Rethinking Made in China

Chinese business growth is a force to be reckoned with—which is why boards need to evolve their thinking.

By Tom Manning

Twenty years ago, most of us considered China a compelling opportunity—huge potential, little competition, and open arms. Multinationals invested huge sums to build major positions. Dell installed a new facility in Xiamen. Motorola invested $6 billion and ramped up in Tianjin and other cities. Procter & Gamble and General Electric (GE) expanded in multiple segments and multiple cities simultaneously. In short, boards approved ambitious China investments with hope and bravado. Not so much anymore.

New Era Beginning

Today the situation is more complicated. Sure, investment in China is still growing in total—and for most Fortune 500 companies—but caution is on the rise given new difficulties. The market is no longer as easily accessible. Competition has grown along with demand, and Chinese government rules and regulations have made the terrain less friendly. The original thesis—enter China, capture a fractional share, and wait for the market to come around to the company's full product line—simply does not apply anymore. The market in nearly every industry is now multidimensional, exhibiting segment preferences, varied buying habits, and numerous direct and indirect marketing channels. Finding success in China is every bit as challenging as finding success in other markets around the world. Some executives would say more so, and many board members would agree.

Furthermore, the advent of the supercharged Chinese company—created through a combination of entrepreneurship, cooperation with state-owned enterprises, and government support—is a significant development that is likely to change the laws of competition in profound ways. These unique firms are becoming major players in key industries worldwide and reshaping these industries in the process. Witness the impact of Huawei, the Chinese colossus that now dominates telecommunications equipment globally, and the reach of Haier, which just purchased GE Appliances to become the largest white-goods company in the world. Both companies exemplify how leading Chinese companies are driving down costs while simultaneously ratcheting up innovation and, perhaps just as important, becoming leaders in domestic as well as foreign markets. A short time ago, virtually no one would have projected such wide-ranging success for these companies. Now it is clear that many more Chinese companies are in the making across a wide range of industries.

Most Fortune 500 boards are now contending with China strategy questions that will literally determine the future of their companies in their entirety, not just the future of their China operations. Increasingly, U.S. companies are recognizing that future growth prospects, profitability, and industry position

DAWID ZAGÃ³RSKI / THINKSTOCK

could well depend on two factors: how well they compete inside China and how effectively they defend their market share outside China against increasingly strong Chinese competitors.

For U.S. companies that already have a presence in China—especially those with a long history there—the question will be whether to double down on current bets or to adopt new strategies to improve positioning for the long term. For those that are just now entering China, the questions will be at what cost, in what way they will enter the market, and whether entry is still worthwhile given the rapidly appreciating cost of doing business there. Of course, whether these companies enter China for the first time or not, they will very likely feel the pressure of Chinese competition in other markets, including their home markets.

Implications for Directors

For Fortune 500 boards, there are at least three risks on the China front. First, there is the strategic risk of misallocation of capital by the company to China business opportunities—either they will invest too much in the wrong areas or in the wrong ways, or they will invest too little to make much of a difference in the end.

Second, there is the risk that the company is making assumptions about China and Chinese competition that are conventional, dated, and naïve. For example, simply believing that products will continue to do well in China given current brand positioning will lead to complacency—particularly considering the pace of change in Chinese industries. Similarly, the top of the market, the once-exclusive preserve of multinationals, is now accessible to local players and has become the new focus of domestic companies intending to capitalize on the potent combination of good-enough quality and national branding.

Third, there is growing anecdotal evidence that many companies underestimate their Chinese competitors, associating them with low-quality or copycat products. However, it turns out that the best Chinese companies are now innovating ahead of the multinationals and in ways that are closely tied to Chinese customer needs. For example, Chinese phone makers brought several iPhone improvements to the market well ahead of Apple.

Other factors such as anti-corruption regulations and intellectual property concerns tend to complicate boardroom debates about China. For example, companies that have violated the Foreign Corrupt Practices Act (FCPA) are understandably gun-shy about stepping back into China, while others who are new to China are concerned about concentrating investments in a country where collusion and bribery are regrettably still commonplace. The Chinese government has also flexed its muscles in recent years to demand that foreign companies adhere more closely to Chinese laws. GlaxoSmithKline, whose once-common practice of marketing to physicians is illegal in China, experienced the brunt of this policy in 2015. Increased regulation by both U.S. and Chinese authorities—each pursuing different goals—has raised the bar for multinationals by requiring scrutiny of Chinese operations and careful compliance in order to avoid violations and never-ending investigations.

