Perspective

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China
An Oasis amid the Global Economic Crisis

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EXECUTIVE SUMMARY

Alan Greenspan, former chairman of the U.S. Federal Reserve, described the global economic crisis that broke out in 2008 as a "once-in-a-century credit tsunami." Indeed, the scale and speed at which this economic tsunami has spread across the world is unprecedented. In the fourth quarter of 2008, the gross domestic products of the U.S., the E.U., and Japan fell at the alarming annualized rates of 6.3, 5.9 and 12.7 percent, respectively. The MSCI world index plummeted by almost 40 percent in the second half of 2008 alone. Although no one at this stage can firmly assert when and how the economy will return to its growth path, it is certain that this crisis that has dragged most parts of the world into recession will change many of the fundamentals of the world's economy. As the new world order and business environment take shape, companies that can accurately evaluate and effectively act upon the current change will be more likely to survive this storm and succeed post-crisis. Being one of the handful of economies still exhibiting relatively strong growth, the importance of China has become even more profound on a relative basis to companies worldwide. This will bring new strategic implications to companies. In a way, China has become the oasis for many companies in the midst of this economic crisis.

CHINA IS FACING CHALLENGES

China's economy, like the rest of the world, is inevitably under challenges given the global nature of this economic crisis. These challenges are most prominent in the country's export. In late December 2008, Booz & Company jointly conducted a study titled "China Manufacturing Competitiveness Study 2008–2009" with the American Chamber of Commerce Shanghai, and surveyed many multinational manufacturers operating in China. The results showed that almost 50 percent of our survey respondents experienced a year-on-year drop in export value of more than 10 percent in the fourth quarter of 2008. Almost 13 percent of respondents even cited a 30 to 49 percent decline. From a more macro perspective, China's total export value fell 25.7 percent in February 2009 when compared to the same month a year earlier. Since demand from the developed markets is unlikely to pick up soon while export value amounts to about one-third of China's GDP, the sustained weakening of the external market conditions will necessarily bring negative impact to the Chinese economy.

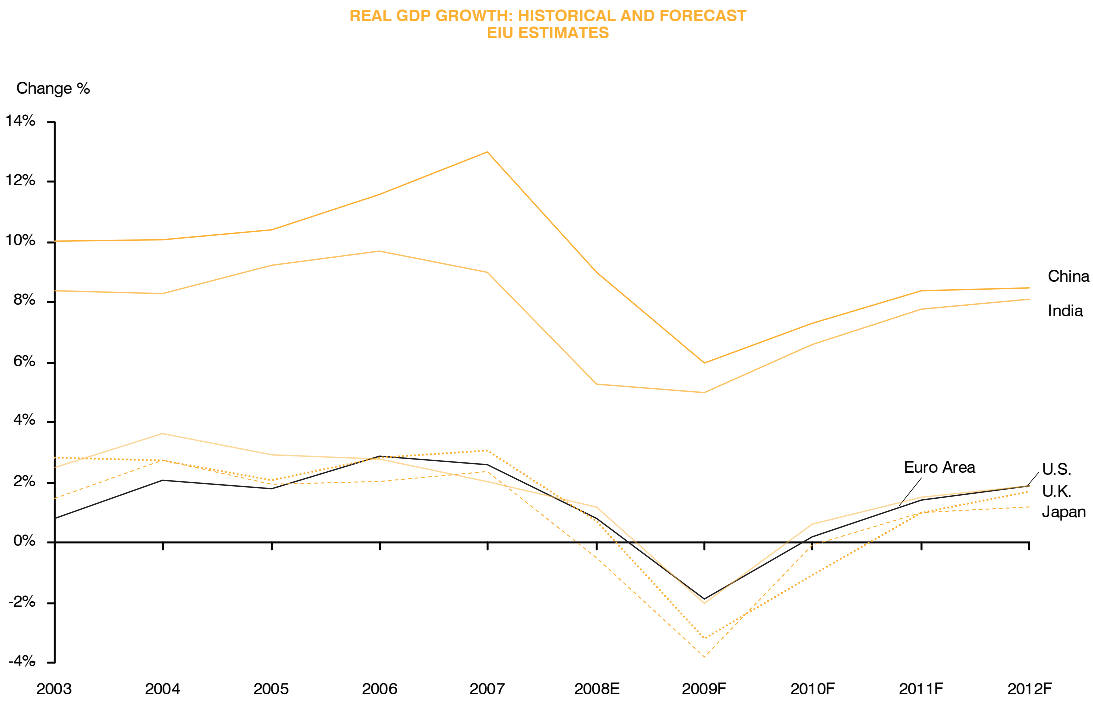
At the outset of the crisis outbreak, the Chinese government resolutely announced a stimulus package that was worth US$590 billion (RMB4 trillion) to ease the economic slowdown. The package covered supportive policies in areas such as infrastructural investment, rural development, renewable energy, healthcare, education, etc. In the four months that followed, the central government put forth additional stimulus plans for 10 industries—i.e. automotive, steel, shipbuilding, textile, machinery manufacturing, electronics and information, light industry, petrochemicals, non-ferrous metals, and logistics. The proposed measures focused on technology innovation, infrastructure upgrade, closing of low-efficiency production, mergers and acquisitions, and tax rebates and subsidies, in an attempt to revitalize industries that were particularly under pressure. Furthermore, provincial and municipal governments across China have also announced investment plans and favorable policies, whose total value has exceeded US$2.6 trillion. Recently, the Chinese government has mentioned further plans to increase its investment in schools, hospitals, outpatient healthcare services, affordable housing, and environmental protection, among many other areas. On top of these, the government is expected to raise its investment in social security by 17.6 percent to US$43 billion. Despite all these proactive efforts of the government, the means, extent, and speed at which these policies can help stimulate domestic demand and reduce export decline are still uncertain. Historically, exports played an important role in the growth of the Chinese economy, resulting to some extent in a reliance on external markets. In contrast, boosting domestic consumption will require a fundamental shift in the consumption patterns and habits of Chinese consumers and institutional buyers. It will be challenging to expect that domestic demand alone can substitute for the lost export demand and can help China return to its previous rate of growth in the short run.

