strategy+business

ONLINE NOVEMBER 12, 2012

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This article was originally published by Booz & Company.

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As China's once-in-a-decade leadership succession gets under way, another transition has been capturing headlines: the country's recent lackluster economic performance after years of double-digit growth. The Chinese economy reportedly grew only 7.4 percent in the third quarter of 2012 — its lowest growth rate since 2009 — and if the economy finishes the year as projected, this rate will mark a 13-year low. The decline varies by industry. Hardest hit have been businesses related to heavy industry and to the real estate sector; new home prices in many cities continue to drop because of government policies intended to control inflation. Growth also varies by region; some of China's interior and western provinces have experienced above-average rates of growth, whereas growth in the traditionally wealthier coastal provinces has cooled.

But other indicators tell a different story. Beijing recently reported that industrial output grew 9.2 percent in September, and retail sales increased 14.2 percent during the same month. Sectors such as healthcare and other services continue to grow strongly. And even as the growth rate comes down, actual GDP continues to expand. Both government officials and executives on the ground say that the Chinese government still has the will and ability to ensure a soft landing through its control over the domestic banking system, foreign exchange rates and capital flows, infrastructure investments, and other macroeconomic policy tools. Although any government stimulus in the coming months will not be as large as the one Beijing launched in 2008, they say, it could effectively mitigate the worst spillover damage from the financial crises in Europe and elsewhere.

Opinions and predictions on China's outlook may vary with the monthly figures, but one reality is beyond question: The Chinese economy is maturing. China is moving away from a focus on low-cost manufacturing toward sustainable growth and higher-value-added business, and from infrastructure- and export-led growth to domestic consumption. In a few years, China could look very different from how it does today, as regional shifts in wealth, more demanding and discerning customers, and highly motivated Chinese companies change the competitive landscape. The country's economy is also evolving in fundamental ways as single-digit annual growth becomes a plausible new normal. Multinational corporations (MNCs) that have grown accustomed to the boom years may be nervously eyeing the situation. But they can be confident that China remains a significant source of opportunity for those who adapt their strategies. To do so, companies first need to understand the trends that are shaping these changes.

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Short-Term Shifts

Domestic demand is growing in China, but today and in the near future, it will come from regions that have been largely ignored by many multinationals. These substantial shifts in demand reflect the movement of wealth away from the coastal areas and toward some of China's interior and western provinces, and away from so-called top-tier cities and toward lower-tier cities and, for some categories, rural areas. This trend is affecting certain sectors, such as consumer goods, automotive, and industrials, particularly strongly.

Both Chinese and multinational companies will need to realign their footprint and operating model accordingly, adopting a *Fit for Growth*SM approach, with a much stronger focus on both the top and bottom lines. They can expand beyond the Tier One and Tier Two markets with which they established themselves in China by deepening and broadening their channels to enter lower-tier markets, implementing what is called a "go down" (*xia chen*) strategy. This will often require changes to their traditional go-to-market model, as well as to core elements of their customer value proposition. For example, they will have to link inland and western regions to the rest of the country and build nationwide logistic and marketing networks. Foreign companies can benefit from partnerships with Chinese players to accelerate this strategy and fill gaps, but they also need to develop their own capabilities to execute this shift successfully.

In addition, companies have increasing opportunities to leverage digital channels, including e-commerce and social media, as part of their strategies. The Chinese e-commerce market is thriving, with well-known and successful retail websites such as Taobao.com, a B2C site owned by Alibaba.com, which is a popular B2B site. The number of Internet users in China is already twice that in the U.S., and China is the largest social media market in the world. Social media is especially important in China as a source of credible information, because the mainstream media is still controlled by the central government.

Execution remains a key challenge in the short term, largely because of a widening talent gap. Such was the finding of two recent surveys, the 2012 China Consumer Market Strategies survey, conducted by Booz & Company and the American Chamber of Commerce in Shanghai, and the 2012 China Innovation survey, conducted by the Benelux Chamber of Commerce, the China Europe International Business School, the Wenzhou Chamber of Commerce, and Booz & Company. Companies need the right leaders in place in their China business, as well as an operating model that balances local flexibility and agility with global control and capability leverage. But China's acute shortage of trained and experienced managers and executives remains a roadblock for companies looking to grow rapidly and profitably. Companies need to take a more holistic approach to addressing the labor supply imbalance. The imbalance is particularly critical at the middle management level, where talent is scarce and expats are inherently less effective than they are at more senior levels. In general, companies need to focus less on recruiting the right people and more on developing and retaining high-potential people through structured talent management programs and a long-term commitment to their China strategy. Companies can also seek out partnerships with universities, where they can establish scholarships, internships, and relevant courses.

