pricing.

Increasing global integration means that the fate of China is increasingly intertwined with that of the rest of the industrial world, reducing the likelihood of China reverting to a closed economy. We expect that the Chinese government will continue to let the Darwinian rivalry in the de-regulated sectors play out, including allowing market forces to continue to impact its state owned enterprises (SOEs), providing an impetus for reform of these enterprises. As long as overall growth and stability remain on track, consumers will undoubtedly win over time and China will in all likelihood continue its migration towards an economic system of managed capitalism.

What determines success in this marketplace?

Across industries, we have seen companies that achieved success in China while others failed. To cite some examples:

- **FMCG:** In the fast moving consumer goods (FMCG) sector, Procter & Gamble (P&G) is widely been regarded as one of the most successful foreign companies in China. Its hair care and cosmetics products, among others, are leaders in these respective spaces. According to the Economist, P&G’s China revenue exceeded \$1.8 billion

at the end of 2003 and profit has been increasing at a rate of 140 percent per year. Today, China is the sixth largest market for P&G in revenue terms and it is forecasted to become the second largest after the U.S. in a few years. When P&G entered China over a decade ago, Wella, another MNC hair care marketer, also set up in the country. Wella was never able to make its business model work in China and eventually sold its business to P&G.

- **Passenger cars:** In this industry the success of Volkswagen is legendary. As an early mover, Volkswagen commanded over half of China’s passenger car market for a long time. Increasing competition in the last year has caused its market share to drop by a fair amount. Nevertheless, China today is the largest market for Volkswagen outside of Germany. Peugeot, on the other hand, another early mover who entered China in the mid 1980s made the decision to withdraw from China in 1997 after years of significant financial losses. A later entrant, General Motors, however, has achieved strong performance so far and continues to grow.
- There are many similar examples in other industries. In the personal computer industry, early movers and once dominant players in China such as AST and Compaq could not sustain their success in China, while as a relatively late comer Dell has been able

to chip away market share from market leader, Lenovo. In liquid packaging, Tetra Pak has built a strong position in China while most of its peers are not getting much traction in the marketplace. In fast foods, both KFC and McDonald's have built a large number of restaurants across China and are very profitable, while most of their international peers are not remotely close to the successes of these two companies.

Many foreign companies entering and operating in China go into an environment that is very different from markets with which they are familiar. Understanding the large number of new variables (which includes previous constants now also becoming variables) is already a major challenge, but because China is undergoing very rapid change, new entrants need to enter a rapid learning cycle in order to stay current and make the right decisions as the environment changes. Managing in China involves much more moving parts than other more mature or more familiar markets. This requires multiple dimensions considerations of non-linear, discontinuous attributes in a fast-changing and highly uncertain environment. Repeatedly we have seen that when given the same information on China, companies in the same industry come to very different conclusions and decide on very different approaches. The result is that companies with very similar competitive positions in their home markets can arrive

at very different end points in China—some will be winners while others will be losers.

Our research of the winners and losers reveals the following key common factors for the winners:

- Ability to understand the real China. In particular, the regulatory context and its implications for competitive advantage and market dynamics, especially on the supply side.
- Value proposition and business models commensurate with market evolution, including need for true integration with a company's global business system.
- Willingness or ability to appreciate and adapt to local cultures throughout China. Specifically, willingness to set aside existing assumptions about the Chinese environment and how it would change or behave; learning by spending real time in the market.
- Organizational nimbleness in adjusting to a rapidly changing environment.
- Ability to successfully learn from previous experiences and/or benchmarking within the proper context, having an effective feedback loop in place.
- Ability to build strong local teams on the ground, in particular, ability to attract and retain leaders who are entrepreneurial and can work effectively in an ambiguous environment.

Critical Decisions for CEOs—It's All About Trade-offs!

When developing a China strategy, CEOs must ask themselves a series of critical questions (see “Critical Decisions for CEOs”, page 6). There will inevitably be trade-offs, and the answers to many of these questions will have direct implications on the resources that the company can and should invest in China, as well as on the competitive risks that they will face.

Steps to Developing and Implementing a Winning Strategy

After reviewing and coming to terms with the critical questions, the next step would be to actually develop a winning strategy. While there is no single formula for developing a winning strategy in China, from our experience, the most successful companies follow these ten steps (or principles):

- 1. Start by understanding the overall context of China, especially the regulatory implications and how they may change over time**
- Understand how contextual change may impact the structure, the market dynamics, and the basis for competition for participants in your industry.
- Be ready to rapidly shift your focus from positional-based advantages to capabilities-based advantages as their industry moves toward de-regulation.

Critical Decisions for CEOs

1. Market Share vs. Profitability

- What are your company's real aspirations in China? Do you want to be the dominant market player building market share first at the expense of immediate profitability or do you need to deliver reasonable profits from day one?
- Alternatively, do you need to deliver reasonable profits from day one?
- Are you prepared for a “big bang” entry quickly building your market presence?
- Or would you prefer to take it “one step at a time”? (major difference in investments required)

2. Positional Advantage vs. Capabilities-based Advantage

- What is the regulatory context within which your industry will be operating under in China?
- What kind of competitive advantages will you need to develop: positional advantages, capabilities-based advantages, or both? (See also Exhibit 1, page 2)
- How much intellectual property are you willing to transfer to China and over what time frame?

3. First Mover vs. Follower

- Is there a natural first mover advantage in your industry? Do you have what it takes to be one?
- Or is it better to be a follower and learn from others?

4. Use of In-house Resources vs. Leveraging Outsiders

- Do you need to perform all activities in China internally?
- Or are you able to leverage other people's/partner's resources?
- Does your company support or discourage partnerships?

