
The Hidden Dragons

Ming Zeng; Peter J. Williamson

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Ask any global manager, and he'll wax eloquent about how Red China has transformed itself over the past 25 years into a latter-day Middle Kingdom, a business realm closer to heaven than earth. China is the fastest-growing market on the planet, after all. Between 1978 and 2002, the country's GDP grew by 9.3% annually—three times faster than the American economy did—and its per capita income more than quadrupled from \$231 to \$940 a year. With a population of 1.3 billion, China has the most consumers in the world, too, and every company wants a piece of the action. Many multinational corporations entered the country in the decades after 1978, when the Communist government started to raise the bamboo curtain, and since China joined the World Trade Organization in December 2001, many more have swarmed into a market whose potential defies imagination.

Still, most multinationals are myopic about China. Carried away by the number of potential customers and the workforce's low wages, they've been focused on setting up manufacturing facilities or selling products there, or both. They've ignored an important development: the emergence of Chinese companies as powerful rivals—not only within China but also throughout the global market. Several Chinese companies haven't been content with rewriting the economics of manufacturing in their industries. They've created brands that have quietly grabbed market share from older, bigger, and financially stronger rivals in Asia, Europe, and the United States. For instance, the Haier Group in Qingdao, one of the world's largest manufacturers of home appliances, captured almost half of the U.S. market for small refrigerators in 2002 under its own brand name. Guangdong Galanz, which manufactures one out of every three microwave ovens in the world, last year carved out a 40% share of the European market for its eponymous brand. And China International Marine Containers (CIMC) had wrested more than 40% of the global market for refrigerated containers by 2002. If the speed with which these companies have penetrated foreign markets is any indication, Chinese brands could soon become a global force in many other industries.

So why aren't Chinese brands on corporate radar screens yet? There are three intertwined reasons: First, many global managers argue that Chinese companies aren't big enough or profitable enough to compete overseas. The Chinese market has grown, but it has become fragmented, partly because regional differences in income have increased sharply since the reforms of the last quarter century. Most companies have found that the products they market in the prosperous coastal areas of China are too expensive for customers in the poorer hinterland. China's weak transportation, distribution, and retail infrastructures also make it expensive to supply goods all over the large country. Furthermore, every provincial government imposes taxes on goods that aren't manufactured in the region because of the economic rivalry between China's provinces. That's why there are many regional brands but few national brands in the country. These factors constrain the ability of Chinese companies to grow organically, and taking over rivals remains a slow, cumbersome, and bureaucratic process. Consequently, Chinese companies are small by both global and Asian standards. For instance, New Hope Group, China's largest private-sector company, had just \$1 billion in sales in 2002. That same year, South Korea's largest company, Samsung, reached \$40 billion in sales. And Thailand's largest private company, Charoen Pokphand Group, reported more than \$5 billion in sales.

Second, the only organizations large enough to compete on a global scale are often the state-owned enterprises. According to Fortune, the government owned 98 of the 100 biggest Chinese companies in 2002. Many of these enterprises suffer losses, stay in business only because of the monopolies they enjoy, and thus aren't globally competitive.

Third, the status quo can't be changed easily because, until recently, the Chinese government usually denied private companies permission to sell equity shares in the capital market or to borrow from commercial banks. (The Chinese

government officially announced that it would support the growth of private business at the 16th National Congress of the Communist Party of China held in November 2002.) However, the state often invests in the shares of public-sector companies and provides them with subsidized credit. Neither public nor private companies can become competitive in such a financial system, goes the conventional wisdom.

These arguments, however comforting they may be to global managers, aren't entirely accurate. Over the past five years, we've studied the strategies and ownership structures of more than 50 Chinese companies. Our research shows that multinational executives who don't perceive China's state-owned and privately held companies as potential competitors have missed the rise of the new breed of Chinese companies that have already succeeded in capturing some foreign markets. These hybrids evolved as the government's policies about the private ownership of companies changed—from forbidding the practice to tolerating, recognizing, and encouraging it. The companies have acquired public-sector, private, and even foreign shareholders in recent years. For instance, Qingdao municipal government, local investors, and the company's managers jointly control Haier's equity. While the Chinese government holds a majority stake in TCL Group, the country's second-largest manufacturer of TVs and mobile phones, strategic investors, such as Japan's Toshiba and Sumitomo, as well as the company's managers, also own shares. And shareholders of China's Legend Group, which last year had a 20% share of the global market for motherboards, include the Chinese Academy of Sciences, local investors, and managers. Officially, Legend is classified as "state-owned, non-government-run."

Companies like Haier, TCL, and Legend have become globally competitive because their mixed ownership allows them to overcome the weaknesses of the Chinese system. They're driven by the profit motive in what is still a Communist country, yet they receive support from one or more arms of the state. The government doesn't interfere with operations at these companies because the businesses aren't part of the public sector, and so these hybrids enjoy almost total autonomy. At the same time, government officials believe that the global success of these companies will further national, regional, and even personal interests. They've often been involved in setting up the hybrids, sitting on their boards, and fashioning industry policies that affect them. The bureaucrats let the hybrids tap the capital market by giving them permission to list on China's stock exchanges ahead of other companies and allow them to take over other companies quickly—two crucial advantages. Haier, for example, grew rapidly by acquiring dozens of unprofitable collective and state-owned enterprises in the early 1990s. The bureaucrats also discreetly provide the hybrids with bank loans and licenses, particularly if they operate in industries that the government has opened up to foreign competition. The less protected the industry, the more competitive the hybrids have become, as the cases of Haier and Galanz in the home appliance industry demonstrate.

