

## **Fortune 1 Perspective: To Be or Not To Be In China**

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### **Introduction**

Asia is the world's largest continent both in geographic area and population. The continent's landscape rises and falls to the highest and lowest points on earth; From Mount Everest at more than 25,000 feet above sea level, to the Dead Shore which is more than 1200 feet below sea level. Civilization began in Asia 5,500 years ago. Asian people established the first advanced societies including cities and legal systems. Writing and consequently literature also originated in Asia.

Looking at China, India, Japan, and the ASEAN nations, Asia includes the fastest growing markets in the world, and some of the most powerful. China and India, both with populations in excess of 1 Billion, equaling more than two-fifth's of the world's population, currently have annual economic growth of 7 percent and 5 percent respectively. Only several centuries ago, China was the number-one economy in the world. It fell substantially behind in the 19th and 20th centuries as it closed its doors and did not interact economically with the rest of the world. Now, again today, China has reached world leader status. In addition to its huge population, China is the fastest growing economy in the world, and is now the seventh largest trader.

The growth of the Chinese economy is a very positive thing for global business, and China's membership in the World Trade Organization (WTO), beginning in December 2001, is leading to even more open trade. In the long run this expansion will provide tremendous opportunities for companies to create new wealth. China is no longer just a cheap production base or a potential big market. By default, it is an integral part of any company's global strategy.

Despite the impressive statistics and optimism, and the ascension of China into the WTO, the political and economic challenges of doing business in China are notorious – complex to say the least. Simply put: There is probably no greater divide than the Western and Eastern mindsets.

### **The China Reality**

For over two decades there has been a siren song about the size of the Chinese market. The "great call" of China, as the most populous nation on earth opened its doors to international investment, has entranced thousands of companies to charge into the Chinese market. However, just counting feet is very naïve. In fact, too many companies have rushed into China because of competitive pressures, and are now paying a high price for their lack of business fundamentals.

International companies have had mixed experiences in China. Some have been extremely profitable, while most others have struggled. Some of the most internationally sophisticated companies in the world, like Pepsi and Volkswagen, have taken tremendous hits in China, and still struggle to make their Chinese businesses produce. The problem is most companies enter China with a vision of selling to 1.2 billion people. Most companies fail to fully investigate the market, and perform little or no real risk assessment. Without the necessary preparation, these companies have stumbled into bad business deals, resulting in trade complaints and lost investments. Pepsi is an excellent example, having partnered

with the local bureau of State Administration of Film, Radio, and Television in the Sichuan province; Pepsi is now wading through a thick and heavy dispute with its partner, resulting in a loss of over \$500 million; and the dispute going through arbitration in Sweden.

The sheer potential of China has convinced companies to throw caution to the wind; to make huge plays and even give up intellectual property rights, often as part of the “bargain.” In this irrational exuberance, there is a very important distinction – it is only the “potential market.”

In reality the Chinese market is only medium-sized. Despite the tremendous global interest and investment, China remains a limited and still very restricted market, albeit one with vast potential. In 2001, China's Gross Domestic Product (GDP) was \$1.08 trillion. This is approximately the size of Italy's economy. When this is spread across a population of 1.2 billion, disposable income for the people of China is paltry. The majority of the Chinese population simply does not have purchasing power. The average per capita disposable income of urban Chinese residents in 2001 was roughly \$810 while rural per capita income was \$280. Rural incomes are overstated because the value of farm produce consumed at home is included; actual cash held is approximately \$200.

Approximately half the Chinese workforce is farmers. There are 350 million Chinese farmers, and more than half of them live below the poverty line.<sup>1</sup> Moreover, these farmers do not own, nor can they buy or sell the land they work on. Even China's central government – infamous for over-stating the good – acknowledges unemployment is a growing problem. China's labor surplus is not reflected in the country's official unemployment rate of 3.3%. The government's official data does not account for approximately 25 million state workers who are laid off “temporarily,” nor does it account for 100 million migrant workers who move between agriculture and construction jobs, but spend much of their time unemployed. Private researchers cite a more accurate figure as being 10-15% unemployment.

