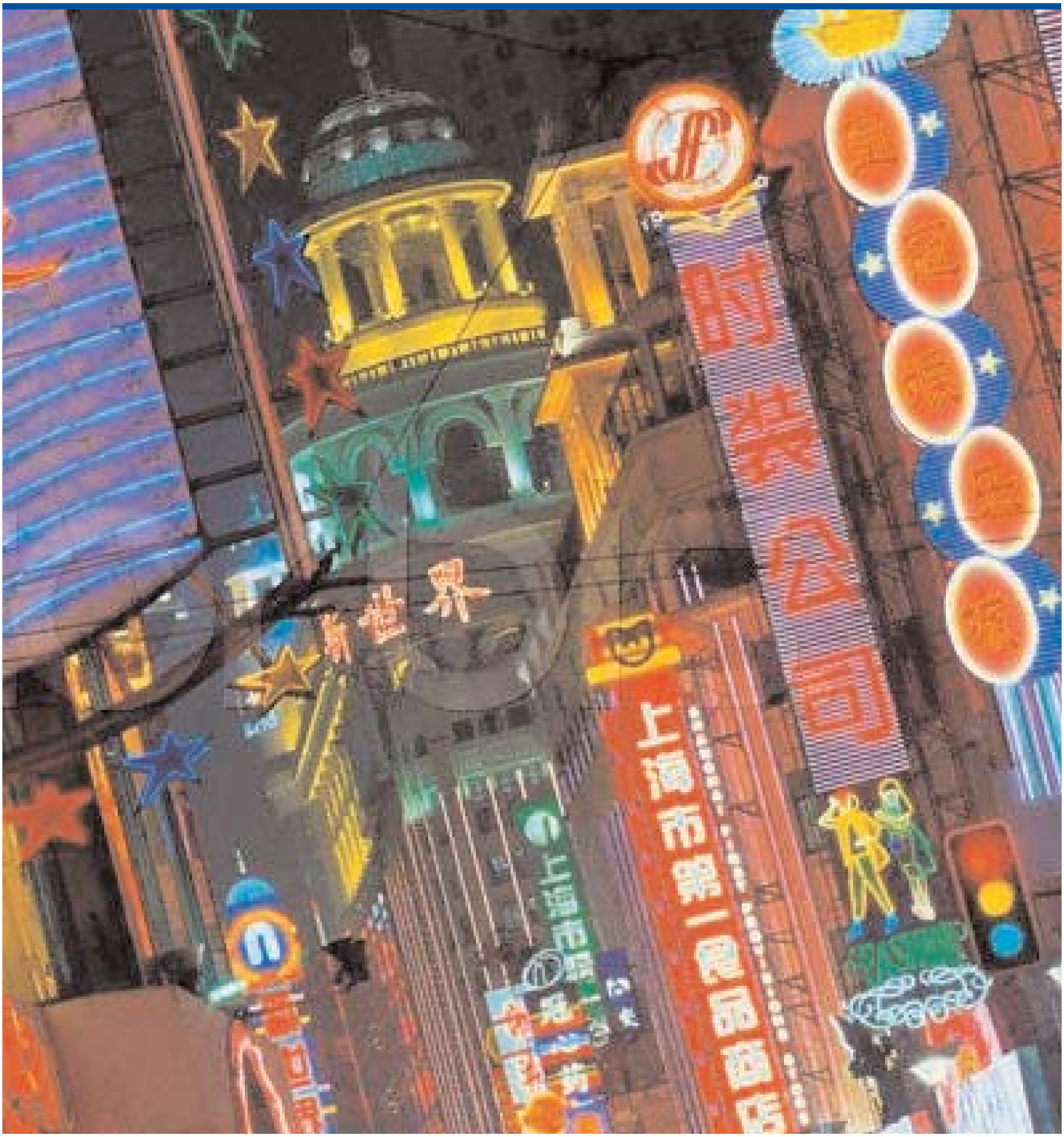

Preparing for China's

China sees itself as an incubator for top companies rather than the workshop of the world, say **Orit Gadiesh**, **Paul di Paola**, **Luca Caruso** and **Oi Chung Leung**

China's rise as the world's factory is well known. But another story is unfolding with amazing speed: China as a huge market for multinational companies (MNCs) and as an emerging challenger in MNCs' core markets. At a stunning pace, China is absorbing foreign direct investment, creating a large middle class and learning to adapt western technologies in a modern Great Leap toward economic prominence. China expects to create as many as 50 of the world's 500 largest companies by the year 2010 – up from 15 in 2005 (*see The Views, facing page*).

