10 Top Findings

CREATING A WINNING BUSINESS IN CHINA
by Savvy Marketing Group

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While many American companies are investing in growth opportunities in China, the hurdles to entry are unique compared to those encountered in the U.S. Strategies may be more difficult to execute for a number of reasons. Cultural differences, public relations issues, and conflicting regulations are some of the major stumbling blocks foreign firms encounter. Often U.S. executives are ill equipped to tackle the country's distinct challenges absent significant Chinese business experience. Overcoming these obstacles can be arduous and time-consuming because the Chinese business world demands a repertoire of skills beyond and often conflicting with Western business practices. U.S. executives need to understand that a successful presence in China entails more than a local sales presence. A comprehensive understanding of the local industry, competitors, customers, business culture, and the trajectory of the market and government policy are a few of the considerations that should dictate a strategy of entry.

China's rapid economic growth, large population, and urbanization have created unprecedented opportunities. And although China surpassed Japan as the world's second largest economy in 2010,[i] the country is not a panacea for slower growth in developed markets like the U.S. The Chinese Communist Party ("CCP"), after 30 years of market-driven reforms, is still grappling with how to govern the world's most populous nation. The CCP will remain the sole ruling party for the foreseeable future so foreign companies need to understand the government's role in the domestic economy. Since vague regulations and selective enforcement are the largest barriers to foreign investment, the most critical step for new entrants is building relationships with government authorities. Thus, smaller companies should consider hiring advisors with contacts and expertise in order to manage their interactions with government officials prior to problems arising.

Furthermore, companies lacking a solid grasp of local economic forces often underestimate the complexity of the Chinese market. Chinese companies are no longer relegated to merely low cost manufacturing. While these companies secured a toehold by manufacturing components at the lowest cost, they have since used strategic acquisitions, licensing and partnerships to gain additional technical and management expertise. This has

allowed Chinese businesses to vertically integrate to the point where they can produce entire products in several industries, such as the automotive and aircraft industries.[ii] Although in the first nine months of 2010 the Chinese manufactured only 1.6 million automobiles, by 2020 the nation aims to export 25 million annually.[iii]

In fact, while Western companies have been preoccupied with internal problems precipitated by The Great Recession, the economic fundamentals in China have strengthened through increased productivity and consolidation. Chinese firms are now using excess capital for larger foreign acquisitions.[iv] Furthermore, while many state-owned enterprises ("SOEs") have been privatized or done away with altogether, several industries remain dominated by government-owned companies that often lack transparency. Top executives at SOEs may even be former members of the Chinese Communist Party.[v] It is critical to never underestimate the significant local advantages afforded to state supported businesses.

Therefore, firms should extensively analyze how to seize opportunities and confront inevitable challenges so they can be responsive post-entry. Moreover, new entrants must be nimble or risk falling behind because China does not buy older technologies; it buys the technologies that will be used in the coming decade.[vi] The majority of companies entering China prefer to hire outside experts when formulating their market strategies. Outside consultants are invaluable tools for understanding the Chinese market because they can facilitate an efficient deployment of limited resources, help companies gain market share, and win fickle Chinese consumers. Alternatively, firms focused on consumer preferences might choose to partner with local Chinese firms in order to understand the distinct market segments within China, which can vary widely from region to region because of local tastes and traditions and economic dynamics.

The underlying proposition of this paper is that the goal for new entrants is to minimize risk while at the same time positioning for maximum future gain. Thus, this paper presents the top ten strategies for establishing a successful business presence in China.

1. Formulate an Entry Strategy

It may seem self-evident but cannot be overstated that the first step is to create a comprehensive strategy. There are several alternative methods to enter China as a foreign invested enterprise ("FIE"). These alternatives, that may be pursued separately or together depending on a company's resources and level of expertise, include: (1) test markets, (2) partnerships and joint ventures, or (3) a wholly foreign-owed enterprise. There are compelling reasons for a company to consider offering its products or services in a test market that makes sense for the product or service. Location is very important. It is hard to find qualified staff in smaller cities and expats face problems, too. While these issues can be offset by financial incentives, these may not be worthwhile in the end. A test market lowers the risk of full-scale entry because it is less capital intensive. Furthermore, it provides important customer feedback about a company's product or service that can improve a company's business plan before a larger investment.

