



A guide to doing **business** in China

China lends itself to sweeping statements about the nature of doing business there. Most are unfounded.

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How does a multinational company take advantage of opportunities in China without getting burned? One of the biggest hurdles is coming to terms with the real China, a land of great geographical, social, political, and industrial diversity. As a starting point, it's essential to cut through the thicket of misunderstandings and misinformation about doing business there. Clearing them up won't guarantee the success of investments, but it will at least increase the chances of getting the foundations right, particularly at a time when fears that the country's economy is overheated are further complicating decision making.

China lends itself to sweeping statements. Here are a few making the rounds: China will be the next economic superpower; its economy is still state run; foreigners don't make money there; relationships count, so a partner is needed. These provocative claims can start a conversation, but they are hyperbolic, misleading, out-of-date, or just not true.

An economic superpower?

Let's look more closely at the observation that China will become the next economic superpower. The country does have a gross domestic product of \$1 trillion and will probably continue to grow quickly. But it will remain a midsize economic power for the next decade. China now has a GDP roughly the size of the United Kingdom's. It may pass Germany in the next few years. But it isn't likely to catch up with Japan until 2020 and, if

current trends hold, won't surpass the United States until 2040. It is, however, an important source of *growth*. The economies of both Japan and South Korea are expanding largely as a result of exports to China. From sectors such as power plants to packaged goods, its share of global growth makes it number one in the world.

Macroeconomic hype can obscure actionable microeconomic trends. Fast economic growth, for example, will put home ownership within reach of hundreds of millions of people; in the past five years, more than five million new homes have been sold. Foreign companies can serve this population by stepping back from the premium segment, to which many are naturally attracted, and selling better-tailored value goods, as the South Korean conglomerate LG Electronics has done in air-conditioning. Increasing numbers of Chinese can afford locally produced durable goods (for instance, refrigerators, cookers, and washing machines). The market penetration of these items is now above 70 percent even in second-tier cities, such as provincial capitals. And although the middle class is a small percentage of the total population, in China that is a big number. Only 4 percent of the country's people have household incomes of more than \$20,000—but that translates into a market of more than 50 million, who are spending increasing amounts of money on things such as services, education, health care, and travel as well as on processed and packaged foods.

China's importance in the world economy clearly varies greatly by sector. In some, the country plays a critical role in the global balance of supply and demand (basic materials and energy), the supply chain (personal computers), or the growth of demand for consumer products (automobiles and mobile phones). Infrastructure-focused multinationals that sell products from elevators to subway systems are finding China to be their most important market for growth. In other fields, the country is not yet a significant factor in global trade, because sophisticated customers are lacking (for high-performance fibers, to give one example) or regulatory barriers impede competition (as in the financial-services and media industries).

In some sectors, late-arriving foreign companies may have already missed the boat: market-shaping positions have been claimed in the manufacture of automobiles, consumer electronics, processed foods, and pharmaceuticals. Here, bigger and bigger commitments are needed to shape the industry structure and so lay a path for sustainable, superior returns. Many companies with the resources and skills to make those commitments are already in China and have been there for as long as 20 years. Volkswagen's partnership with the Shanghai Automotive Industry Corporation and Shanghai's government, for instance, began in the mid-1980s and has since grabbed the dominant position in the Chinese automobile market and a handsome payback. Motorola has invested \$3 billion in eight joint ventures and

EXHIBIT I

Three Chinas

2002¹ population and GDP per capita in China by autonomous region, municipality, and province



Western China		Interior region		Coastal region	
Population, millions	83	Population, millions	710	Population, millions	482
GDP per capita, \$	773	GDP per capita, \$	765	GDP per capita, \$	2,117
Share of national GDP	4%	Share of national GDP	38%	Share of national GDP	58%

¹Latest available provincial data; figures are rounded.
 Source: *China Statistical Abstract, 2001*; *China Statistical Yearbook, 2003*; *China Urban Statistical Yearbook, 2000*; Global Insight; McKinsey analysis

26 local subsidiaries over the past 15 years. Nonetheless, China’s government is open to proposals that bring new technologies, capabilities, and business models to the country. Multinationals will not be prevented from investing if they can show that they have leapfrog opportunities.