The implications are clear. Global firms must find a way to penetrate China's expanding market and defend their global position – and with the same determination as the Chinese.

Building barriers

For global firms, preparing for China's next Great Leap requires not only relearning vital engineering and sourcing skills in order to compete on cost, but also strengthening their customer franchises. In an increasingly flat world of commerce, knowing and serving core customers can create the most effective barrier to low-cost competition.

How far and how fast will Chinese companies leap? Looking back at how Japanese and Korean companies became global leaders, a trajectory emerges with three distinct phases. We will call them "build", "borrow" and "buy".

Japanese and Korean companies built local manufacturing, often in order to provide low-cost sourcing to MNCs. They borrowed capabilities through technology licensing and joint ventures to improve quality and processes and begin exporting. Finally, they bought assets and brands abroad to secure their global positions.

China catches up

Chinese companies are travelling the same path – but are on track to equal their neighbours' trajectories in 10 to 15 years compared with the average 25 years it took Japanese and Korean

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firms to become global leaders. How? Chinese manufacturers are folding "borrow" into "build" and even "buy".

First, Chinese companies are borrowing capabilities and technologies as they supply giants such as Wal-Mart. To speed the process, China's policymakers now encourage foreign direct investment to include a China-based research and development (R&D) component.

In this way, China has become the world's leading exporter of toys, games and clothing, as well as the number one supplier in office and telecoms equipment, and the number four provider of machinery and transport equipment. It is now the world's third-largest exporter after America and Germany, fuelled by MNC manufacturing in country.

Second, Chinese firms are buying management know-how as well as global brands – Lenovo's successful bid for IBM's personal computer (PC) business, for instance, and white goods-maker Haier's attempt to take over Maytag. They are being aided by a government policy that is staging development, region by region, thus assuring low-cost labour for decades. Meanwhile, it is also orchestrating the rise by 2010 of a 100 million-strong middle class of domestic consumers, with annual per capita income averaging $20,000 and assets averaging $75,000.

The microeconomics of China's progress surface when you compare two sets of Japanese, Korean and Chinese companies. In all cases, companies move through phases of building, borrowing and buying assets. But with China's leading corporations, it is happening all at once.

Toyota, Hyundai and Shanghai Automotive

The automotive sector shows what happens when MNCs fail to compete on cost. Japan's Toyota became the most profitable automaker in the world, building its global manufacturing capabilities, and leadership in quality and technology, and then in products over 34 years.

After conquering its internal market, Toyota initiated global exports in 1957 and, by 1974, the Toyota Corolla had become the world's best-selling model. Korea's Hyundai started in 1968 as an original equipment manufacturer (OEM) for Ford and took 28 years to move from its first exports in 1976 to top-selling car brand in 2004, when it broke through 5% global market share. Neither Toyota, nor Hyundai bought foreign assets until their products were well established abroad.

Turn now to China. Shanghai Automotive, which began as an OEM in 1985, has entered into 18 joint ventures and attempted to buy Britain's Rover group, eventually purchasing two models that it could export under its own brand. Rover, itself, was purchased by China's Nanjing Automobile. With MNCs such as GM and Volkswagen now making money in China, and with China's own mass market, inexpensive labour and growing transportation needs, the country appears en route to join America and Japan as a world automotive leader.

Sony, Samsung and Lenovo

The same accelerated progression plays out in Asia's technology industry. Sony, which entered the US in 1960, burst on the world scene with its hit Walkman portable radio in 1979. Sony only borrowed unique technologies through acquisition where it wanted to test synergies with new products and customer segments adjacent to its core business.

For example, in 1988 it purchased CBS

next Great Leap

THE VIEW FROM THE MULTI-NATIONAL COMPANIES

Since Deng Xiaoping's capitalist reforms, most CEOs have focused on the first half of China's story, seeing China as a land of opportunity for inexpensive sourcing and, most recently, new sales in a vast market.

What do the statistics look like? A number of 2005 surveys found that, despite early losses and failed ventures, about 70% of US firms in China are making money – and with margins equalling or surpassing home margins. In our interviews of MNCs, we found that 80% of manufacturing ventures were profitable. Foreign sales into China have doubled since 2000. And nearly 50% of MNCs expect 10% of their sales to come from China by 2009.

Slowly but steadily, MNCs have figured out the six keys to success: differentiate your products; move production into line with local cost structures; design offerings for local tastes; create smart partnerships; develop close government relationships; and hire strong, "China-fluent" management, both local and expatriate. China is already a top market for Motorola, which generated $3 billion of Chinese revenue in 2004, and Yum, which owns KFC, Pizza Hut and Taco Bell, and sold more than $1 billion.

