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*Question How to*  
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*Changing World*

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# The Shifting Nature of Chinese Industry

## Chinese Executives Question How to Compete in a Changing World

Business and political leaders around the world are asking how they can best come to terms with China's emergence as a global power, particularly an economic power. But what is rarely discussed, certainly outside of China, is how the newly emerging China is also forcing the Chinese to ask themselves about their own position and prospects. Nowhere is this new introspection more evident than in China's business sector. Over the last 15 years, the growth in the Chinese economy has allowed many companies to develop, and some to prosper—be they state-owned, private, or collective. Markets are far more open than they were a decade ago. Consumers are wealthier. A huge array of infrastructure has been built and brought into operation. And, above all, competition has intensified.

These changes have led many foreign companies to rethink their strategies for China. But they are not alone. Facing intense competition—especially in manufacturing, where productive overcapacity has relentlessly driven down the prices of many goods—domestic companies are also

acknowledging that they will have to do things differently. Booz Allen Hamilton has identified a number of questions that Chinese managers are repeatedly asking. Five of these stand out:

1. How long will the low-cost approach continue to work for Chinese companies?
2. With China increasingly opening its economy to foreign participation, how can Chinese companies develop new and sustainable competitive advantages?
3. How can Chinese companies learn to become innovative and move up the value chain?
4. How can Chinese companies transform domestic success into global reach?
5. How should Chinese companies view Western multinationals—as partners or competitors?

Chinese managers are asking these questions now because although China's economic growth has led to the emergence of some very successful businesses, managers at even the best-performing companies recognize that they cannot continue along the same development route that they have followed to date. Zhang Ruimin, the chairman of Haier, China's leading appliance maker, has said more than once that his company's growth has reached a plateau, and he is now searching for new ways to take

Haier to the next level. Before Lenovo (formerly Legend) bought IBM's PC division, Yang Yuanqing, then its CEO and now its chairman, questioned how his company could compete, given that the Chinese PC market had turned from—in his words—a “marshland,” where Chinese companies could hide and fight, into a “wide and straight highway,” where the battlefield was level and open. Ren Zhengfei, the founder and CEO of Huawei Technologies, the leading Chinese telecommunications equipment maker, has been warning company staff for several years that the company would inevitably undergo a “winter” if it failed to change its way of operating.

Since China entered the World Trade Organization at the end of 2001, agreeing to open over time various sectors that had previously been closed, managers have been asking ever more urgently how they can best compete both with other Chinese companies and the increasing number of foreign companies doing business in China. They know they need to improve their management capabilities and corporate governance—often with a total overhaul and reworking of all aspects of their operations—in order to compete in a new and changing environment.

The issue, then, is not whether Chinese companies need to change, but how—and how fast. The answers are far from clear, even for the most successful Chinese businesses. And although the answers to these five questions are still being formulated, the fact that these are the key considerations for Chinese executives is vital information for anyone, Chinese or foreign, attempting to do business in China, to partner with Chinese companies, or to integrate their China operations into their global business systems. As such, the questions deserve deeper analysis.

### **1. How long will the low-cost approach continue to work for Chinese companies?**

Low-cost production—the ability to put tens of millions of people to work assembling and manufacturing consumer and other goods—has been at the core of China's economic success story, and especially its rise as an export powerhouse. For instance, China's light industrial heartland in Guangdong Province's Pearl River Delta, just north of Hong Kong, has succeeded because it offered the world the best low-cost production location. But it is not alone: Other production centers are mushrooming, in the Yangtze River Delta; at Wenzhou on the eastern coast, south of Shanghai; and in the Northeast, which was formerly a bastion of heavy industry but is now undergoing a reform into a more modern manufacturing base. It is the success of these and other regions that has earned China the sobriquet “workshop of the world.”