CHINA IS STILL THE BRIGHT SPOT

Despite the challenges at hand, China is still one of the few, if not the only, bright spots in the world for many global companies. All developed markets are hit hard in this crisis. Based on estimates of the Economist Intelligence Unit (EIU), developed nations such as the U.S., Japan, Germany, France, and the U.K. are expecting GDP decline in 2009 at rates ranging from 2.5 to 5.9 percent. The majority of emerging economies are also under severe challenges. The economies of Brazil and Russia, both having experienced considerable growth in the past few years, are forecasted to shrink in 2009. Decline is also expected in Asian countries such as Korea and Thailand. Despite such recessionary environment around the globe, forecasting agencies are still suggesting that China will grow by 5 to 8 percent in 2009 (EIU's forecast at 6 percent; World Bank's forecast at 7.1 percent). This growth rate far exceeds the rate expected for nearly all major economies. India is the only market coming close *(see Exhibit 1, page 4)*. In the first quarter of 2009, China's GDP grew at 6.1 percent, an encouraging rate when compared to the deep recession that plagued most world economies in the same period.

In the meantime, the financial situation of the Chinese government and Chinese financial institutions is relatively healthy. This effectively lowers the risks that China will experience the credit crunch and extreme financial volatility that have plagued the U.S. and European markets, enabling the authority and market mechanisms to best utilize the financial system to revive the local economy. Although the 2009 fiscal deficit of the Chinese government will be at a record-breaking US$140 billion, this level only amounts to about 3 percent of China's GDP, a level deemed "manageable" by the World Bank. Moreover, China's foreign exchange reserve exceeds US$1.9 trillion. This has made China's reserve the largest in the world, more than doubling the size of Japan's foreign exchange reserve, which ranks number two in the world. The considerable size of this reserve will be crucial to China's ability to maintain stability of its financial system and currency. As for the banking system, the bad debt levels of major banks remain at a secured level. The chairman of China Banking Regulatory Commission (CBRC), Liu Mingkang, commented at the Boao Forum Asia 2009 that he expected both the stock and ratio of nonperforming loans to fall in 2009. Supported by relatively loose monetary policies, the amount of bank loans extended has been rapidly increasingly in the past few months. In the first two months of 2009, new loans extended per month reached US$190 billion, exceeding 4 percent of GDP and representing a growth of 24.2 percent. In particular, a lot of the new loans were in the form of short-term paper, which had very low interest rates. These loans should be very helpful to companies needing access to short-term liquidity. Owing to these advantages of the Chinese financial and government institutions, as well as the close relationships between the government and the businesses, we believe China is at a good position to speed up its revival from the global crisis relative to other nations.