The population of China is 1.2 Billion. The country has 95 cities with populations in excess of 1 million. Five of these cities: Beijing, Shanghai, Tianjin, Shenyang, and Wuhan have more than 4 million people. A back-of-the-napkin sketch extrapolates to:

**5 x 4 million + 90 x 1.5 million = 155 million people living in the major cities**

Indeed, this is a rough sketch, but it corresponds to the estimate that the employed urban workforce in China is roughly 150 million people.<sup>2</sup> This is the Chinese market who can afford to buy (and not all of them at that) international products. It is sobering to understand that currently less than 15% of the huge Chinese population actually forms the China market.

Furthermore, although there is certainly an increasing number of strong professional Chinese managers, the vast majority of the population are not professionals. As of 2000, there was only an estimated 5 million university graduates in China. For example, the China Education and Research Network (CERNet) states that from 1979 through 1997, 829,100 people completed their associates or bachelor degree programs. This was 2.6 times the number who did so in the 30 years prior to 1979. From 1981 to 1996, universities and scientific research institutions granted doctoral degrees to 20,514 people and master degrees to 285,943 people. Although many Chinese students study abroad, the majority who leave China for international university studies do not return. China is developing a

<sup>1</sup> The World Bank estimates that as many as 200 million Chinese live below the poverty line.

<sup>2</sup> UCLA, Anderson School of Management, Global Window Program.

professional class, but it is small and developing slowly; and like many developing countries, China suffers from a drain of some of its best talent, as they look for better opportunities and a better life elsewhere.

Doing business in China today, is not about the size of the market. It is about the potential size of the market. Although China is growing fast, real change will take time, and there will undoubtedly be steps backward that will affect the market for international products and the economy as a whole. The central government will also remain involved, which will slow the pace of change and decrease the transparency of China's development. In considering these things, there is not an overwhelming pressure for companies to jump in and compete. On the contrary the last 20 years, and the reality of China's market, indicates that a well measured, slow approach into China is the best way forward for most companies.

## **Moving Forward**

In some people's minds, China faces one of two futures: 1) It will take over the world or 2) It will rise sharply but ultimately fizzle. Neither of these extremes is true. In reality, China will continue to slowly develop. For all nations, and especially one the size of China, and considering its previous level of isolation, there are no quick fixes. The consistent pursuit of policies that liberalize China's markets will create the most positive long term and lasting effects.

China and its people are very cognizant of the questions about the country's willingness or ability to live up to WTO protocols – to essentially undo centuries of highly politicized economic systems. It is only logical that China cannot solve all its problems overnight. However, the country's experience over the last 20 years proves that integration with the world economy pays off. Hence, China will continue its move forward. China's hard fought WTO membership all but guarantees this. As well, now with WTO membership, the tools become available to address protectionism in China's market.

China's restructuring in order to be considered for WTO membership was substantial and was accomplished in record time. The country made a tremendous commitment in doing this, and December 2001 marked the end of a 16 year long cycle of negotiations. As part of its trade liberalization agreement, China agreed to lower tariffs and to abolish market impediments. Both international and domestic companies now have the right to import and export and market their products on their own without going through a government intermediary. Average tariff rates on agricultural exports will drop from 31% to 14% in 2004 and on industrial products from 25% to 9% by 2005. China is also reforming its tax system to minimize distinctions between domestic and foreign entities, in-line with the WTO principle of national treatment; and China is clarifying its licensing procedures in accordance with the WTO's transparency requirement. These WTO agreements have opened up new opportunities in the service sector including banking, insurance, and telecommunications.

