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Context and Complexity

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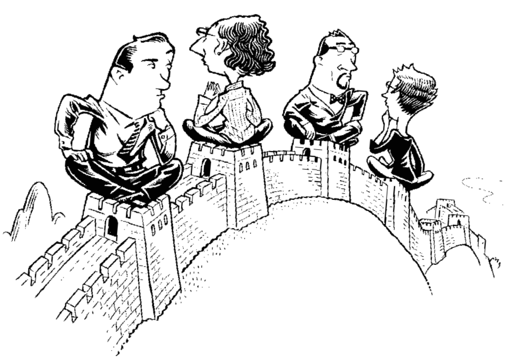
Context and Complexity

Success in China requires a flexible approach for a diverse market.

by Edward Tse

Illustration by Lars Leetaru

In working with multinational companies that enter China, either to manufacture goods or to sell to Chinese markets, we can almost always tell which ones will succeed and which will probably fail. It's a matter of attitude. Those that approach the region with a monodimensional mind-set, applying the same methods they use to run their business in their home country, tend to falter. Those that enter with an appreciation of China's multifaceted diversity, fast pace of change, and history and culture — in short, those with an understanding of context — tend to have a better chance of finding the markets and revenues they're looking for. That's the essential paradox of China today: Growth comes only to those who don't pursue it single-mindedly.



Many multinational companies are staking their future on dramatic expansion here because they have seen their growth top out on their home turf and in long-standing foreign markets. They look to emerging regions like China and India for that extra propulsion forward, and they find it there for good reason. China's transition from a planned to a market economy has revolutionized business. International and local competitors are racing to serve the expanding market with a broadening array of products or services via new and increasingly varied distribution channels. The regulatory environment governing all this activity is moving, in fits and starts, toward greater liberalization.

Knowing all this, many companies come to us for help in gaining a significant increase in their overall global revenue growth — often hoping for as much as two or three times their existing growth rates — in just a couple of years. Most of them are already selling products or services in certain parts of China. That's their starting point. But achieving a quantum jump in the size of their business within a short period of time is more difficult than it seems, even — or especially — in an economy as vibrant as China's. This vibrancy is a symptom of the complexity of the country's economic engine. Thus, if you're an executive of a multinational company looking to turn China into an engine of growth, you need to add another element to the classic "three C's" that you learned in business school. In addition to customers, company, and competitors — the traditional factors in any corporate strategy — you need to add context. Without a deep understanding of China's context; the nature of its social, regulatory, economic, and infrastructure environments; how they're changing in a period of explosive dynamism; and how they affect one another, you cannot tap the true potential of China's market.

There are several elements of the Chinese context that deserve consideration. Each involves a kind of geopolitical differentiation. The first is the consumer market, which is heterogeneous and changing fast at both the macro (regional) and micro (city/township) levels. The second is China's regulatory environment, which has been liberalizing for 15 years but has recently suffered some hiccups. The third element is Chinese culture, which is opening to the outside world in ways that have surprised even the Chinese as globalism integrates China with the rest of the world. And the fourth is, in a sense, a consequence of the first three: The myriad opportunities in China stem directly from the newness of Chinese growth and manifest themselves in a nonlinear, disruptive manner that requires a particular mind-set to manage.

Inconsistent Consumer Markets

For the past 15 years, the Chinese consumer market has been notable for its fast-paced growth and receptiveness to new products. But that doesn't mean that the whole country is moving forward at the same pace and in the same way, and therein lies the growth challenge. Companies that want to propel their sales need to contend with a landscape, both actual and metaphorical, that is highly variable and inconsistent.

Many global companies are setting targets for their China operations that they can't possibly reach without expanding beyond the biggest demand centers — Beijing, Shanghai, or Guangzhou, for instance — into second-, third-, or even fourth-tier cities. Doing this is not as easy as, say, expanding beyond New York and Chicago to Buffalo and Peoria. As you move into China's second-, third-, and fourth-tier markets, you'll find a steep drop-off in infrastructure, channels, management sophistication, and disposable income. Entering these new geographic markets can be intimidating to multinational companies. Many foreign executives have never even heard of cities like Datong or Baoji, let alone had experience doing business there.

Although this state of affairs holds true for most emerging markets, China presents a market environment of exceptional complexity. Many people are already aware of the differences across China's various geographical regions. However, few people understand the tremendous diversity even within regions, where there is significant variation between bigger cities and smaller

Expanding beyond Beijing is not like expanding beyond New York or Chicago to Buffalo or Peoria.

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cities and towns. Often just a 30-minute drive outside a large city takes you into a local economy that is far more modest and a commercial environment that is far less sophisticated. Complicating this situation is China's breathtaking economic growth, which has transformed its major cities at a breakneck pace and has deepened the divide between these urban centers and the rest of the country. The speed of change, together with China's size and diversity, makes it a market highly difficult to predict.