New entrants may also want to consider whether to establish local partnerships, such as joint ventures. The traditional benefits of this option is that it allows a firm to leverage existing government relationships, market intelligence, hiring experience, and manufacturing expertise rather than developing these resources and capabilities internally. Currently, there are two types of joint ventures permitted in China, either a cooperative joint venture ("CJV") or an equity joint venture ("EJV"). The joint venture decision is company specific and should be researched carefully because the Chinese government mandates that the Chinese partner own at least 51% such that the foreign company cannot take back the technology and know-how. JVs are hard to unwind, and while Chinese companies love them, for US companies, it is something they should think twice about. Those JVs which are currently ongoing are those which were started way back when that was one of the only options (or which carried preferential treatment/benefits).

A wholly foreign-owned enterprise ("WFOE") is now the most common way that foreign companies invest in China. This alternative requires the firm to establish a separate Chinese subsidiary.[vii]

Despite the array of options, new entrants should be cognizant of the fact that a substantial investment is required prior to operations because the approval, permit, and hiring process may take up to a year or longer to complete. FIEs will need approval from the Ministry of Commerce of the People's Republic of China ("MOFCOM"), which will conduct a foreign investment review. They must also register with the State Administration of Industry and Commerce ("SAIC"), which will issue a business license.[viii] However, these are not the only legal requirements for establishing a FIE, and new entrants would be wise to consult an attorney about these issues. In addition to legal issues, companies also need to make business choices, such as: (1) decision-making hierarchy between corporate and China operations, (2) importing or local manufacturing, (3) channels of distribution, and (4) marketing strategy.

2. Embrace the Government and Its Policies

New entrants often make the mistake of approaching the Chinese market with a narrow focus on sales growth. This myopic focus generally fails to address the Chinese market as a whole, specifically overlooking the intricate role that government plays in the domestic economy. When the government speaks, all should listen. Companies should educate themselves about the central government's policies toward their particular industry and also the local government's role in regulating their business. While the central government is still the ultimate decision-maker, local authorities are powerful, and the interplay between both can be convoluted at times.[ix] Keep in mind that courts are all about "stability", not justice in conflict resolution.

Despite the success of the "*Open Door Policy"* over the last three decades in attracting large numbers of foreign companies, many Western businesses still face political and regulatory obstacles, such as restrictions on ownership rights and protection of intellectual property. These challenges can result in firms having to spend an unanticipated and disproportionate amount of time working with Chinese authorities. The degree of economic ownership and product restrictions imposed by the CCP varies by industry. Generally, the media and telecom industries have more government restrictions than consumer goods. However, a recent campaign of "indigenous innovation" has increased government support

for local companies in many sectors. A timely example of the central government's influence on a foreign company's operations is Google's decision to relocate its Mainland China search service to Hong Kong after losing its censorship battle with the Chinese government in early 2010. After its move, Google's user base in Mainland China decreased by 50% as it ceded market share to Baidu and Bing.[x]

Companies should carefully manage their interactions with numerous Chinese government authorities and agencies. Similar to the U.S. there are several agencies that regulate businesses, such as the Bureau of Commerce, Bureau of Taxation, and Customs. If a company has a positive relationship with Customs, for example, the company may get a break from the random audits that the entity frequently conducts. Furthermore, free trade zones are controlled by the CCP, and there are specific administrative committees assigned to specific economic zones. The following is a list of best practices to navigate government policies successfully:

- Understand how the Chinese government interacts with businesses
- Align corporate strategy with the direction of government policies
- Keep a constant open dialogue with authorities that regulate your business, especially since personnel changes in government are frequent and deliberate to prevent corruption
- Be prepared to *give up* – earning government approval often requires compromise in areas such as business policies and intellectual property rights
- Attend events that show commitment to the CCP. Show support to local government and their affiliated administrative organizations in charge of operation of Special Economic Zones.

It should be noted, however, that challenging government policies create new opportunities. Competition amongst provinces, cities, and even districts for foreign direct investment means some localities offer a myriad of incentives to attract job-creating influxes of capital. Tax breaks, preferential policies, and other benefits increase directly with the size of investment. Free trade zones are a prime example. One of the largest free trade zones is

Waigaogiao located outside Shanghai. Waigaogiao offers foreign companies numerous advantages by loosening government restrictions and providing tax incentives, simplifying customs requirements, duty exemptions, and looser importer/exporter quotas.[xi] Many local districts now provide discretionary competitive tax incentives which can include rent subsidies and tax rebates for senior management.