For some, the opportunity in China lies no farther than Beijing, Guangzhou, and Shanghai. Foreign executives concentrate on these big eastern cities primarily because the country’s coast represents 58 percent of the economy, though only 37.8 percent of the population. Average GDP per capita in coastal areas is about \$2,100—in Shanghai, it is nearly \$5,000—far higher

than that of the rest of China (Exhibit 1, on the previous page). In fact, China’s smaller cities and rural areas, far into the interior, already account for more than 50 percent of consumption of many consumer goods. Now that the populations of these areas are becoming more active economically, their markets are growing faster than those of top cities.

Some consumer goods multinationals, such as Procter & Gamble (see the following article, “Understanding the Chinese consumer”) and Groupe Danone, have recognized this opportunity by adjusting their marketing and product strategies to serve the more modest income brackets typical of such regions. (The recent battle between Anheuser-Busch and SABMiller for control of Harbin Brewery Group, located in the large but poor second-tier city of Harbin, also exemplifies this trend.) Meanwhile, Coca-Cola has introduced flavors and products to capture local tastes across the country, and so have Uni-President Enterprises and Tinghsin International, the world’s two largest noodle makers. Industrial multinationals that want to enter the smaller cities and rural markets have had to follow a different approach, with more emphasis on financing and distribution.

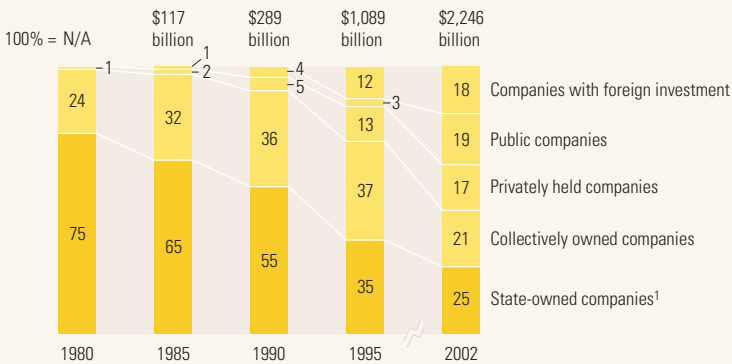
The role of the state

Executives who make investment decisions about China believing that its economy is dominated by the state, and is thus sclerotic, are in for a shock. Government ownership is declining rapidly; today only about one-quarter of China’s industrial output is generated by state-owned enterprises (Exhibit 2). Springing up in their place are private companies and companies with foreign

EXHIBIT 2

Good-bye, comrade

China’s industrial output by type of enterprise, %



¹Includes enterprises with controlling interest held by government.

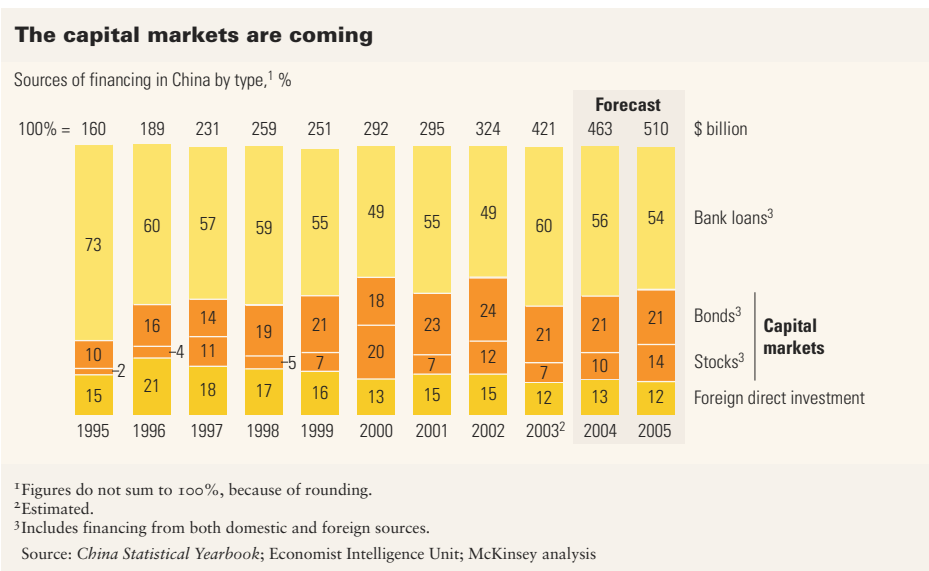
Source: China Industry Economy Statistical Yearbook, 2001; China Statistical Yearbook

investment. Except in a few sectors—defense, telecommunications services, and energy, for example—much of the economy is now in private hands. The rationale is straightforward: China’s leaders recognize that state enterprises are inefficient and must be stimulated from the outside to compete in the marketplace. A corollary is that China’s government now relies far more on taxes from private commerce and less on revenues from the declining state sector. Over the past five years, tax receipts have risen to 17 percent of GDP, from 11 percent.