Nevertheless, make no mistake; China is a country that is changing its very fundamentals – its entire economic, political and social mindset. China is changing the way it manages its economy and is changing the way it governs the state. These are sweeping changes. Consequently it will take time. The time horizon for China is 50 years, not five years. For example, my Chinese colleague consistently reminds me, "*When we get there, we get there.*" China is a long play. This reinforces the important point that companies need not worry about being in China TODAY. It pays off to take a measured approach in how companies enter the market and organize their business in China.

## **Inside China**

America's, Europe's, and Japan's Sino romance have pushed the Chinese economy to grow at an average annual rate of nearly 9% for the past 20 years. The number of international companies doing business in China has grown exponentially. According to Chinese statistics, U.S. companies alone have invested over \$23 billion in the last ten years.

Since 1990, U.S. exports to China have grown almost 12% annually. Even then, this still only adds up to China consuming less than 2% of total U.S. exports. Hence, China still holds huge potential for most companies. For industrial sectors such as energy, telecommunications, medical equipment, and banking and insurance services, China is an interesting and very viable market. Now, with China's accession to the WTO, the number of sectors with market potential for international companies will expand even more.

Despite China's impressive economic development during the past two decades, reforming the state enterprise sector and modernizing the banking system remain major hurdles. For example, it was only four years ago that the government shifted banking practices from a quota basis to a commercial viability basis in terms of investment projects. Now, China's banking sector is scheduled to have full international access by 2008, but many experts question if China's banking system is robust enough to accommodate this time frame. China's huge state-owned banks have amassed outrageous sums of bad debt. Considering these financial system problems, together with the difficulty in finding employment for hundreds of millions of rural Chinese, and managing a workforce which includes over 75 million government employees, China may not be able to create investment levels high enough to fix these structural problems. These are serious long term challenges.

## **Trade and Investment**

Export growth continues to be the major component supporting China's economic expansion. According to IMF statistics, China's global trade totaled \$454 billion in 2000. China's primary trading partners include Japan, the EU, the United States, South Korea, Hong Kong, and Taiwan. The United States is one of China's primary suppliers of power generating equipment, aircrafts, computers, industrial machinery, raw materials, and chemical and agricultural products.

## **Foreign Investment**

China significantly revised its laws on Wholly Foreign Owned Enterprises (WFOE) and China Foreign Equity Joint Ventures in 2000 and 2001, easing export performance and domestic content requirements. This makes it far easier to set up business in China, and will help increase investment.

In 2000, China received nearly \$41 billion in foreign direct investment. International companies' investments produced approximately 45 percent of China's exports. For the past eight years, China has been the world's second largest recipient of foreign direct investment after the United States.

## **Science and Technology**

Science and technology have always preoccupied Chinese leaders. However, state run distortions in the economy and society have hurt the Chinese science and research and development sectors. The Chinese Academy of Sciences places most of China's greatest scientific talent into large, under funded state run systems that remain isolated from industry. Some reforms are beginning to address this problem as China focuses its efforts on opportunities in biotechnology and computers.

Although most Chinese students who study abroad do not return to China, there is strong evidence that they build networks with colleagues inside China. This will ideally facilitate increased international scientific cooperation in future years. The U.S., Europe, and Japan all have cooperative science and technology relationships with China.

### **Agriculture**

Most of China's labor force is engaged in agriculture, even though less than 10% of the land is suitable for cultivation. Virtually all cultivatable land is used to grow food, and China is among the world's largest producers of rice, potatoes, sorghum, millet, barley, peanuts, tea, and pork. Major non-food crops include: cotton and other fibers. These products furnish China with a large proportion of its foreign trade revenue.

### **Industry**

Major state owned industries are iron, steel, coal, machine building, light industrial products, weapons, and textiles. Overall there are approximately 8,000,000 industrial enterprises in China including small (1-3 employees) companies. International companies are well positioned to take advantage of opportunities created by China's WTO membership and subsequent increasingly relaxed barriers in these sectors.