Long-Term Competition

True, Chinese customers are now prepared to pay more for higher quality, and they may have more brand loyalty than in the past. But the value of these developments for MNCs will be limited by ambitious local competitors that are fast acquiring the technology and know-how to produce high-quality goods on par with multinationals' offerings. The days of winning purely by having the allure of a foreign brand are largely over, thus more clearly differentiated customer value propositions are needed.

Although Chinese companies still have capabilities gaps, especially in branding and marketing, many are moving beyond their copycat reputations to become serious innovative competitors. Indeed, the 2012 China Innovation survey found that many Chinese companies have already replaced their *shanzhai* reputations (in which they rapidly put out low-cost, knockoff-style products) with an entrepreneurial Need Seeker model (in which they pay closer attention to the market and release products that fit consumer demand as they see it). Among the MNCs interviewed as part of the study, 45 percent said they have Chinese competitors that are at least as innovative as they are.

The survey's findings are further supported by Booz & Company's analysis of a new category of Chinese competitor: mid-market innovators. In some sectors, MNCs increasingly find themselves competing with this new category of local companies that have strong brands and fast-improving (or equivalent) technologies and quality standards. Sectors with a large and vibrant Chinese mid-market include construction equipment (Sany Heavy Industry), logistics (China International Marine Containers Group), motorcycles (Lifeng Group), and household appliances (Haier and Galanz). Now able to sell into China's immense market, these companies have taken advantage of the explosive growth in infrastructure investment and the huge supply of cheap labor at all levels to produce high technology and variety at low cost, with a strong home base to build from globally. (See "China's Mid-Market Innovators," by Edward Tse, John Jullens, and Bill Russo, *s+b,* Summer 2012.)

Not all of these companies will succeed. Indeed, the recent global economic crisis has provided a reality check for many Chinese companies. Sany Heavy Industry, for example, viewed until recently as a potentially major threat to companies such as Caterpillar and Komatsu, has started to lay off staff after seeing its China sales fall. And the financial performance of many industrial state-owned enterprises has sharply declined. Still, enough will rise in prominence that MNCs need to take notice.

Finding Opportunity

To cope with these shifts in both the short and long runs, multinationals should follow one of these courses of action.

1. Double down. Some companies anticipated the growth of China's inland regions and are using the opportunity to aggressively compete — with pricing, for example — to put pressure on the competition. This strategy is paying off, at least so far. For instance, General Motors has introduced a budget brand called the Baojun ("treasured horse") specifically for emerging customer segments in China's interior markets.

2. Reposition. Companies that are facing a fundamental shift in demand — in the logistics sector, for

example — need to adapt proactively. This could mean altering their business model. It could also mean seeking out a new way to play in the market. For instance, Damco, the logistics arm of the A.P. Moller-Maersk Group, has recently opened new offices in western China and made several acquisitions in response to the changing nature of demand in China.

3. Wait and see. Companies that can afford this option, for example, high-end brands such as Gucci and Cartier or companies that control irreplaceable resources as De Beers does, are considering a more careful approach. These are companies that can gain market share in any environment through innovation or brand strength. However, they tend to be spurred to act either by a desire to expand faster when they can or by pressure from headquarters.

4. Pull back. Companies with weak positions and a lack of ability to gain market share need to broadly rethink their strategy. They may need to make more radical choices about their portfolio strategy and where and how they play, for example, by leveraging the strengths of a Chinese partner or refocusing on parts of the business that make the best use of their current, most distinctive capabilities. There have been a few well-known examples recently of companies that have failed in China and needed to pull back and regroup, including Google and Best Buy.

Most companies should regard these options as part of their effort to develop an overall global strategy with China at its core, incorporating China's many competitive advantages into their global operations. To pursue this type of strategy, companies will need to migrate more and more of their major value-chain activities, such as R&D and product development, to China — while maintaining global scale and leveraging their global capabilities. They will also need an in-depth understanding of the local context — in particular, a stronger grasp of their local competitors. They will then need to invest in two types of capabilities: the competitive necessities that are required to win in this new market, and a few distinctive capabilities that can set them apart from every other company in their industry in China.

Should MNCs stay in China? Yes, but their approach will likely change as the Chinese economy continues to mature. It remains to be seen how China's new leaders will affect the country's economic and fiscal policies, but under every plausible scenario, China will grow in importance during the next decade as a key strategic market and a source of global competitiveness. +

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