Even more important, financing has started to move toward the capital-markets model. In the past, more than 70 percent of all investment funds in China were channeled through the state banking system. Recognizing its inherent inefficiencies, the government has both initiated banking reform and encouraged the growth of a more robust equity and debt market. China’s stock market is already the second largest in Asia, after Japan’s. By 2005, capital markets will probably generate more than 35 percent of corporate investment, and bank lending will have declined (Exhibit 3). With this shift, the government hopes that Chinese enterprises will respond to shareholder expectations.

What does it mean for foreign companies that so much of the economy is in private hands? For one thing, it suggests that local competitors are economically rational. That conclusion comes hard to multinationals facing low-price Chinese competitors, but an analysis of their costs shows that many can be profitable at price points far below those global companies

EXHIBIT 3



require. The main driver of this profit differential is the locals' much greater efficiency in capital usage. In some industries, the use of local equipment, design, and construction firms allows the Chinese to build factories and install machinery for just 30 to 50 percent of what their foreign rivals would pay. Moreover, Chinese entrepreneurs have succeeded by expanding their companies, over a decade or more, mostly in competitive sectors of the economy, not through sweetheart privatizations. Some of China's most successful entrepreneurs compete in relatively low-tech sectors: auto components, furniture, steel, and textiles.

Multinationals that fail to take advantage of local resources, preferring instead to stick to a global formula, run the risk of creating uneconomic cost structures. But multinationals that don't make this mistake can benefit from China's unrivaled potential as a global sourcing center. General Electric, for example, has more than 300 purchasing agents in the country who certify suppliers for global sourcing. The company's stated goal is to have \$5 billion in Chinese sales and to source \$5 billion worth of products in China by 2005. Samsung also has a large presence. Winners also harness China's human-resources pool as a global advantage. GE, for instance, has set up its North Asia customer-service center in Dalian, Intel and Microsoft have R&D centers in China, and HSBC does much of its back-office work there.

EXHIBIT 4

Profiting in China



Source: 2003 American Chamber of Commerce (Am-Cham China) survey of 254 US companies; McKinsey analysis

Foreign executives may not understand the extent to which the Chinese economy is now open to the world. No other economy built on scale has allowed foreign participation in the way China has; what other country, for example, let foreign companies dominate its auto industry before domestic competitors really got started? Much the same thing has happened in telecom equipment, modern retailing, and logistics. In China, fast economic growth is generally regarded as more important than local ownership. Government leaders are distinctive in recognizing the value of

foreign capital in accelerating the pace of the country's development and in their willingness to experiment with different ways of introducing foreign capital. China thus attracts more than \$50 billion a year in foreign direct investment, second only to the United States. The technology, energy, and

automotive sectors are the major fields (other than real estate) for foreign investment, and companies such as BP, Motorola, Royal Dutch/Shell Group, and Samsung rank among the leading investors.

Making money in China

Some businesses have resisted taking the plunge into China because they fear that foreign investors can make money only in the long term, if at all. In fact, the profits of multinationals in China are up sevenfold since 1990, and it is one of the largest sources of overseas profits for many companies. Dozens of consumer-oriented multinationals, with sales running into many billions of dollars, have profitable businesses in China and are rolling out coverage to 30 to 50 cities. P&G and Yum! Brands (a PepsiCo spin-off that owns restaurant brands such as KFC and Taco Bell) say they are making money in China. Other profitable investors include AIG, Alcatel, Carrefour, Motorola, Nestlé, and Siemens. Goldman Sachs estimates that Volkswagen has generated higher profits in China than in Germany during recent years, and in 2004 more Buicks will likely be sold in China than in the United States. These investors would be unlikely to go on plowing billions of dollars into the country if they were not getting a reasonable return.