A consumer goods maker, for example, may be seeing great success selling in major cities, where the channels and distribution systems are fairly sophisticated and consumers have money to spend. But those population centers alone may not furnish enough growth potential to fulfill the expectations of many global companies; to really boost revenue, most companies are going to have to tap into second-, third-, and fourth-tier cities. That means that the company may need to introduce products or services better suited to the small city or rural demographic, sell them through more traditional channels, and cobble together a distribution network that can handle erratic terrain and a patchwork of customers. In short, they need different business models.

Companies entering China will also find a variety of evolving tastes to serve, as consumers get used to goods and even foods that they were unfamiliar with before. One example is milk. A decade ago, the only way Chinese consumers could buy milk was in powdered form because there was no suitable packaging to allow for transportation over long distance. As new packaging formats that employed pasteurization and ultra-high-temperature sterilization were introduced, the liquid milk market took off exponentially. Milk has now become a staple of the Chinese diet, especially among children. As a result, the Chinese dairy industry, led by companies like Mengniu and Yili, is very profitable and fast-growing today. One telling index to the industry's success: Mengniu is now the single largest customer of Tetra Pak, the liquid packaging supplier.

Too few business leaders really understand the regulatory context, and fewer understand how it's likely to change.

Evolving Regulations

An enormously important element of the business context is the regulatory environment. We've found that too few business leaders really understand the regulatory context, and even fewer understand how it's likely to change in the future. Although some outsiders may perceive that Beijing makes it very difficult for foreign companies to break into the Chinese market, the truth is that for the last 15 years, China has been quite progressive. That doesn't mean that every industry embraces foreign competition, but compared to countries like Japan and Korea, which are still fairly restrictive toward foreign trade and business, China has been quite open. That's especially true for such industries as fast-moving consumer goods, where the market is open to all participants and competition is very intense. Increasingly, the Chinese government is opening up its industries to more foreign participation, sector by sector and step by step.

However, regulatory progress does not necessarily proceed in linear fashion. In 2006, after China National Offshore Oil Corporation (CNOOC) lost its bid for Unocal, some officials in China felt that Beijing had opened its markets too wide too quickly. The CNOOC case also taught the Chinese that "national security" could be used as a reason for refusing foreign investment, but the question was how to define that criterion in the context of business investment. In the aftermath of the CNOOC episode, there has been vigorous debate in China over whether Beijing should approve the attempt by the Carlyle Group, a U.S. buyout firm, to purchase an 85 percent stake in Xugong, China's largest construction machinery manufacturer and distributor. In addition, the National Development and Reform Commission, China's central policymaking body has specified, in the name of national security, seven industries in which foreign companies cannot control majority shares: defense, power generation and distribution, oil and petrochemicals, telecommunications, coal, aviation, and shipping.

China's regulators are balancing sometimes competing concerns; they want to continue the country's growth, but within boundaries that will prevent the economy from overheating and collapsing. They want to help China integrate into the international community, but they recognize that nationalism is still a potent force. They will need to allow global competitors entry while ensuring that Chinese companies don't lose their edge. Insight into how Beijing adjusts its rules to address these concerns will help executives weather the inevitable regulatory vicissitudes of China.

Outward-Facing Aspiration

Similarly, one must have a deep understanding of the aspirations of Chinese businesses. It's no longer enough for Chinese business leaders to rule the domestic market. They want to be world class. The chairman of a regional Chinese airline recently told me that his goal is to bring his carrier to the high standards of Singapore Airlines. I've heard similar aspirations from the head of a large Chinese telecommunications operator and the leader of a major local airport. And the CEO of a Chinese beverage maker wants to turn his company into the next Coca-Cola. They know they're not at that level yet, but they're determined to get there.

That's another dynamic element of China's context: Chinese companies are learning to become even more competitive as they take on a rush of international competitors both at home and abroad and as they partner with multinationals. To join the top rank of international businesses, Chinese executives are very willing to learn international best practices, even if that means evolving beyond their own established ways of doing things. They are thirsty for new knowledge in business, management, and technology. In Chinese bookstores, management books are easily the most popular category and occupy the most shelf space. Chinese translations of recent titles by such business celebrities as Jack Welch, Lou Gerstner, and Jim Collins are fixtures on the Chinese bestseller lists.

The nature of global integration is changing in ways that affect both Chinese companies and foreign companies operating in China. China has grown beyond its role as the world's factory, and homegrown businesses have evolved beyond their role as a local toehold for global companies that need a Chinese partner just to crack the market. Increasingly, Chinese companies such as Huawei and Haier are now serving as product and process innovators both for the Chinese market and for international markets. And more foreign companies are integrating their Chinese manufacturing, sourcing, branding, marketing and sales, and distribution with their operations in the rest of the world; in the last five years, many of them have set up R&D centers in China that are an integral part of their global R&D system. At the same time, more Chinese companies are seeking expansion overseas.

Chinese executives are thirsty for knowledge in business, management, and technology.

Fleeting Opportunities

Growth and change are often nonlinear and therefore disruptive qualities that China's size and pace of change only amplify. Consider how consumer demand has skyrocketed as more and more people have money to spend. The mobile phone market in China stood at nearly zero in 1993, hit 40 million in 1999, and then exploded to 400 million by 2006. Sales of passenger cars went from 400,000 in 1995 to 700,000 in 2001 and then to an astonishing 2.2 million in 2004. Such discontinuities and complexities characterize most emerging markets, but China's scale and diversity render them more extreme — and profoundly consequential to any company with global aspirations. The opportunities are enormous and, given the speed and scope of China's economic development, they demand good timing.