3. Know Thy Consumer

Competition in China is fierce and product offerings are often broader than in the U.S. Further complicating the market is China's huge population and sprawling landmass, which translate into diverse consumer preferences. The majority of Chinese consumers are price-conscious, and brand loyalty is generally absent. Consequently, market share can shift dramatically. Some strategies for responding to these challenges include: (1) tracking customer preferences by province and (2) creating a feedback loop by fostering a relationship of trust with existing customers.

Product differentiation may be a key component of a firm's positioning strategy. According to McKinsey & Company, China will account for $27 billion in global luxury-goods sales by 2015, which equates to 20% of the global luxury-goods market.[xii] Bain & Company estimates that China is already the seventh largest market for luxury-goods by sales. Large foreign companies have been slow to position themselves to capitalize on this growth. For example, Luxottica will now offer Asian collections of its popular Ray-Ban, Oakley, and Vogue sunglass lines. According to Chief Executive, Andrea Guerra, Luxottica recognizes that to capture this growth the company needs to "really become domestic in these markets" so it can design product offerings consistent with domestic preferences and the physical differences between Asian faces and those of other nationalities. In 2009, the company established a new design hub in Shanghai.[xiii] Two conclusions can be drawn from this example – a local physical presence may be a competitive imperative at some point, but smaller companies can be more nimble in adapting to local markets than their larger competitors.

Thus, new entrants should not expect that a uniform marketing strategy is sufficient. Simply translating advertisements into Chinese and keeping western models does not always work well. Localize marketing.

Companies need to design solutions that account for cultural and regional differences by staying informed and remaining flexible. When formulating solutions, companies should begin by analyzing customers' needs, preferences, and desires. For instance, while Chinese consumers are willing to pay for individualized, non-replicable products and services, they expect customer service to be included. Furthermore, companies should not fight a losing battle by basing their China business model on how consumers behave in the U.S. Best Buy's failed foray into the crowded, cut-rate electronics retail industry is a telling example of relying on such false assumptions. Thus, firms should relentlessly gather new information about their key markets and customers to stay abreast of shifting preferences and to identify new competitors. They should also remember to remain patient because customer acquisition may have a longer lead-time.

4. Proactively Approach the IP Conundrum

Another decision companies must weigh carefully is whether to keep technology in their home country or develop it locally. The Chinese government is the largest customer in China. For a time, the government mandated a forced technology transfer by requiring foreign companies to design products in China if a company wanted to sell products to the government. This mandate was a clear indication that the Chinese government intended to foster domestic innovation. And some U.S. companies believe it is evidence that local firms are favored over foreign firms. However, during a January, 2011 summit between President Obama and President Hu Jintao, there was an agreement to abolish this mandate. President Hu's first state visit to the U.S. with Chinese executives was conducted with deliberate ceremony and respect to emphasize the U.S. view of China as a partner and marketplace and that increasing interdependence on strategic and economic issues is inevitable and desirable.

Nonetheless, U.S. companies have complained to trade officials that provincial leaders have not enforced the new agreement locally – where most procurement decisions are made. Aside from this issue though, several other recently passed regulations can be

pitfalls for the unwary, including: (1) Chinese laws that limit market access for U.S. companies, (2) national-security policies that provide advantages to Chinese companies, (3) re-engineering standards that require products meet Chinese specifications, (4) patent laws that allow for seizure of foreign innovation, and (5) soft enforcement of intellectual property laws generally.[xiv] In addition to weak legal safeguards, there are evidentiary problems with intellectual property protection. Specifically, it is difficult to prove criminal intent in OEM production and distribution cases. Therefore, the strategy for protecting intellectual property remains a prominent consideration for new entrants. Enforcement requires proof that damage has been done. This is both hard to produce and hard to get accepted.

5. Market American, Operate Chinese

When exporting U.S. products and services to the Chinese marketplace, costs typically force companies to position their brands higher up the value chain than in America. For instance, Howard Johnson operates 5-star hotels, and Pizza Hut locations feature velvet ropes that allow throngs of visitors to queue up for dinner. Chinese consumers have a perception that American brands inherently offer higher quality than their local counterparts. This is a powerful marketing advantage that new entrants should learn to exploit. It does not mean, however, that companies should ignore local market conditions and operate their businesses in a vacuum. On the contrary, adapting to local values, tastes, and preferences is critical to success.

Part of the adaptation process requires a concerted effort to learn more about China. It is not enough to open a local office in a tier one city like Beijing, Shanghai or Guangzhou. It is important for top executives to experience China first-hand to gain a deeper understanding of the cultural differences. Networking with government officials, visiting a trade show, talking with suppliers, and meeting with key staff can be invaluable marketing opportunities. Regular visits from the CEO signal to all stakeholders how important the Chinese market is to that company. Bill Gates' first visit to China was very short. President Jiang Zemin told him that he should understand Chinese language and culture in order to collaborate more. Bill Gates learned the hard way about the necessary respect in visiting to be according that were critical for Microsoft to succeed in China.