Intellectual property (IP) protection, which has long troubled American companies in China, will become even more important given new developments. Recent improvements to Chinese IP laws and regulations finally provide a framework for multinationals, although the remedies and procedures for adjudication remain inadequate and frustrating. Multinationals themselves are raising the risk level by more frequently introducing their best and latest products to the Chinese market because the past practice of initially marketing older designs or less sophisticated products is no longer viable in many segments, where the latest innovations are in demand. Companies that are unwilling to accommodate the increased appetite risk may be conceding the market to local companies. Domestic innovation is clearly on the rise, making it imperative that American companies know which Chinese firms are innovating in ways that will affect market positioning both inside and outside China.

> **Increased regulation by both U.S. and Chinese authorities—each pursuing different goals—has raised the compliance bar for multinationals.**

A heads-down approach to innovating in America with a long-term goal of someday selling to China is no longer viable. It is now critical that American companies register their new inventions in China in order to play defense immediately—even if they are not yet involved there. With China's current surge in investments in innovation-driven industries, and the large number of students specializing in science, math, and technology graduating each year, boards will want to ensure that they are paying adequate attention to Chinese IP developments when planning their research and development strategies, regardless of the company's degree of focus on China.

Overall, the main question that boards need to ask is whether their company's current China strategy is sufficiently well-developed in light of the market changes that have occurred in recent years (*see "In the Beginning," page 48*). We are approaching an

In the Beginning

When Fortune 500 companies began investing in the Far East juggernaut in the 1990s, the Chinese market was defined by the following conditions:

- Fragmented industries
- Unstructured markets
- Unknown and/or uneven demand
- Limited competition
- Few laws and regulations

Market Conditions Today

Companies now need to keep these factors in mind when considering investments in China:

- Consolidating industries
- Organized markets and a growing number of segments
- Predictable, increasingly sophisticated demand
- Intense competition from strong local companies, improved state-owned enterprises, and more foreign players
- A long list of laws and regulations that require careful complian

inflection point where China could well drive an American company's strategy more than its own CEO or board. Your company might find itself the tail rather than the dog because of the competitive forces now taking shape. This should be a wake-up call for boards to revisit their China strategy to ensure that they are not still pursuing China Strategy 101 when China Strategy 401 is required.

Advanced Strategies

As a director, you will want to challenge your CEO, yourself, and your board colleagues to contemplate what competition will be like in a world that will be heavily influenced by Chinese business—regardless of whether your company is already active inside China or still operating mainly in its home market. The critical questions to ask may seem rather obvious, but answering them thoroughly delivers incredible value in light of China's growing position of prominence (*see "Questions for Your CEO," page* 50). This might prove difficult because CEOs who think his or her company's China strategy is set may want to brush off the request to revisit the subject. But given the stakes, it is worth issuing the challenge. The key is to push on whether the strategy is adequately addressing the magnitude of the changes in your industry brought on by China's rise, and whether your company is acting fast enough and in a bold enough way to counter any threats. Most companies are aware of new developments in their field that emanate from China, but many underappreciate the pace and impact of these changes.

As you and your board delve further into your China strategy, it will be useful to consider what an advanced strategy for this era might look like and how it will be different from your current approach. The answer will depend on your circumstances and your starting point, but three advanced strategies deserve consideration given the current competitive environment:

1. Double down. For American companies that believe that over half of their future market could well be in China, there is probably no alternative to finding a way to compete sustainably and at reasonable levels of return over the long term. Anything less would constitute retreat and perhaps full concession. Asking whether your company needs to double down represents good shorthand for asking if there is sufficient confidence in the current strategy to go twice as fast, invest a multiple of the current amount, and so on. Do not be surprised if the answer is more tentative than expected—and do not be disappointed if the conversation reveals a lack of confidence. This can lead to greater consideration of downside hedges and upside levers, which will enhance the sophistication of the strategy. Doubling down need not refer to resourcing alone, but, ideally, to techniques that amplify the intensity of the strategy.

It is now critical that American companies register their new inventions in China in order to play defense immediately—even if they are not yet involved in China.

Which companies are doing this? Intel Corp. has been pursuing an all-in strategy for China for quite some time, placing huge bets in cities like Chengdu well ahead of competitors and preparing for China's shift toward innovation industries in which microprocessors play a key role. The Walt Disney Co. has opened theme parks in Hong Kong and Shanghai over the past decade and has an eye on further expansion, recognizing that Chinese tourists will dominate the travel market within the decade.

Two more examples are Airbus Group SE and Boeing; however, these companies have slightly different footprints. Both companies foresee that China will account for more than half of all plane sales in the next 20 years, and both have committed to making China an essential part of their ecosystems. Airbus has pressed ahead with integrated manufacturing, essentially permitting Chinese companies to enter its IP framework at the risk of furthering the development of a true local competitor. Boeing has been more cautious, parsing out various portions of aircraft manufacturing and servicing while retaining control

over integration and design. Arguably, both strategies constitute a doubling down, but in distinct ways and according to different preferences. Notably, neither company can afford to be tentative given the stakes.