Exhibit 1
Real GDP Forecasts (%): China vs. Other Major Economies



Source: Booz & Company analysis

MANY GLOBAL COMPANIES CONTINUE TO FOCUS ON CHINA

Even during the global slowdown, CEOs must still look for business growth. To this end, the opportunities available in the Chinese market are providing the growth momentum that companies need. In fact, many leading companies in the world already recognize that the importance of China is even more significant in the current worldwide economic crisis. These companies understand that their traditional markets are unlikely to return to growth anytime soon. The Chinese market therefore becomes one of the most important, if not the only major, sources of growth. Despite operating in such difficult times, many of them are still confident of the long-term potential of China and are committed to increase their investment in China.

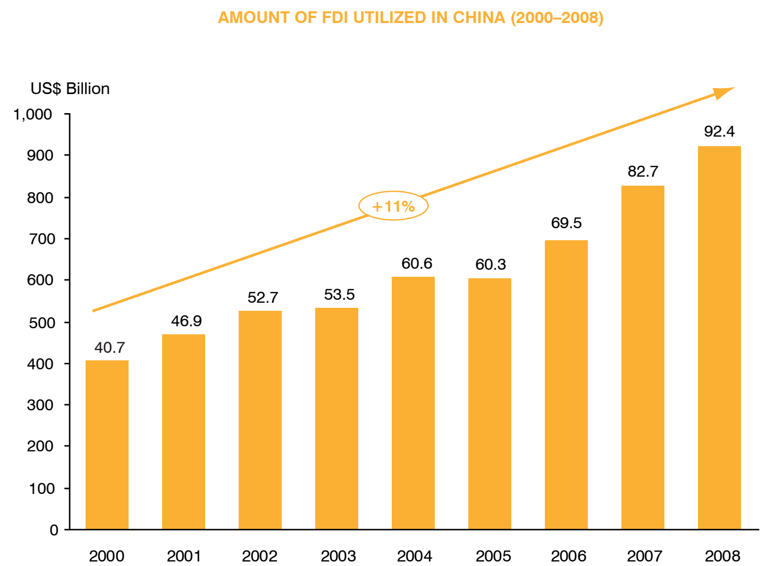
In 2008, a multinational fast-moving consumer goods company's business in China accounted for 25 percent of the company's global growth. This company expects its China business in 2009 will generate about 60 percent of the company's global growth. Another example is Intel, which has been facing rising cost pressures in China. Its decision to relocate its facilities in coastal Shanghai to an inland city, Chengdu, demonstrated its concerns about cost management. Indeed, rising costs along the coasts of China have induced many multinational companies to consider shifting their manufacturing bases or hubs of their supply chains to the inland areas, where costs are lower. This trend is also seen among local Chinese companies such as Li Ning, a sportswear company that has plans to move part of its manufacturing operations to central or even western China. Reportedly, its new manufacturing base in Hubei province will account for 40 to 50 percent of the company's capacity, expected to achieve 10 to 15 percent cost savings.

However, these relocations do not mean that companies are reducing their presence in China. On the contrary, Intel was closing down its facilities in Malaysia and the Philippines, planning to integrate their capacities into the new Chengdu hub. Intel also announced that it would keep its R&D center in Shanghai, complete its investment in the Hangzhou-based Enjoyor Technology Group to augment its innovation and go to market capability in China, and increase its registered capital in China by US$110 million.