According to the U.S. State Department, the best prospects for business in China include:

- Telecommunications Equipment
- Oil & Gas
- Medical Equipment
- Pharmaceuticals
- Cable TV and Radio Network Equipment
- Pollution Control Equipment
- Insurance – Life and Property
- Airport and Ground Support Equipment
- Computers and Peripherals
- Home Building Materials & Decoration Products
- Software
- Education & Training
- Plastic Materials & Resins
- Agricultural Chemicals

### **Doing Business In China**

Despite China's entry into the World Trade Organization, and its far reaching reforms, there are many other changes which have not yet taken place. Cultural capital is the most important form of capital. Like natural resources cultures significantly affect the wealth generating power of a nation. Cultures and economies that embrace ethical business standards and the rule of law economically prosper. However, observing law and order, and transparent decision making are not core Asian business values – at least not by international standards. China and other developing countries are growing and legislating

these values, but here again this is a major cultural shift; it takes generations to cycle out entrenched political, social, and economic systems, and the philosophies of what an acceptable business practice is. With this in mind, international companies must deal with the current China environment in a realistic manner. Companies must digest this mindset gap and evaluate risks carefully.

China is ranked 31 out of 50 in IMD's World Competitiveness Scoreboard; And scores 3.5 out of 10, in Transparency International's Corruption Index (10 = highly clean and 0 = highly corrupt)

The problems of doing business in China can be grouped into four categories:

1. China's business environment is unpredictable and lacks transparency. China's current legal and regulatory system can be obscure, inconsistent, and often arbitrary.
2. China has a protectionist communist government, which takes a very long term view. Many parts of China's state bureaucracy still protect local companies and state owned businesses.
3. China is still a planned economy. Although it is changing, the understanding of free enterprise and competition is imperfect to say the least. True to communist governments, the Chinese economy is prone to building over capacity because it is a function of central planning not a function of supply and demand.
4. As stated earlier, international companies are over enthusiastic about China.

For example, looking at acquisitions and takeovers, China's lack of merger laws and policies and the absence of guidelines for property rights have posed nearly impossible obstacles for international merger and acquisition activity in China. While a share buy-out can be done under existing regulations, it is subject to the approval of all partners in the venture and also the supervising government agency. More recently, foreigners can now purchase shares in a small number of Chinese companies that are traded on Chinese stock exchanges, however foreign investment is restricted to less than majority ownership. Eventually, the laws will be rewritten to accommodate mergers and acquisitions, but this is still years away.

Another example is China's notoriously weak legal structure, resulting in the failure to enforce contracts and court decisions. Business and politics are not transparent, and laws and regulations are unevenly applied. This makes it significantly difficult for international businesses to plan for changes in the Chinese marketplace. More specifically, the Chinese view of a contract is not set in stone – a contract is not a blueprint, nor an operating document in China, and it can be changed at any time. One measure being taken by international companies to dampen the effects of China's notoriously corrupt court system is to insist that their contracts with Chinese partners and clients include a provision for international arbitration. Unfortunately, the default setting in China is to trust no one. The only reliable method is to begin with someone who is known to be honest; and politically connected is helpful too. However, where do you find him, and how do you know he is honest and politically connected?

## **Setting Up Shop**

WTO membership is bringing an end to China's monopoly of state owned trading companies, and has paved the way for international companies to import into China without working through local intermediaries. For years, the Chinese government used joint ventures to crack open new industries and get hold of technology. Indeed, a joint venture was originally the only way into China; and due to complex laws for many companies this is still the most practical way in. However, as laws have been relaxed, many international companies are now buying out their Chinese JV partners, to reduce management problems, and to put a more international corporate stamp on the business.

The Chinese government recognizes three forms of business organizations which are available to international companies:

### **1. Representative Office**

A Representative Office can engage in business activities which do not result in direct profits being made by the office. Representative Offices are not allowed to operate as partnerships or sole proprietorships in China, because they are not recognized as legal entities or persons. However, they are allowed to conduct indirect activities such as product introduction, market research, and technology exchange.