At the board level, having strategic discussions will raise high-value questions about the company's focus and the choice of remaining a broad-based player or becoming a niche player in the China market, readiness to commit to a large overseas market as a pseudo main-market, and resourcing in both capital and talent terms. The decisions will certainly involve the scale and pace of investment, but could also involve additional nuances in market focus and choice of partner-collaborators.

Companies that depend on China for sourcing for their global supply chain will face somewhat different factors, but the thrust of strategic questioning will be the same. How can we utilize China going forward? How will it compare to alternatives that might become lower-cost over time? Given that many of China's latest factory initiatives are designing for robotics rather than staff, how does this change the equation for us and for our foreign competitors?

Even if an American company has no intentions of marketing itself in China and sources very little or nothing from the country, it still must be aware of China's capacity to supply goods to foreign markets via other American companies and Chinese competitors. Importantly, the company might still need to consider doubling down in order to defend its home market. We only need to ask companies in other industries that have capsized as a result of rapid and all-too-often unexpected pressures—such as those in apparel, furniture, electronics, and even dental crowns, to name a few.

Further, if you think these observations pertain to manufactured goods alone, you are missing China's dramatic impact on a diverse array of service industries. In corporate finance, for example, dealmakers are routinely seeking Chinese lenders, equity investors, and strategic buyers. In clinical research, Chinese companies have made clinical data gathering the fastest way to facilitate pharmaceutical regulatory submissions. And in construction and field services, Chinese companies are now acting much like Bechtel Corp. did just a few decades ago. No matter

ZHU HUANAN - IMAGINECHINA

The Walt Disney Co.'s Shanghai theme park attracted four million visitors in its first four months and is anticipated to be close to breaking even in 2017, after only a year of operation. More than half of the park's visitors come from outside the Shanghai area, exceeding Disney's expectations.

the field, the influence of China's productive capacity must be respected—and seriously considered when developing strategies.

2. **Affiliate for more power.** After launching a strategic review of your China strategy, you might discover that your position is not strong enough or your market not large enough to command the bulk of your resources—or that your resources are simply insufficient. Consequently, you might want to consider increasing your power via partnerships or alliances. Many of you probably tried this in the past and wonder why it might be relevant again. When China first opened up, the government encouraged and sometimes mandated that foreign companies partner with Chinese companies via joint ventures as a means for entering the market. Neither side ever really felt comfortable in these early relationships despite the prospective benefits touted. Management styles were different, skills varied, and commitment and trust were an issue. Most multinationals evolved away from joint ventures toward wholly owned subsidiaries as soon as possible in an effort to regain control of their businesses.

While the joint venture model might no longer be appropriate, the concept of alliances provides a superior option to going it alone in China in certain circumstances because it is becoming more difficult for multinationals to compete as Chinese companies grow in capability and influence. Local companies often have a precise and rapid means for adjusting products and services to suit very specific market demands.

Questions for Your CEO

1. Do we understand how China will affect our industry and our business model?
2. If we witness wholesale change in our industry as a result, what will we need to do to survive?
3. What can we do to bolster our business before the situation dramatically changes?
4. What alliances might be required to offset private Chinese companies operating in concert with even larger state-owned enterprises and government ministries?
5. Should we monetize our existing China-based business before the valuation declines?

In addition, Chinese customers are becoming loyal to national brands and increasingly support local names when the trade-off is not substantial. The government is also prone to assisting its own by purchasing national products and encouraging consumers to support local products and services, such as for example, open-source software that is vendor-agnostic, i.e., unaffiliated with American companies such as Microsoft.

Moreover, while it is expensive to build brand positioning in a highly competitive market like China, it might be possible in certain industries to leverage the brand or other market access rights of local companies to maintain or even grow one's business. Success requires complementary skills and a good definition of needs and procedures—and quite a lot of tolerance. Given alternatives, most companies would still prefer to be independent of partners, but that might not be possible for much longer.

Affiliations could go well beyond marketing to include all business model elements, even those you had hoped to protect. Assuming you do not see an attractive future in simply muddling along at a low return on your China business, finding imaginative ways to affiliate with Chinese companies might actually be the only way to compete going forward. You already know that plenty of Fortune 500 companies have conventional joint ventures in place, but you might be surprised to know that more companies are now pursuing selective alliances with a very deliberate focus on addressing the areas where an alliance makes the most sense for the business model. Here are three recent examples:

- Hewlett Packard Enterprise elected to sell a controlling interest in its China-based networking, server and storage business to Tsinghua Unigroup, concluding the business would become more valuable in the hands of a Chinese partner.
- GE and Huawei Technologies Co. recently decided to enter a strategic collaboration arrangement concerning big data exchange and analytics across industrial applications. The idea builds on GE's view that all industrial components will eventually communicate and collaborate with one another and that inviting the leading Chinese technology company to participate in the new applications that GE is developing will make sense for both parties.