Decision making needs to be very fast, since market changes, local competition, and other dynamics are faster in China than in the U.S. Also, local companies get very frustrated over slow decision making and are hard to keep if they sense weakness, hesitation, and inability to be nimble. They may leave and start become a competitor; this is quite common. In sum, U.S. firms should sell their American heritage while at the same time learn how to merge their practices with Chinese culture.

6. Leverage Chinese Media Platforms

As in the U.S. leveraging social media and networks may be as important as traditional marketing in order to gain traction in China.[xv] Mobile platforms are the dominant mode of content access for young Chinese. In fact, online networking has made the Chinese population increasingly powerful because it facilitates a form of mental mobility that cannot be as easily restricted as traditional media sources. Social media and viral advertising campaigns illustrate the potential for word-of-mouth for businesses. Companies that have diversified, unique approaches to Internet content will reap significant advantages in China.[xvi]

Nevertheless, the Internet is strictly monitored. Americans are frequently surprised at the seemingly insular nature of Chinese communication. Social media network sites such as Facebook, Twitter, Youtube, and Blogspot are currently inaccessible because of the "Great Chinese Firewall." Government monitoring also slows access to overseas servers. This has caused most Chinese Internet users to spend little time on sites outside of China, which has led to explosive growth for several domestic alternatives. A vast majority of user interactions are concentrated on a handful of platforms, such as Baidu, the leading search engine, QQ for instant messaging; taobao.com for ecommerce; Renren and Kaixin001.com for social networking; and portals like Sina Weibo for microblogging. At the same time, China leads the world in the number of citizens it has online, and its connectivity infrastructure is more advanced than every other emerging economy. Therefore, U.S. companies need to establish a strong marketing presence using Chinese Internet platforms to compete for customers.

7. Identify and Invest in Local Talent

A driving factor for investment in China is the lower cost of labor. However, China's developing economy lacks an experienced, creative work force. Despite relatively high unemployment, especially among college graduates, turnover remains high. And many professional workers lack a sense of loyalty to their employers. Compensation often determines the level of loyalty. Not surprisingly, Chinese citizens returning from abroad are the most desirable candidates. These individuals have the advantage of an international perspective in addition to language skills, cultural awareness, and local contacts. However, the competition for local talent is fierce in China. Experts believe that the demand for Chinese labor has now surpassed supply, which will lead to higher wages.[xvii]

Firms with greater resources and lacking in substantial institutional knowledge in Chinese business practices would be wise to invest the time and resources to develop local managers. The confidence and support of Chinese managers is essential to facilitate leadership over time. Unfortunately, many firms place expatriates in high-level leadership roles, often in short rotations, to ensure that the company's business strategy is followed precisely and updates are communicated back to headquarters. Foreign executives that lack strong cultural backgrounds and language proficiency will find it difficult to make inroads with the Chinese business community. Moreover, this practice eliminates advancement opportunities for local managers, which can discourage commitment and inhibit performance.

The talent pool increases significantly if employees do not need to speak English. Thus, encourage or require managers to learn Chinese not vice versa. Another strong pool of talent are from Hong Kong, Singapore, and Taiwan. They are commonly hired into China, but the most desirable talent to lead in China, as noted above, are Chinese managers born in China.

Companies that provide Chinese employees with opportunities for learning and advancement will increase retention rates, improve performance, and guarantee their long-term success. In the manufacturing sector, earning trust and sustained commitment is especially difficult. Some management techniques, however, can have a huge impact, such as

managing from the floor, greeting employees on a first name basis, publicly recognizing excellent performance and innovation, and establishing a positive career path. Employing local talent is not without its pitfalls in other industries as well. To combat turnover and training difficulties, companies can partner with technical schools and universities to create a pipeline for talent. Firms should also use team-building exercises to forge strong connections. Some other best practices include the following:

- Attention from the senior executive team
- Visible performance standards
- Awarding employee performance
- Opportunities for upward mobility
- Training opportunities abroad or overseas assignment

Thus, companies need to provide added incentives aside from compensation to successfully hire and retain local talent.