Records, and in 1989 Columbia film studios. Given its relatively small home market in Korea, Samsung rose through a strategy of producing for the world. Just 17 years after Samsung began exporting, it was the world's largest producer of thin film transistor flat-screen displays, memory chips, colour monitors, colour TVs and DVD/video-player combos.

China's Lenovo covered the distance in about half that time. Founded by 11 scientists on a Beijing campus in 1984, Lenovo began as a distributor of foreign-brand PCs, including IBM and Hewlett Packard. First called Legend, it became a motherboard supplier in 1989, then from the late nineties it borrowed know-how through more than a dozen joint ventures with the likes of AOL and Microsoft. In 2003, it changed its name to Lenovo and last year leapt ahead by acquiring IBM's PC unit.

Curves on the road?

China's accelerated development and focus on production have countervailing weaknesses that MNCs can exploit. Beyond undercapitalized banks and a moribund stock market, Chinese companies struggle with "soft" issues, such as understanding customers, building brands, innovating and developing human resources and organizations.

The emphasis on low-cost manufacturing for retailing giants such as Wal-Mart, for example, means that Chinese companies have little experience of working directly with western customers or selling products into diverse retail and distribution channels in mature markets. China spent just 1.5% of its national income on research and development in 2004. That is roughly half the 2.7% invested in America, and 3.2% spent in Japan. Admittedly, when you factor in the low cost of Chinese engineering talent, the numbers are closer. Yet most of China's R&D is aimed at adapting products solely for the Chinese market. And China's lax intellectual property rights laws to date have deterred many MNCs and Chinese companies from locating anything except basic R&D in country.

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Chinese companies are behind, too, in training skilled managers. Although as many as 700,000 engineers graduate each year, according to government statistics, China only recently began investing in business-degree programmes.

How MNCs can gear up

Whether China's ascendancy comes sooner or later, MNCs need to prepare now. How can today's global leaders meet the challenge?

»Develop Chinese toehold operations into self-standing and profitable units. First, MNCs will need to plunge in and learn how to play in the most competitive market in the world. Colgate, for example, became China's top oral care company, in large part by cutting production costs and passing those savings on to consumers. Other MNCs need to follow Colgate's lead.

»Dramatically reset the standards for cost competitiveness. Committing to compete in China's home market will reinvigorate MNCs' global competitiveness. To succeed, they will have to relearn how to compete on cost, prune legacy systems, update technologies and even determine new sourcing strategies, or locales, such as eastern Europe or India – a tall but necessary order.

»Protect the value segments in your core markets. MNCs will also need to keep a close eye on their value segments. Asian precedents predict that Chinese companies will gain a toehold in the value end of any market they enter, building up a core of customers who shop on price, as they climb within categories toward premium products.

»Treat human resource management as a strategic global function. MNCs must ensure that their human resources departments are developing and supplying leadership at every level of the organization. Companies will need to be the best in class at this in every country they compete, in order to maintain an edge in recruiting, motivating, deploying, developing and retaining management talent.

THE VIEW FROM CHINA

The view from the towers of Shanghai looks more like a fast-forward apprenticeship to grow Asia's next crop of global champions in critical, technology-intensive industries. Moreover, China is set to execute this feat at a 95% labour cost advantage to the US and Japan's, and with a workforce capacity that is 10 times Japan's and 4.5 times America's. To this effort, China's business leaders bring a fierce resolve to modernize, not westernise.

Indeed, the nation's exports of office and telecom gear already exceed those of Japan and Korea and are virtually at par with those of America. This extraordinary growth is coming at the expense of China's Asian neighbours and as a result of wide-scale MNC production there. China's next push to buy global branding is foreshadowed by such moves as Lenovo's purchase of IBM's PC business and white goods-maker Haier's bid for Maytag.

»Accelerate and globalize R&D. To stay out in front, MNCs will have to both quicken the pace of R&D and widen its geographic footprint. Constant innovation and creating faster product cycles make it harder for Chinese companies to fashion knock-offs.

»Ensure each business is delivering what it promises to core customers. MNCs should strive to get ever closer to their core customers, innovating in ways that serve them better and strengthen their loyalty. This will require perfecting deployable segmentation to design the right experience for the right customers and to deliver the right experience across the entire organization. And they will need to build customer feedback mechanisms into their organizations to improve customers' experiences continuously.

Where will China's next economic leap take its companies? Onto foreign shores. The question is whether Chinese firms will land on their feet when they arrive or stumble.

The answer to that depends largely on what MNCs do now. GA

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