This success, however, has come at a price. Many Chinese companies have grown over the years by becoming suppliers or original equipment manufacturers (OEMs) for branded companies, usually companies based outside China. Many of the Chinese companies that have developed their own brands—consumer electronics companies Skyworth and Konka, telecom equipment manufacturers Datang and ZTE, carmakers Chery and Geely—have positioned themselves in the lower price segments. But as they have developed, more and more Chinese OEM companies have recognized that they receive less than \$10 from products that sell for \$100 in the United States, with most of the value being captured by the brand owner.

Faced with a business environment in which Chinese companies can essentially destroy a market by getting in and bringing prices so low that the business is no longer viable for mature companies, many Chinese companies are asking themselves whether this is a sustainable way of

doing business—and finding the answer to be *no*. Low prices are predicated on cheap inputs, but the costs of labor and materials are rising. Even though improvements in infrastructure are opening up new regions with cheaper land and their own pools of underemployed labor, more and more companies are finding that although the low-cost approach enabled them to get started, its thin margins keep it from being a long-term strategy for growth. In addition, the pressure to keep costs low is so intense that it leaves few resources for doing anything else that may add value, meaning that most businesses are operating more on perspiration than inspiration.

Adding to these pressures, some foreign companies are adapting themselves to Chinese ways. They are adopting the same low-cost manufacturing techniques or—especially in electronics and consumer goods—outsourcing their manufacturing to other companies, based in Taiwan or Hong Kong, that are even more skilled in the low-cost approach.

Of course, the low-cost approach is far from finished in China. The highly efficient supply chains that have been developed in key parts of the country, especially around the Pearl River Delta region and the Yangtze River Delta, near Shanghai, will be hard for any other country to reproduce quickly, even if they can offer even cheaper labor than China's. For more and more industries, including the automotive, electronic, and light industrial sectors, the shifts in the overall supply chain to China further reinforced this strong positioning. Nonetheless, many Chinese companies are not content with the low-cost approach and are now searching for new and different strategies.

## **2. With China increasingly opening its economy to foreign participation, how can Chinese companies develop new and sustainable competitive advantages?**

This question follows from the first one. Over the last 15 years, China has been steadily deregulating many of its industries. Although some sectors remain closed or severely restricted, the majority of industries are now very open. Non-Chinese companies can participate in many sectors, and are increasingly able to do so without a mandatory Chinese partner. Even where foreign companies are still required to operate in joint ventures (JVs), they are often allowed to hold a majority share.

Partly as a result of this deregulation, and partly as a result of China's extraordinary economic growth, more and more foreign companies are coming to China. Simultaneously, China's own private sector has expanded enormously. It now accounts for approximately 65 percent of the economy, up from almost nothing 15 years ago. Although this rapid expansion in the role of market forces is making the country's economy much more efficient and productive, it is also enormously intensifying the competitive pressures that domestic companies are facing.

Chinese companies know that the deregulation of the economy is unlikely to abate—indeed, in many key sectors, the trend is for further liberalization. In December 2006, for example, the final restrictions barring foreign banks from doing renminbi business in China were finally lifted. Citigroup, together with a consortium of foreign and Chinese investors, has obtained approval to own 86 percent of Guangdong Development Bank, one of China's sizable commercial banks. Since Citigroup is the largest shareholder in combination with another foreign investor, IBM, Citigroup looks certain to end up responsible for managing the bank—a major breakthrough in foreign companies' level of involvement in China's financial sector.

Many domestic companies have taken advantage of China's rapid economic growth of the last 15 years; as the saying goes, "A rising tide lifts all

boats.” Much of this success can be attributed to entrepreneurialism, an ability to move quickly, fearless experimentation, and the willingness to produce goods or services that are just good enough for the customer, even if sometimes at the expense of quality. In Chinese, this is called “*cu fang xing guangli*,” or “rough-and-tough management.” Consequently, it is fair to say that although many companies have done enough to get by, few have shown the knowledge or resources to be able to continue to excel. The key reasons that these Chinese companies have survived are, first, the overall speed of market development, and second, in many cases, protection from regulations.