### **2. Wholly Foreign Owned Enterprise (WFOE)**

A Wholly Foreign Owned Enterprise is a business formed in China entirely with foreign capital, completely under foreign control, and without any formal Chinese ownership. WFOEs are set up as limited liability companies and are viewed as separate legal entities. WFOEs can generally control their own governance through their articles of association. WFOEs are the best choice for international companies who want to keep 100% control over their investments in China.

### **3. Joint Venture (JV)**

A joint venture is a business arrangement in which a Chinese partner and the international company create a new business entity and enter into an official contractual relationship. The two parties share investment and operating expenses, management responsibilities, and profits and losses. Despite the power of, and in some cases the obvious need for, a domestic Chinese partner, the history of international companies in China proves that it is extremely difficult to arrange and manage a satisfactory partner relationship.

Originally, Wholly Foreign Owned Enterprises were only permitted to be established in some free trade zones or were only based on high technology businesses with strict export requirements. China significantly revised its laws on WFOEs in 2000 and 2001, and they are now the most popular type of business formation in China. The growth and the value of new WFOEs now exceeds that of JVs. In 2000, WFOEs accounted for 45% of total foreign investment. International companies pursuing a global strategy in China will prefer setting up a WFOE because global coordination is most likely to be achieved by a company that is 100% owned and controlled by the international company.

## **Doing It Right**

China is a very fragmented market. Although industries such as aircrafts and locomotives, have the luxury of viewing China as a single market, most companies need to view the market as "many Chinas." Most international companies find themselves engaged in multiple partnering relationships in order to address all of China. The good news is this is beginning change, especially in the area of such consumer goods as refrigerators and

washing machines. However, for most companies China remains similar to the European Union, in that it is a somewhat united market of many markets. China can roughly be divided into at five major regions:

1. The South (Guangzhou)
2. The East (Shanghai)
3. The Central/North (Beijing-Tianjin)
4. West China
5. The Northeast

This means different business plans and different partners may be necessary in different regions of the country. Also note, language and dialects are not the same from one region of China to the next.

Logistics is another day-to-day challenge in China. Managing transportation within China is much more challenging than in the United States or Europe. Whereas the United States and Europe have well developed transportation infrastructure and commerce regulations are relatively standard, companies in China are forced to contend with a number of issues when it comes to moving products into, out of, or even just within China. The logistics infrastructure is improving, but only in China's urban areas. There are many informal distribution channels to deal with, and often there are so many people involved in the transaction that it is difficult to manage goods from end-to-end. In China there are more than 16,000 registered logistics companies. The industry is highly fragmented, with no single logistics provider controlling more than two percent of the market. There are numerous hurdles in China even with basic transportation and supply chain logistics. Some international companies such as Coca-Cola, Nokia, and Johnson & Johnson have more or less taken full control of their supply and distribution chain activities in order to build the national markets they aspire to. Even outsourcing to international logistics companies such as UPS or TNT does not guarantee a reliable supply chain.

Intellectual property remains a very real concern in China. The attractiveness of the market and the believed competitive pressures sometimes overwhelm a company's desire to protect its intellectual property, and too often it is bargained away. Some companies offer intellectual property as a way of ingratiating themselves with their Chinese partners. Still others, simply do not fully understand the process and inadvertently give up their intellectual property along the way. This results in a number of partnerships where IP has effectively been lost by the international company. The Chinese government is reaching for all the technology it can grasp, to pull it into China. Although the WTO will help in this regard, intellectual property will remain a significantly hot issue in China moving forward.