According to the US Department of Commerce, the net income of US foreign affiliates based in China and Hong Kong rose from \$1 billion in 1990 to more than \$6 billion in 2002. A survey of China by the American Chamber of Commerce (Exhibit 4) and other data indicate that more than 65 percent of US companies in China are profitable and that their margins in China are equal to or greater than their global margins. This market's challenge is that profits must often be reinvested to maintain market position. The sheer size of China, coupled with its rapid growth and competition, means that even market leaders must continually invest to maintain share.

Furthermore, interested foreign companies must stake a considerable claim now if they want to be in China at all. Its markets evolve quickly, and the best deals take place before the competitive free-for-all starts. The right way to proceed depends on the sector and, in particular, on how well China adheres to its commitments to the World Trade Organization. Consumer goods and pharmaceuticals, for instance, are already very competitive, so the WTO-induced opening has had a minimal impact. In more capital-intensive industries, such as automotive and energy, China's entry into the WTO increases competition through lower tariffs but is unlikely to change the industry structure dramatically given the incumbents' strong position.

WTO membership will have its greatest impact in financial services, retailing, and distribution. In financial services, the deregulation of banking, insurance, and securities makes competition likely by 2006. The time is thus

right for leading companies to secure their initial positions and to build brands and local workforces. HSBC's preemptive investments—before the arrival of competition—already exceed \$1 billion. Citibank has a credit card joint venture, with Shanghai Pudong Development Bank, that will allow it to capture a profitable early-mover opportunity, and AIG has built an early lead in insurance in Shanghai.

In retailing, the market is developing quickly, but opportunities remain to introduce modern trade formats such as hypermarkets, discounters, and specialty stores. (Carrefour, though, was developing hypermarkets even before the coming of deregulation.) In distribution, the expansion of big local companies and of nationwide highways creates opportunities to

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build logistics businesses, which have so far been largely the preserve of local and Asian companies, though a few European ones are starting to arrive. Finally, the media industry historically has been among the most protected in China, but rising

consumer demand and the restructuring of domestic media groups will create opportunities for foreign companies through joint content development, distribution ventures, and even multimedia. News Corporation and Viacom have been among the most aggressive companies in defining their position through ventures with China Netcom, Shanghai Media Group, and other state enterprises.

Relationships

Many executives are convinced that relationships are the key to doing business in China. That was certainly true in the early days of its economic opening to the outside world, when its decision makers had few ways of determining which companies could truly deliver what they had promised. Accordingly, lengthy discussions, often accompanied by extensive socializing, were the norm as the country's negotiators strove to understand their foreign counterparts. Now the Chinese, with more than 20 years of investment experience under their belt, are looking at the tangible business track records of foreign companies. Those that fail to bring tangible advantages, such as new capabilities, technologies, or business models—as well as a record of success—are unlikely to win the deal, no matter how good their relationships.

Nevertheless, a strong government-relations program remains an important factor for success in China, where, as in other emerging markets, the state uses its influence over market access and business rights to shape how far

foreign companies can go. Unfortunately, for many of them the management of government relations often takes a backseat to other business operations and, most important, lacks long-term consistency. Such companies have government-relations departments in China but plan and execute less systematically in this respect than business units usually do.

Finally, joint ventures are less important as a success factor in China. In fact, true 50-50 joint ventures are increasingly rare as foreign investors realize that their Chinese partners can't add the expected business value, particularly in go-to-market access. In response, investors are going it alone; wholly owned enterprises already account for more than 50 percent of annual investment in China. Partnerships, including long-established ones, are being restructured as the foreign and Chinese parties resolve inequalities in performance by buying out the other side. Even government-driven deals can be restructured if the price is right: after cooperating with the Ministry of Information Industry for more than a decade, Alcatel moved from minority to majority control of its venture, having persuaded the ministry that its technology had great value. Fuji Xerox and Unilever likewise have purchased their partners' share of their joint ventures. In the future, wholly owned enterprises and acquisitions will dominate foreign investment in China, much as they do in the rest of the world.

Generalizations about China may be interesting conversation starters but are potentially dangerous distractions for companies considering investments there. The best advice is to focus on your own industry and operating issues. Performance in China varies greatly within industries, and the market operates on the winner-takes-all principle. The main concern is to become that winner by responding nimbly to fast-changing market dynamics and by relying as much as possible on skilled local managers, who are still rare in China. For companies operating in sectors that are not yet fully deregulated, the focus should be on creating a competitive advantage before the gloves come off. Merely transferring Western business approaches that fail to match China's reality won't work. **Q**

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