As liberalization proceeds, Chinese companies are finding that they cannot continue to operate in this rough and tough manner. They observe how the best foreign multinationals are run and they know that these companies typically are much more rigorous and precise in their management approaches. Many domestic companies are very interested in learning how they can improve their management skills, processes, and systems, with the objective of achieving best practices. To this end, we are often asked how to implement management techniques such as business process reengineering or Six Sigma, or how to improve everything from their organizational design, supply chain management, and quality assurance to brand development, innovation activity, risk management, and incentive systems. These companies are extremely eager to acquire state-of-the-art management practices and aspire to embrace international practices as quickly as possible.

In addition, Chinese companies are increasingly practicing better corporate governance. This is especially true at state-owned enterprises (SOEs), which—under the supervision of China’s State-owned Assets Supervisory and Administration Commission (SASAC)—are implementing a

program to establish boards of directors to oversee management performance. To ensure companies have adequate checks and balances in place, the number of independent directors must exceed that of executive directors. SASAC intends to spread this practice to more SOEs over time. So far, SASAC has approved 19 SOEs for board restructuring under this scheme.

### **3. How can Chinese companies learn to become innovative and move up the value chain?**

Innovation, be it of products or processes, lies at the heart of long-term corporate success—a fact of which the Chinese government is only too aware. The country’s 11th Five-Year Plan, covering the period from 2006 to 2010, identifies the promotion of technological innovation as a key priority. However, this will be a new undertaking for many companies: Much of China’s economic success in the last 15 years has come from mobilizing underutilized labor and putting it to work—be it in factories or on construction sites, driving taxis or manning bank counters. Companies have generally found it easy to imitate products or service offerings that worked in other markets and rapidly and successfully apply them in China, taking advantage of the country’s lower costs, looser regulatory requirements, and substandard quality levels.

A prominent Chinese business leader once said, “Imitation is an appropriate form of innovation.” Every time a hot sector emerges—be it mobile phones, white goods, or passenger cars—companies, driven by an intense entrepreneurialism and often funded by cheap bank loans, spring up in many parts of the country, scrabbling for market share by lowering their prices. However, managers in China know that this strategy will be hard to maintain in the long run.

They also know that the way to survive in this ferocious struggle is to move up the value chain,

and the key to doing this is developing their skills in innovation. However, knowing that something should be done is very different from knowing how to do it. It further complicates matters that most of the high-tech or even not-so-high-tech products now being manufactured in China are still reliant on core technologies owned or controlled by foreign companies. Take mobile phones as an example: In the late 1990s, a host of Chinese companies found themselves able to produce handsets more cheaply than the big foreign companies. Over the next couple of years, they achieved market share in China of more than 50 percent. But since then, their share has rapidly slipped. First, foreign companies adopted the low-cost manufacturing processes used by Chinese companies, making it more difficult for Chinese companies to compete on price. Second, Chinese companies never owned the chipset, the core technology at the heart of every mobile phone; therefore, they were not able to innovate at that level, and their products' features and quality soon dropped behind the offerings of their rivals. Today, China's handset market is once again dominated by foreign companies—Nokia, Motorola, and Samsung.

Having witnessed such a rapid turnaround in fortunes, Chinese companies have concluded that they must learn how to innovate if they are to move up the value chain and so consolidate and maintain their early successes. But how? Should they be throwing more money at research and development? How much is enough? If so, given the imperfection in China's intellectual property protection, how can they protect any new goods or processes they generate? Foreign companies may be the loudest complainers about the piracy of intellectual property in China, but domestic companies are arguably even worse off. For instance, Ren Zhengfei, Huawei's CEO and one of the most prominent business leaders in China, has been very vocal in asking the Chinese government to create a better environment for

protecting intellectual property and in trying to persuade Chinese enterprises to behave responsibly in this regard. Finally, and perhaps most problematic, how can Chinese companies find the funds to support innovation, given that price competition remains, in far too many cases, their principal strategy?