Intel is only one of the many multinational companies that have plans to strengthen their China business. The Coca-Cola Company, for example, announced in March 2009 that it would invest US$2 billion in China in the next three years. The scale of this investment plan surpasses the total value of investment that the company has made in the past 30 years, since it returned to China in 1979. The scope of the investment encompasses many dimensions including factory sites, production facilities, route-to-market, product development, marketing, etc. Its geographic coverage reaches western China, such as Xinjiang province. Earlier in the year, its major competitor, PepsiCo, also announced a plan to invest US$1 billion in China in the coming four years in order to expand its capacity in the inland and western provinces in China. Furthermore, global leading electronics company Samsung decided to invest US$1 billion in 2009 to develop more low- to mid-tier products for broader market coverage across China. On top of the US$1.4 billion China investment announced in 2006, Siemens is adding US$208 million of new investment in China in the next three years, with a focus on alternative energy. Novo Nordisk, a leading pharmaceutical company in the diabetes space, plans to invest US$400 million to set up a new insulin production facility in Tianjin as the new manufacturing hub for the company's Asia Pacific business. The American retail company Best Buy completed the buyout of China's third largest electronics retailer, Five Star, as planned despite the challenges it faced globally. In the next two years, the company is planning to invest US$160 million worldwide, of which a substantial proportion is likely to go to China. Harman International, a U.S. audio equipment manufacturer, is expanding its China business, tripling its number of employees in China while committing the capital needed to triple its China sales in five years. The Barbie brand, a subsidiary under the toy giant Mattel, started its first flagship store of the world in Shanghai, in the hope of exploring a new operating model in China. Bayer Schering Pharma announced that it would invest US$139 million in the next five years in a global R&D center in Beijing. This was a move to strengthen the company's global R&D capability. Disney is considering setting up in Shanghai a new theme park that will be its biggest outside the United States. Nike is investing about US$100 million to build its biggest logistics center in Asia in the Jiangsu province along the east coast of China. Hewlett-Packard will develop its second personal computer production center in the Chongqing municipality. Microsoft will invest US$1 billion in the next three years to improve its R&D capabilities for different business units including its mobile and Internet platforms.

In the "China Manufacturing Competitiveness Study 2008–2009" that we conducted in late 2008, nearly 50 percent of respondents (all multinational companies) indicated that they had plans to increase their capacity in China in the next year or two, while almost 40 percent suggested they would invest in new process technology in China in the same time frame. Overall, a lower percentage of companies had plans to build new manufacturing bases outside of China (10 percent in 2008 versus 17 percent in 2007). Only 17 percent of companies felt pessimistic about their post-crisis competitive positioning. In fact, foreign direct

Exhibit 2
Foreign Investment into China Remains Strong



Source: Booz & Company analysis

investment utilized in China still reached a record high of US$92.4 billion in 2008, a 12 percent growth from 2007 *(see Exhibit 2)*. Although the amount of investment utilized has shown some decline in the past few months, the rate of decline has significantly improved (16 percent year-on-year decline in February 2009 versus 33 percent decline in January 2009).

The emphasis that these leading multinational companies put on China demonstrates their confidence in China. According to a recent *Newsweek* report, Nike's 2008 China sales grew by 50 percent (discounting the effect of changes in currency exchange rates), compared with 4 percent growth in its U.S. sales and 9 percent growth in its global sales (discounting the effect of changes in currency exchange rates). Citigroup, while experiencing a US$27.7 billion loss in 2008 globally, still recorded a 95 percent increase in its net income in China to about US$190 million. KFC's store count in the U.S. has fallen each of the last four years, from 5,525 in 2004 to 5,253 in 2008, whereas in China, a new KFC outlet is opening almost every day on top of the 2,980 restaurants already in operation. As for the deeply troubled General Motors Corporation, the number of vehicles it sold in China rose by 6 percent in 2008, whereas the number sold in the other world regions declined by 13 percent during the same period. In April 2009, GM sold about 173,000 vehicles in the U.S., down 34 percent from April 2008. But in the same month, GM's sales in China jumped 25 percent to a record high of 151,084.

Due to the burst of the U.S. housing bubble, the U.S. water heater manufacturer A.O. Smith experienced a 9 percent year-on-year decline in its global sales in the fourth quarter of 2008. Yet during the same period, the company's sales in China recorded 11 percent growth. This result again demonstrates the strategic advantages of China in a multinational company's global footprint. The company's president and CEO, Paul W. Jones, commented in a recent interview that the company still expected the China market to grow at 6 percent in 2009 and this growth would ease the company's difficulty arising from the ongoing decline of the U.S. real estate market. Hence, A.O. Smith has no plans to halt its new investment in China. Its third phase of capacity expansion is expected to be completed by the end of 2009. This expansion will double the company's capacity in China on top of the new capacity added in 2008.

Most companies are no doubt under tight financial constraints in this economic crisis. Companies' decisions to invest in China during such times make their moves more "valuable" and strategically significant. And in the meantime, these moves also augment China's role in their global business landscape. The investment in and attention paid to the Chinese market are more likely a representation of the company's long-term direction than of a short-term contingency plan.