One remarkable story of fleeting opportunity is that of Zhang Yin, owner of the Nine Dragon Paper Company. In the 1990s, she was a trader in Hong Kong, cashing in on China's paper shortage by collecting scrap and shipping it to mainland China for recycling. She saw a bigger opportunity in the container ships that took full loads of goods to the U.S. and Europe and returned empty. Her idea was to fill those empty ships with wastepaper collected in the U.S. and Europe and recycle the contents in China into cardboard boxes to be used for shipping Chinese goods back to the American and European markets, where the process would start all over again. Leveraging China's low costs and quickly building scale, she created a thriving business that is now the envy of many of the major multinational paper companies that are eyeing the same market in China and abroad. In just a few short years, according to the *Hurun Report*'s 2006 China Rich List, Zhang has become the wealthiest person in China and one of the richest female entrepreneurs in the world.

Another example is Baidu, a Chinese search engine company. Baidu was founded in January 2000 with an investment of US$1.2 million and today has a market cap of $5.23 billion. Its design resembles that of Google, but it is tailored to meet Chinese needs. Approximately 45 percent of all Internet searches in China — the world's second-largest online market, with more than 100 million Internet users — are conducted by Baidu. By July 2005, Baidu was already the sixth-most-visited site on the Internet, and today it commands a 57 percent share of the Chinese search market against such strong competitors as Google and Yahoo.

Yin Core, Yang Portfolio

There is a way to organize your company to embed strategic anticipation and insulate the core enterprise from the disruptions that characterize business in China. Given the vast differences within China's markets, growing a business isn't a matter of running operations in the same way across the entire country. A company cannot behave as if it is pursuing just one business in China; rather, it must pursue a portfolio of businesses that require a portfolio of organizations to lend support. And, in the same way that a multinational cannot expect to thrive by transplanting to China the business approach that brought it success at home, it cannot transplant its Shanghai approach into Wuhu, or its Beijing business model into Dali.

In other words, a company needs a yin and yang of the organization — opposing yet complementary dynamics that protect existing business while driving growth. The yin is the existing core business. The yang is a matter of continuing to push growth in the same ways along the same dimensions of company, customer, and competitors. In other words, the company will use its existing organization to sell the same array of products to the same kinds of customers in the same kinds of places.

A company cannot behave as if it is pursuing just one business in China; rather, it must pursue a portfolio of businesses.

Because of varying contexts, each new product market may really constitute a new business, with each at a vastly different point in the life cycle and with a vastly different business approach. For the mature elements of the portfolio, the company may need to defend its market share in a hotly contested environment. For the nascent pieces, the business needs to be incubated and perhaps must shoot for first-mover advantage in a rudimentary marketplace.

As the business approaches for different parts of the portfolio may differ, each of these new businesses may require a different type of organization to address the idiosyncrasies. So the manager of a multinational's China operations is no longer "running a China." From the business and organizational standpoint, she's running a portfolio of Chinas, meaning an array of organizations serving a variety of segments. Consider the case of a certain paint company in China: It is expanding its core product of emulsion paint from Tier One and Tier Two cities, where the markets are already mature, into Tier Three cities that still have plenty of growth potential. In addition, it plans to introduce new offerings, such as wood-care products, into the country. This company therefore had to deal with a wide variance in business segments in widely varying markets with products in widely different stages of their life cycles. The company in turn had to devise a portfolio of strategies and organizations to sell its paint and wood-care products effectively in China.

Running a portfolio of businesses takes rare management skill, and that's all the more true in China. Not only does the executive need to understand the various contexts of her markets, she needs to deal with the inherent constraints of any organization. Those constraints — of funding, resources, and personnel (China's leadership bench strength is relatively shallow) — necessitate trade-offs. Running a portfolio of China businesses requires sizing up the trade-offs across multiple dimensions of context. And given the speed of change in China, running the China portfolio requires continuous reassessment of those trade-offs. The executive will need to communicate constantly with the company's headquarters on these trade-offs and their implications for the company's investment in China and the potential returns; frequent alignment with the headquarters is a key to success.

Therefore, executives in China need a "helicopter view" — the perspective gained by rising above the quotidian operations to discern the overall landscape and the patterns of change. The ability to recognize patterns amid of seemingly chaotic and sometimes contradictory data is invaluable. Executives must also be able to see beyond the obvious, anticipate the potential discontinuities in the marketplace, and decide appropriately how to further the company's interests. A pure operational view focusing on near-term incremental phenomena and linear extrapolation of past data will simply not work. Success in China requires a leader who can cope with the inevitable spasms of change in the Chinese market, whether they involve supply and demand or regulatory, political, social, or economic issues. This is a leader who understands that change in any one sphere usually touches off changes in the others, and who can use that insight to help the organization thrive amid the complexity. +

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