It is widely accepted that fostering a culture of innovation is a must, although in many ways the necessary mind-set has not quite caught on. A case in point: When we met with managers at one of the leading industrial SOEs in China to discuss innovation, they were interested in how to make innovation happen. However, they were equally, if not more, interested in understanding how innovation could be measured, so that it could become part of each manager's balanced scorecard. Because the performance of the senior managers was evaluated by the central government, making sure that the scorecard could appropriately reflect innovation effectiveness was of key importance to the SOEs' executives—more so than the real essence of innovation itself.

#### **4. How can Chinese companies transform domestic success into global reach?**

The last decade has seen a host of domestic companies establish themselves as recognized names across China. The best of these companies—and some of the not-so-good ones—are asking themselves whether they can reproduce their domestic prowess in international markets. “*Zou chu qu*,” or “going out,” has become a motto for many of them.

The government is pushing its biggest companies overseas. Most prominent are the energy companies looking for new sources of oil, gas, and other resources to fuel the country's economic growth. But others are following in their wake. Huawei and ZTE are selling their branded products in many overseas markets. The major state-owned commercial banks, especially the

three that have listed internationally—Bank of China, China Construction Bank, and Industrial and Commercial Bank of China—are beginning to look at possible acquisition targets abroad. Some businesses have already realized some notable achievements, most famously Lenovo and its \$1.75 billion purchase of IBM's personal computing division in 2004. But managers also know that buying overseas can be extremely problematic, having witnessed the failure of China National Offshore Oil Corporation (CNOOC) to buy U.S.-based Unocal in 2005.

Even when Chinese companies are successful with their purchases, turning them into successful, long-term businesses is not easy. In 2004, electronic consumer goods manufacturer TCL became the world's biggest television manufacturer when it paid \$282 million to become the dominant partner in a joint venture with French consumer electronics company Thomson Electronics. Its strategy was straightforward: Use Thomson's brand name and marketing reach to go global. The venture has been a disaster, losing some \$270 million in its first 21 months of operation. Now the company is closing most of its European operations and preparing to stop using Thomson as a brand name.

Nonetheless, despite the mixed success of overseas ventures so far, many companies are interested in learning how to expand internationally. Managers are aware that taking their operations overseas will prove an extremely complex process, as indicated by the inquiries we have received about the extent to which they will have to restructure their organizations and management structures, the kind of risk management and incentive systems that would need to be introduced, what role international partnerships could play, and, most crucially, whether it will be possible to recreate in other countries the same kind of production processes that have made them successful at home.

In their process of planning to go overseas, Chinese companies are finding they need to learn how to develop their "soft power." First proposed by Professor Joseph Nye of Harvard University's Kennedy School of Government, the notion of soft power revolves around an entity's ability to shape the views of others. Although some Chinese companies have amassed significant assets and capital, their soft power is generally weak. CNOOC's bid for Unocal, for instance, failed not because of its offer price or its size, but because many people in the United States, particularly politicians, found the idea of a Chinese company acquiring Unocal unacceptable—a clear illustration of a failure to project soft power. If Chinese companies want to expand overseas successfully, they will need to develop their soft power as much as their business skills.

### **5. How should Chinese companies view Western multinationals—as partners or competitors?**

This is probably the most urgent of the five questions, given the amount of disquiet recently expressed in China at the role of foreign investment in the economy, and in particular whether foreigners should be allowed to control industries or sectors, even those not deemed strategic.

To a certain extent, this question has come full circle. In the early days of foreign investment in China, during the 1980s and early 1990s, there was a tendency among Chinese officials and managers of SOEs to regard business as a zero-sum game in which one side would eventually emerge victorious at the expense of the other. Certainly, those officials and managers wanted foreign companies to come to China because of their capital and technology, but these companies were seen as adversaries to be outmaneuvered and defeated. In the mid-1990s, such feelings gave way to a wider appreciation of the role foreign investment could play in fostering growth to the benefit of both Chinese and non-Chinese companies.