CHINA IS INTEGRATING INTO COMPANIES' GLOBAL VALUE CHAIN

Along with the increasing strategic emphasis on China, we also observe that more and more multinational companies are transforming their China operations into a hub for their global value chains. This integration with the global value chains embodies itself in two key aspects: (1) Companies are more fully leveraging the "duality" of China (i.e., positioning China both as a key sales market and as a hub for exporting products to the rest of the world), and (2) companies are integrating more of their upstream activities, such as R&D and product development, into their China value chains.

1. The "Duality" of China

As the Chinese market develops, more multinational companies realize that their China business expansion not only can increase their revenue but can also significantly improve their economies of scale in production and sourcing for a better cost positioning of their exports. And as companies develop their export business in China, the superior product designs/standards and latest trends in their global export destinations can be applied back to the Chinese market, raising the companies' competitiveness in China as a result. We believe that effectively integrating the dual roles of China as sales market and export hub can be mutually reinforcing to either business. This mutually reinforcing effect will further help companies develop their presence around the world including China. The findings of our earlier study on multinational companies in China point to the growing popularity of this model. In our "China Manufacturing Competitiveness Study 2008–2009," more respondents (57 percent this year versus 47 percent last year) claimed that they viewed both local sales market and cost savings as their primary motives for setting up their manufacturing bases in China. Meanwhile, the percentage of companies finding only labor or material cost savings, but not local market, as their key motive fell by half, from 22 percent to 11 percent. And more important, the EBIT level of companies that applied duality principles is on average 8 percent higher than for companies with a single motive. This shows that the duality of local sales and export is likely to have real benefits to a company's profitability.

If multinational companies are fully leveraging China's duality, we call these companies global supply chain integrators (GSCIs). These GSCIs are more likely to take advantage of the China potentials than companies that only regard China as a low-cost processing base or low-standard sales market. A client that we have engaged recently is A.O. Smith, the water heater manufacturer that we mentioned earlier. In the past decade, A.O. Smith has proactively localized its China management team and has developed a sales network that spans across the whole nation. Meanwhile, the company began to leverage its China market experience and production capacity to develop other overseas markets. For example, some water heater designs in China were not found in the U.S. market. Through exporting these "new products" from China, A.O. Smith was able to strengthen its competitiveness in some of the U.S. market segments. Some of the capacity in China was also used for exporting to India. This series of actions that took advantage of China's duality led to huge success for A.O. Smith China. Its sales in 2007 were six times its sales in 2001, representing a CAGR of over 33 percent. In terms of its market share, A.O. Smith is leading all foreign brands operating in China, second only to the local home appliance giant Haier.

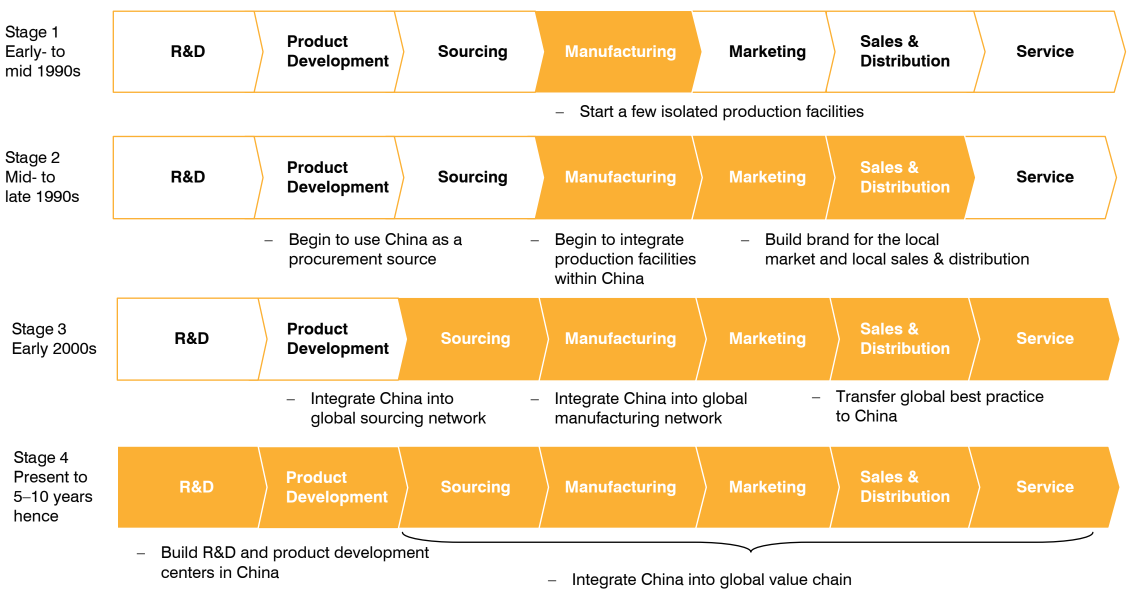
Goodyear, the global leading tire manufacturer, is another example of effective leverage of China's duality. When Goodyear first set up its plants in China in 1994, the company primarily positioned China as a low-cost country for manufacturing, and did not fully leverage China's market scale. But since 2002, Goodyear has amended this China strategy. It defined dual roles for China—important source of sales growth and supply base for its global value chain. On one hand, Goodyear rapidly expanded its sales network. Within 10 months in 2005, it established 300 new outlets across different regions of China. On the other hand, it installed its world's leading process technologies in its plants in Dalian. Leveraging China's cost advantages in sourcing and human resources, Goodyear has been able to manufacture and export products that are competitive in price and superior in quality for its markets around the world. Since 2006, the China sourcing initiatives on raw materials, machinery, and finished goods have achieved over US$35 million of annual savings for Goodyear globally. And between 2002 and 2006, the global sales of Goodyear grew at an annual rate of 10 percent. This contrasted with the less than 1 percent growth recorded before the strategic transition of Goodyear China (1995–2002). This case provides support that duality is an important route toward maximizing a company's China strategy.