5. One Global Business Model vs. Significant Local Adaptation

- How well does your global business model fit with what will be required to succeed in China?
- What adaptations are you willing to make in China?

6. Global Brands vs. Local Brands

- What will be the balance between marketing your global brands in China versus developing local ones?
- What brand portfolio with what specific brand positioning would make the most sense for you in China?
- Are your brands strong enough to be introduced in China? What are the local cultural biases for/against them?

7. Headquarters vs. Local Organization Roles

- What is the right balance between controlling your China operations from HQs versus empowering the local organization?
- What internal systems will need to be set up to facilitate quick decision-making across time zones and geographies?

8. Business Units vs. Geographic Coordination (for Multi-BU Companies)

- What degree of geographic coordination would you want to exercise across BUs in China?

- What role should the geographic lead person play? To what extent should shared services be deployed in the China organization

9. Global vs. Local Market-driven Values and Standards

- What global values and standards will be non-negotiables in China? (including ethics, legal issues)
- What flexibility will you allow in the local organization?

10. Role of Expats vs. Staff Localization

- How will you localize your management team over time?
- What is the role of expatriates during the transition period?

2. Develop a deep, insightful understanding of the market, noting all the associated risks

- Don't just look at demand (it is present and growing in virtually every industry), pay particular attention to the supply side. The supply side can be equally or even more important to understand as MNCs, local companies and SOEs battle for customers with very different business models.
- Look closely at the current and likely future discontinuities in demand/supply and draw the appropriate implications for your strategy. Anticipate "unseen S-curves" and be positioned to act on them, or even to drive them, before others do.
- Spend real time on the ground collecting primary information. It is neither possible nor advisable to control China remotely or try to develop a deep understanding of China by relying only on secondary data. Secondary data about China is typically inaccurate

and insufficiently granular for decision-making purposes.

- During fact-finding visits, collect and synthesize the "real" numbers, not just the official numbers. There is often a major gap between real and official data. Understand the reasons behind the differences.
- Be careful about using benchmarks or lessons learned from other industries as a benchmark for your own business. They may or may not apply to your industry now or in the future.
- Continuously update your knowledge and understanding of the market. Regularly capture market, competitive and regulatory information and build in institutional mechanisms to stay current.

3. Develop a culture that emphasizes adaptability, flexibility, and entrepreneurship, and be willing to accept ambiguity

- The business environment in China can change rapidly.

Anticipate and respond quickly to changes.

- Live with uncertainty. Organizational flexibility and adaptability along with cultural sensitivity are important keys to success in China. Managers in China must be entrepreneurial (yet disciplined) and willing to accept high levels of ambiguity.
- ## 4. Once you decide to enter China, articulate and commit to a vision and understand its full implications
- Define aspirations in China early on. What are they? Are you seeking to become the market share leader or seeking near-term profitability, or both? Are your aspirations realistic?
 - Define pace of entry into China, yet be willing to change plans as new opportunities present themselves, or anticipated ones take longer than expected to materialize.
 - Define frame of reference for managers on the ground in China. What is your desired product market positioning?

What end game position can you envision that the China team should work towards?

5. Ensure the basis of your strategy (both entry and/or second generation growth) is not only clear and logical but also practical

- What segments or niches do you intend to pursue? What core competences can you leverage against each?
- What are the key levers for growth (e.g., share gain in existing markets, category expansion, geographic expansion)? How will you pull them? What results can you expect from each?
- What are the practical aspects about operating in China that you must consider?

6. Find out who and what you can leverage to generate growth. Understand how to use these levers

- What global capabilities can/should you deploy in China? How will this be done?
- How can you leverage local resources via JVs, alliances, mergers and/or acquisitions to grow?
- What other mechanisms will you need to rely on to complement your China capabilities (e.g., advisory boards, key influencers, etc.)? Avoid trying to do everything on your own.

7. Plan on achieving operational excellence from day one

- Build in operational excellence

with disciplined cost management from day one. Both are crucial to sustainable success in China. In some industries, especially where labor content is not high, operating costs in China can be relatively high.

- Build efficient, reliable supply chains as early as possible, especially in industries where global supply chain integration is critical.

8. Plan on integrating China operations with global business systems and value chains from day one

- Where is China relative to your global industry life cycle and how fast will China evolve? In what direction?
- How important is global integration for your China business today and in the future?
- How can you ensure that integration will be properly designed and executed?
- What impact will there be to your global competitive position if you cannot integrate your China business into your global business systems? Exhibit 2, page 3 outlines the key stages of companies integrating China into their global operations and where we can expect to be five to ten years hence.

9. Commit to building a local, on-the-ground organization with strong capabilities

- Regardless of your industry position in the regulatory framework and the entry option that you choose, build

strong, local capabilities in China either organically or through acquisitions. Think very carefully about the role of expatriates and how long they will be required in China.

- Build value-adding, mutually beneficial relationships with local partners. Guanxi alone, even in highly regulated industries, will not be sufficient in the long term.
- 10. Finally, remember to maintain and properly manage communications with global headquarters**
- Manage expectations with global headquarters, which often have misconceptions about what is really happening in China. Lack of alignment between corporate headquarters and the China operations frequently lead to decisions that adversely affect a company's position in China.
 - Maintain proper communications and linkages with global headquarters to ensure corporate support at critical moments as well as to smooth daily operations.

Ultimately, succeeding in China requires taking a long-term view. Inevitably there will be ups and downs, just like in any other market. More and more, companies that are persistent over time do ultimately succeed!

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