GE announced a partnership with China's Huawei Technologies to develop its industrial Internet strategy.

- Combining manufacturing and specialized research and development, Volkswagen Group (VW) is evaluating a strategic arrangement with Anhui Jianghuai Automobile (JAC) in which VW would make JAC its principal development partner for electric vehicles worldwide.

If affiliating for greater power makes sense to your company, it might not be exclusively with Chinese companies. Keep in mind that other multinationals operating in China (such as your American and European competitors) are experiencing the same pressures. Therefore, it might be logical to band together two, three, or even four companies into a syndicate or broad joint venture for the purposes of capitalizing on one another's strong suits. This might be objectionable in the U.S. market for legal reasons, but it might well be permissible and necessary for success or survival in hyper-competitive industries in China like auto parts, solar panels, batteries, information technology services, asset management, and so on. There might also be merit in involving sovereign wealth firms operating in Asia or connected with Asian companies operating in China (e.g., Temasek or GIC of Singapore) in such collaborative efforts. The deliberate assemblage of skills, capital, and practices could well offer a solid profile for competing effectively in the long term.

RU WEIZHEN - IMAGINECHINA

3. Monetize now. Somewhat surprisingly, a number of companies have decided that the value of their China business is greater now than it will be in the future. Of course, this represents an interpretation of how their business might evolve and how much additional capital the business will require to generate attractive returns. Yum! Brands, for example, has decided to sell its business to local Chinese investors in order to cash out now rather than continue to invest under the current ownership structure, which is American and which might offer less value over time given distance and the increasing need to adapt to local trends and preferences. McDonald's Corp. is making a similar push as it recruits local Chinese investors to take over its stores in China.

This might sound like giving up, but it is entirely rational for a board to ask whether there is a change coming that could either require large amounts of capital or entail new risks such that continuing becomes less attractive. In such cases, it could make sense to consider what immediate monetization might mean.

The current appetite of local Chinese companies for foreign brands and know-how is strong, and in certain industries, surging. As a result, local strategic buyers provide one way to monetize an existing business or portion of a business like a factory. There is also plenty of capital in China from domestic and foreign private equity firms, as well as commercial banks and sovereign funds, looking for operating investment opportunities, and buying from existing strategic owners is generally attractive to such financial investors.

Have any firms simply given up and gone home? Yes, several have done just that—without monetizing much, if anything at all. The most visible is probably Best Buy, which spent the better part of a decade trying to succeed but which finally chose to exit. Google also tried but conceded. Note that an exit does not necessarily block a return. The ideal exit includes options for stepping back into the game later after conditions change to a more favorable state. Monetization will make the most sense for a firm with measurable current China value but little future China ambition.

The Largest American Companies Acquired by the Chinese

#	Company	Acquirer	Deal size	Date
1.	Smithfield Foods	Shuanghui International	$7.1 billion	May 29, 2013
2.	Ingram Micro	Tianjin Tianhai Investement Development Co.	$6.3 billion	(announced): Feb. 17, 2016
3.	General Electric Appliance Business	Qingdao Haier Co.	$5.4 billion	(announced): Jan. 15, 2016
4.	Terex Corp.	Zoomlion Heavy Industry Science	$5.4 billion	(announced): Jan. 26, 2016
5.	Legendary Entertainment Group	Dalian Wanda	$3.5 billion	(announced): Jan. 12, 2016
6.	Motorola Mobility	Lenovo	$3.1 billion	Jan. 12, 2014
7.	AMC Entertainment Holdings	Dalian Wanda	$2.6 billion	May 20, 2012

Source: Fortune.com

Board-Level Imperative

Directors today might feel uncomfortable about how frequently China arises as a boardroom topic. Given how many discussions take place in relatively random and isolated ways, such as when focusing on one business unit or on a special investment, a well-organized discussion about China strategy and its implications for corporate strategy would doubtlessly be useful for most boards—and sooner rather than later. The three advanced strategies previously described can serve as stalking horses to drive discussion, but the real creativity will come from your management team and board working together to push toward second- and third-order insights about your particular industry and business model.

Re-examining your company's China strategy will prompt questions about your broader strategy as a corporation and may provoke a deeper set of discoveries than expected. Given the pervasive nature of the China factor and the high likelihood that we will all be living in a China-modified world going forward, regardless of our industry, it is both opportune and imperative that all board directors ask more about how China, either directly or indirectly, will reshape their companies.

Tom Manning is an NACD Fellow and serves on the boards of Dun & Bradstreet, CommScope, and Clear Media. He advises CEOs on their China strategies and teaches courses on governance, private equity, and China at the University of Chicago Law School.