8. Communicate Culturally

The way in which Chinese businesspeople communicate and interact is more spontaneous than in the U.S. For example, cell phones are typically the most popular means of communication. In fact, Chinese businesspeople are on the phone virtually all the time. When attempting to connect with a Chinese businessperson, scheduling an appointment is often not as effective as simply calling his or her cell phone. This is especially true for small and medium size companies because the boss is often the biggest salesperson. However, face-to-face interaction is strongly preferred in some instances, and dining is an integral part of the business culture. Companies need to determine the appropriate style of communication under the circumstances.

When interacting across the cultural divide, one predictor of success is whether foreign executives learn to embrace the Chinese concept of *guanxi*. Though there is no equivalent English phrase that fully explains the concept, Guanxi can be explained as a form of networking based on building trust between two or more parties in everyday life and

business. Fostering guanxi requires an understanding of interpersonal dynamics between networks of influence based on local connections and local knowledge. Be sure to get to invest time to get to know partners. A personal relationship is more effective than a contract, which may or may not be enforceable.

Newcomers often overlook the constant attention Chinese pay to such acts as the reciprocity of gifts and favors. When practiced successfully by local Chinese, *guanxi* is not a skill; it is a way of life. Furthermore, the structure of the Chinese legal system means that the Chinese rely more on people than laws to guide their business relationships. To a Chinese businessperson "a contract creates a platform on which a relationship will be built, rather than boundaries of the relationship."[xviii] Consequently, fostering relationships of trust and understanding the hierarchy of networks are paramount factors for business relationships in China.

9. Actively Track and Forecast Trends

There are many questions companies should ask themselves about China. What legal protections will exist for IP in 10 years? What provinces and market segments will see the fastest growth over the next 5 years? e.g. U.S. energy and pharmaceutical companies currently have a small presence in China to gain a foothold, as they await regulatory policy changes before beginning to actively operate. To stay abreast of a dynamic economy, new entrants should track and forecast numerous trends in China, including: (1) government policies, (2) their industry and market segments, and (3) consumer habits and preferences. These trends will ultimately modify company strategy and positioning decisions. Moreover, U.S. policies toward Chinese businesses can signal how the Chinese government will respond to similar situations. For example, the U.S. Committee on Foreign Investment recently ruled that Huawei, a Chinese telecom equipment maker, must divest its purchase of a small U.S. technology firm because of the company founder's suspected ties to the Chinese military.[xix]

Macroeconomic trends are important as well. The Chinese government intends to allow the yuan to rapidly appreciate in order to tame inflation. At the end of March 2011, China's foreign-exchange reserves had grown to $3 trillion because of the nation's policy,

which forces its central bank to purchase dollars from foreign investors and exporters.[xx] The impetus behind the move is China's massive importation of basic commodities, including oil and iron ore, which have had sustained price increases. A meeting between the State Council and Premier Wen Jiabao indicate that "strengthening the flexibility of the yuan's exchange rate" is a primary goal. Experts believe this could signal a change in policy in which the central government views the exchange rate not only as a method to control exports, but a tool to manage growth and inflation. Paradoxically, an artificially cheap yuan fuels exporters, which increase inflation.[xxi] The commencement of currency trading in Hong Kong, and other efforts to encourage settling trades with the local currency or even allowing U.S. multinationals to issue yuan denominated bonds illustrate the nation's move away from the dollar.[xxii] Clearly, these policies shifts can have a huge impact on a foreign company's competitive position.

10. Prepare for the Unexpected

Finally, as important as it is for new entrants to have a strategy for entry, it is equally important to make contingency plans to neutralize unexpected challenges. As discussed throughout this paper, unanticipated obstacles arise quite frequently for foreign companies in China. Companies must be able to adapt quickly to changing conditions. Simply because a new entrant has a superior technology or a proven U.S. business model does not mean success will follow. There are companies that failed precisely because they believed these advantages were sufficient.

Best Buy, for instance, believed that its Chinese operations could successfully mimic those in North America. The company failed to realize that margins are slimmer in the Chinese electronics industry. Its "big box business model" was not an attractive venue to Chinese consumers, who thought the product offerings were overpriced. Moreover, Best Buy did not use a commission structure to incentivize employees to push particular brands like its local competitors do. After five years in China, the company is closing all of its locations to refocus on a new business model.[xxiii]

By studying the market, preparing for the unexpected, and making a small capital allocation initially, firms can avoid similar missteps. Moreover, patience and persistence are key success factors for new entrants. Success will not happen over night. Neither the

challenges of such an endeavor, nor the realities of the market should be underestimated, but these strategies provide U.S. companies some direction for creating a winning business in China.

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