More recently, views have changed again, due in part to the opening of China's markets. China's entry into the World Trade Organization allowed more foreign companies both to enter more sectors and to do so as wholly owned entities rather than partners in joint ventures. In addition, many foreign companies that were in JVs have bought out their partners or converted minority stakes into majority ones—among them such prominent names as Siemens, Alcatel, UPS, and FedEx Express. The outcome has been a resurgence of nationalist sentiment, further fueled by such high-profile moves as the attempt by U.S. private equity firm The Carlyle Group to buy 85 percent of Xuzhou Construction Machinery Group (XCMG). (After much fanfare, this deal appears to have been settled, with Carlyle buying 50 percent of XCMG.) Over the last year, foreign companies have been allowed to buy into a variety of Chinese SOEs, most notably taking minority stakes in some of the most prominent commercial banks in China. These sales, however, have also led to concerns about whether the Chinese enterprises are being sold out too easily, too quickly, and too cheaply to foreigners.

For managers at Chinese companies, these issues should be beside the point; they should be concentrating on what would be of most benefit to their companies. All the same, the issues are relevant, because they point to the question of whether foreign companies should be seen principally as competitors or whether there is still a role for them as partners. Furthermore, if they are to work together, what methods offer the most benefit to both sides? In the 1990s, many Chinese companies were willing to form JVs with foreign companies because they thought this would offer them foreign expertise and technology in return for access to China's markets. In most cases, that didn't turn out to be the case. From the Chinese perspective, foreign companies were extremely protective of their technology and know-how, whereas from the foreign companies' point

of view, the Chinese were trying to steal their intellectual property while failing to add value to their JV businesses. In today's more liberalized environment, the quid pro quos of JVs no longer have much appeal for most businesses.

Exacerbating the question for China are the tens of billions of U.S. dollars that continue to be invested every year, and that—combined with its soaring exports—have left China with the world's largest foreign exchange reserves. Clearly the quantity of foreign money flowing in is not a problem. Its quality, however, is becoming one. The government would prefer foreign companies to be investing in adding value to Chinese industry rather than simply adding capacity, even if this creates further problems for domestic companies trying to close the quality gap and compete with these newcomers.

### **Implications**

The common element of these five questions is their attempt to determine how Chinese companies can best achieve sustainable long-term growth. Chinese companies recognize they cannot continue with their current operational paradigm and will need to change.

Many Chinese companies have very high aspirations. They are not willing to sit around doing nothing. They are always on the move, are very quick on their feet, and are constantly asking, "What is the next step?" Chinese national pride, which is being revived as a result of the country's economic success in the last decade, is also a major driving force behind these companies' quest for knowledge and competitive advantage.

Many Chinese businesses see themselves at an inflection point. Their business models have served them well until now but do not appear suited for future changes in the competitive landscape. Many of them recognize the fundamental shortcomings of their current business strategies and core competencies, and are all too aware that

their current core competencies cannot help them sustain growth in the long run.

But these questions also tell us as much about these companies' dreams as their weaknesses; these are companies that want to be "world class." Whether they understand what being world class means and what it takes to realize it is less clear, although the fact that they remain so open to considering foreign companies as potential partners as well as competitive adversaries suggests this is something they very much want to learn.

For foreign companies, reflecting on these questions is also worthwhile. Many businesses are finding that they need to search continuously for sources of sustainable competitive advantage, and that often China (and India) are important sources of such advantage. In the process of building globally integrated organizations, they need to understand better the dynamics driving Chinese companies in order to identify them as either competitive threats or possible partners, or perhaps both. The continued integration of China into the world will redefine the competitive landscape of many industries, both within China and beyond its borders. From this process, new ideas, new sources of sustainable competitive advantage, new ownership approaches, and new business models will emerge—and with them a new breed of global competitors.



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