2. Integrating R&D and Product Development into China's Value Chain

In the early 1990s, China was a low-cost processing workshop in the eyes of many multinational companies. Labor-intensive manufacturing leveraged the low labor costs in China to swiftly expand. Yet by now, more and more multinational companies in China have already extended its value chain coverage upstream and downstream. This extension involves not only activities that we have mentioned (e.g., sourcing, export, local sales, etc.) but also R&D and product development *(see Exhibit 3)*. We believe this trend will become more prominent as the China market is increasingly emphasized.

In fact, the Chinese market is highly heterogeneous with very different consumer needs in different market tiers. Consumer behaviors in China also differ substantially from behaviors in the traditional markets of multinational companies. In the past, multinational companies focused mostly on China's high-end customers and Tier 1 cities, where the difference in needs was less apparent

Exhibit 3
The Integration of China and the Global Value Chain



Source: Booz & Company analysis

when compared to developed markets. But as companies seek to explore the latent sales potential of low- to mid-end customers, Tier 2 and Tier 3 cities, or even rural markets, their ability to tailor products to local needs and to realize this tailoring through R&D becomes very crucial. Multinational companies that entered China early and have achieved huge success in China, such as Coca-Cola and P&G, tend to make conscious efforts in R&D activities that target the local market. Many of their local products—e.g., Minute Maid with orange pulp—are effective combinations of local consumer needs and their global brand/platform. Meanwhile, many countries in Asia are still at a similar development stage as China. Products designed for the Chinese market are often good reference to these emerging Asian economies. Beyond developing products for China, the China R&D centers of leading companies often serve the design and development needs of the Asia Pacific region and other world markets as well.

An example is ABB. The company is a global leading manufacturer in power and automation technologies. Since establishing its first office in Beijing in 1979, ABB has grown substantially in China. By now, it has 27 local companies in China, sales and servicing organizations in 60 major Chinese cities, and production bases in areas such as power transmission, automated products and systems, etc. But in order to succeed in the competitive Chinese market, ABB finds that "made in China" alone is not enough. The strategic importance and value of "designed in China" is increasingly recognized.

As a means to realize the paradigm shift from "made in China" to "designed in China," ABB global headquarters made a strategic decision in 2005 to set up China research centers in Beijing and Shanghai. These centers were viewed as core elements of ABB's global R&D team. At the same time, ABB was committed to develop local talent for the Chinese market. Many R&D employees from China were sent to ABB's R&D centers in Germany, Sweden, and many other countries for systematic training, in order to strengthen local innovative capability in China. This strategy has been instrumental in the rapid growth of ABB China. ABB's sales in China reached US$3.4 billion in 2007, making China its sales champion among all sales regions. Furthermore, the R&D talent in China is also heavily involved in tasks from other markets. Designs from China have been accepted by clients from countries including the U.S., Germany, and Sweden. The impact of ABB's "designed in China" model extends far beyond China and reaches its business worldwide.