On a more positive note, in my opinion the concept of *Guanxi* – the power of and the importance of relationships in China – is often overstated. Many international companies are intimidated by the almost mystical quality that some people attach to this part of Asian culture. The fact is, everywhere in the world business depends highly on personal networks and friendships. Relationships run deep in the United States too. Any company anywhere, trying to set up business without a good relationship in the region is setting itself up for failure. Rapport is the best type of equity any company can build in any market. *Guanxi* is indeed a critical component in China, just as network building, friendship, affection, and favors are significant pieces of the business puzzle everywhere in the world. In this respect,

Chinese are no different from Americans or Europeans – They also appreciate friendship sincerity, and help especially in their times of need.

Many international companies struggle with the complexity of surviving in the Chinese market and simultaneously meeting corporate targets. This results from unexpected legal obstacles, talent and management issues, different work habits, and inflated corporate expectations. International companies need clear strategies for succeeding in China. As always, the use of first class talent remains the ultimate key strategic factor – success always comes down to the people doing the job. The greatest challenge international companies face is finding and motivating strong talent. In a market as fraught with challenges as China, talent is even more important. Strong expatriates and local Chinese managers, who are equally at ease with the culture of the international company and with the Chinese environment, are essential. Too many companies parachute their executives in, but have not prepared them for what comes next.

International companies with a clear strategy and objectives are more likely to succeed in China, as opposed to those you opportunistically rush in. Companies who have a clear idea about who they are, what role their China business plays in their global strategy, and who are realistic about the China market, will more successfully organize their business and will enter into more productive partnerships. Key success factors in China are not really different from those in other markets. International companies moving into China need the following:

- Talented management
- Well thought out business strategies and objectives
- A trusted Chinese advisor(s) or partner
- Products adapted to the local markets
- Competitive quality and service
- A reliable and cost effective supply chain

## **Conclusion**

There's no question China will be a big market, but the market is still in the early stages of development. This development will continue to grow, and China's accession to the WTO brings even more opportunities. Problems will not disappear over night, but now with China's WTO membership and disposable income growing, China's market will increasingly open and expand. This will be a gradual process, but the expanse and size of the economy make China an important part of every company's international strategy.

True to centrally managed economies, China is in some ways still a big lie. It is not representative of reality – it is what the communist government wants it to be. The Chinese government is highly organized, and it can afford to exist; It will of course outlast any company. With approximately 75 million workers, the Communist Party is still the biggest company in China, and will remain so for some time. That said, one very significant change in the Communist Party's politics is they are now allowing private entrepreneurs into the Party ranks, albeit only a token number for now. The WTO will push China's government ever faster away from protectionism, and increasingly toward sincere cooperation and openness. The country's restrictive trade practices including high tariffs, lack of

transparency, and inequality in the application of laws will be addressed through WTO channels now that the tools exist to do so.

Despite the complexities and problems, there are many reasons to be optimistic about China, assuming its market continues opening to increased trade and investment. Rock bottom land and labor costs, and the market potential are only a few of the reasons for starting a business in China. However, the “great call of China” should not persuade companies to jump in with abandon. International companies must understand and plan for the wide and disparate cultural gaps and day-to-day logistical issues of getting business one *before* investing heavily in China. Success in China requires companies to thoroughly investigate the market, pre-qualify potential business partners, take steps to assure that they will be paid, and craft contracts which minimize misunderstandings between the parties.

China is a market for companies who want to ultimately take big swings. That is NOT to say, that entry into the China market requires a big swing right out of the blocks. However, ultimately to be a player, companies will need to invest significant sums and be prepared for significant differences in what it takes to get business done in China compared to their other international operations. China is a long, long term strategic move. It’s a big bet, but China WILL ultimately evolve into the absolute largest market on earth. Companies who have adequate resources, business, market, and cultural intelligence, and endurance will likely be rewarded in the long term.

Yes, companies should be expanding into China, but they should start small and then move forward. Like using simple dollar-cost averaging for personal investing, the point is not to bring Wall Street, or in this case the Chinese market, to its knees. The key is consistent strategy, investment, and execution. It is important not to be carried away with the “potential” of the China market. It is huge and complex; and consequently it is not going away, nor is the competition conquering the whole thing by next week.