Nokia is another leading company committed to investing in R&D in China. Nokia set up its first research center in China in 1998, and has since extended its R&D operations to six facilities that are located in Beijing, Hangzhou, and Chengdu. These facilities' areas of research cover a broad spectrum of business activities including products, terminals, infrastructure, technologies, and solutions. The chairman of Nokia once discussed China's position as a key strategic unit of Nokia's global R&D network. With China being one of Nokia's largest markets, R&D investment in the country can significantly facilitate the localization of Nokia's products to quickly respond to Chinese consumers' needs. And meanwhile, products developed and designed in China are, in fact, adopted in other markets in the world. Estimates suggest that the models of over 40 percent of all handsets sold by Nokia globally are designed or developed in China.

Indeed, this trend of strengthening global R&D capabilities in China is noted in many industries, including industries that require higher technology barriers. For instance, Sanofi Aventis, a leading pharmaceutical company, announced in 2008 its plan to expand the scale of its R&D operations in China. The plan included expanding the company's R&D facility in Shanghai, initiating its new state-of-the-art biometrics center in Beijing, and strengthening its cooperation with the Chinese Academy of Sciences. All these are expected to improve the company's capabilities and efficiency for programs ranging from new drug development to late-stage clinical studies. Agilent, a premier measurement equipment manufacturer, set up an R&D center in Chengdu. Through committed localization efforts in product development, Agilent has been able to design, develop, and manufacture measurement equipment entirely locally in barely two years. At present, Agilent already has four models of radio frequency products successfully launched in the Chinese and international markets. GE, renowned for its R&D capabilities and advanced technologies, established its first China technological center in Shanghai in 2000. The center now has 28 research laboratories and is at the core of GE's R&D efforts. GE only has three other technological facilities of comparable scale and scope, respectively located in the U.S., Germany, and India. More important, the areas of research in China encompass state-of-the-art domains that GE relies on to maintain its global business growth, such as advanced materials, nanotechnologies, alternative energy, electrochemistry, laser processing, and digital manufacturing. Learning from the experience of these companies, we believe that integrating R&D and product development into China's value chain is a critical strategic move to increase a company's competitiveness in China and in the world.

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MOVING FORWARD SUCCESSFULLY IN THE CRISIS

As mentioned, China has a lot more opportunities for development and room for growth compared to other markets. Industries that are relatively "open," such as fast-moving consumer goods (FMCG), automotives, industrial goods, pharmaceutical goods, etc., will pose the largest opportunities. In our "China Manufacturing Competitiveness Study 2008–2009," quite a number of companies suggested that the Chinese government could do more to protect intellectual property rights, improve labor productivity, coordinate policies of different levels of government, and reform tax structures. In addition, cost increases (including costs of raw material, labor, logistics, etc.), exchange rate fluctuation, and talent retention were also cited as key challenges companies were facing.

In sum, the Chinese market can truly become an oasis for companies during this economic crisis. Nevertheless, the ongoing instability and volatility of the global markets is making the future highly unpredictable. The traditional approach of relying on historical data and probabilities to determine likely scenarios is rendered ineffective when developing strategy for today's Chinese market. Therefore, the ability to develop and execute strategy under uncertainty becomes the key for companies to successfully realize their "China strategy."

Booz & Company has helped many multinational and local companies in China and in the world to develop and implement their strategy. For example, we have been engaged by a leading local FMCG company since the fourth quarter of 2008 to further optimize its strategy and business processes. Since the outbreak of the economic crisis, this company has leveraged its superior resilience and execution power to effectively modify its strategy and strengthen its capabilities. In the situation when the Chinese market growth was slowing down, the company still recorded 40 and 30 precent growth in sales and profit, respectively, in 2008. Booz's management philosophy believes that this type of resilient and action-driven company is most able to fully leverage the opportunities available in the Chinese market. These admirable traits are not inborn but can be acquired. We firmly believe that every company has the capacity to transform the current challenges into opportunities given persistent self-reflection, systematic analysis, and strategic adjustment. Every economic crisis is a test for companies. What the greatest companies have relied on to lift themselves out of crisis after crisis has always been their long-term vision, proactive strategy, and prudent actions.

About the Author

Dr. Edward Tse is Booz & Company's managing partner for Greater China, specializing in definition and implementation of business strategies, organizational effectiveness, and corporate transformation. He has assisted several hundred companies—headquartered both within and outside China—on all aspects of business related to China and its integration with the rest of the world.

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