China's challenge to the rest of the global market has been difficult to track because it hasn't taken one predictable form, as Japan's or South Korea's did. Instead of a few, large, privately owned companies trying to make inroads in the international arena, four groups of Chinese companies are simultaneously tackling the global market. China's national champions are using their advantages as domestic leaders to build global brands. The country's dedicated exporters are attempting to enter foreign markets on the strength of their economies of scale. China's competitive networks have taken on world markets by bringing together small, specialized companies that operate in close proximity. And the technology upstarts are using innovations developed by China's government-owned research institutes to enter emerging sectors such as biotechnology. Each group, starting from a strong base of cost competitiveness, has found a way to make its presence felt outside China's borders.

National Champions

After competing for decades with global leaders selling products on their home turf, some Chinese companies decided to concentrate on developing and selling products not just in the domestic market but also overseas. These national champions, as we call them, have tested the waters confidently, because they have successfully kept their multinational rivals at bay at home. But overseas, they don't challenge their bigger opponents head-on. Instead, they scout for segments that the market leaders have vacated or aren't interested in serving because profit margins or volumes are low. They use their experience in adapting technologies and features to meet the price points of cost-conscious Chinese buyers to develop products for those segments. Not surprisingly, low manufacturing costs allow these national champions to turn a profit where their rivals can't.

Haier exemplifies this strategy. By the early 1990s, the company had battled Whirlpool, Electrolux, Siemens, and Matsushita to become the leader in China's market for home appliances. The \$8.6 billion company manufactures 250 types of refrigerators, air conditioners, dishwashers, and ovens. When it entered the U.S. refrigerator market in 1994, Haier sidestepped market leaders like GE and Whirlpool. For five years, it focused on selling only compact refrigerators—units smaller than 180 liters—that could be used as minibars in hotel rooms or that students could squeeze into dorm rooms. The incumbent leaders had dismissed these market segments as peripheral, but they proved

to be quite profitable for Haier, which last year had about half of the minifridge market.

The company's second strategic foray was equally cautious: In 1997, Haier entered the market for "wine coolers"—refrigerated units for storing bottles of wine—and captured 60% of that specialized segment last year. In 2000, Haier set up a design center in Los Angeles and a manufacturing facility in Camden, South Carolina, to expand the range of products it sold and to bypass the nontariff barriers imposed by the United States on imports of appliances. Haier has persuaded nine of the ten largest retail chains in the United States to carry its products, and the company has won several U.S. government contracts.

Haier's customers didn't demand groundbreaking innovations or state-of-the-art technologies; they only wanted products that were reliable, cheap, and designed to meet their basic needs. Like Haier, many Chinese companies can deliver such products in both low- and high-tech industries. That allows them to surprise their rivals who are more worried about disruptive technologies and breakthrough innovations. For instance, no one took much notice when the \$2.7 billion Huawei overtook Shanghai Bell (an Alcatel joint venture) to become a dominant supplier of digital switches and routers in China. Market leaders Cisco, Nortel, and even Alcatel attributed Huawei's success to the peculiarities of the Chinese telecommunications market. They didn't feel threatened because they believed their high-end networking products were superior to Huawei's. So you can imagine how shocked they were when Huawei entered the low end of the international market with routers that were 40% cheaper than the competitors'. By 2002, Huawei had 3% of the world market for routers, and one Wall Street analyst was recently quoted in *Forbes* as saying that Huawei is "the biggest reason I know to sell Cisco stock."

Despite the advances they've made, China's national champions have found it difficult to leverage their strengths in some highly segmented markets because they lack a deep enough understanding of local tastes and customer habits—for example, in the markets for cosmetics and regional foods. Moreover, these companies haven't invested heavily in new product development or customization. Part of the problem is that not all of them use proprietary technologies. Chinese DVD manufacturers, for instance, depend on Japanese and European companies for certain component technologies. Still, China's national champions are learning to overcome these deficiencies, employing the same techniques they've used before to fight their global rivals in the domestic market, including increased investment in R&D and novel marketing campaigns.

Dedicated Exporters

Despite the pull of the domestic market, some Chinese companies set their sights squarely on the external market when the government opened the economy. These dedicated exporters were probably motivated by the prospect of reaping global economies of scale or the knowledge that competition in their businesses was inherently global. Some of them attacked the overseas market from the start; others, which were subcontractors to big international players, had to think small at first to ensure that they didn't jeopardize their supplier relationships.

Not surprisingly, China's dedicated exporters first broke into mass markets, where they enjoyed an edge over rivals because of their low production costs. Take the case of Guangzhou-based Pearl River Piano, which set up one of the world's largest piano-manufacturing facilities in 1992. Even as the \$88 million company established its reputation as a reliable supplier of pianos in the local market, it also scouted for a beachhead in the United States. By 1999, Pearl River had concluded there was demand in North America for a high-quality, inexpensive, entry-level piano—a gap it could easily fill as one of the world's cheapest piano producers. The next year, the company sent a four-member team to sign up distributors to help build the brand and launch the product in the United States. Despite the recession, the Chinese company increased its share of the U.S. market from 5% in 2001 to 10% in 2002. Not only is Pearl River investing more in its brands, it is also building a design center in Germany as a prelude to a European launch.

China's dedicated exporters don't confine themselves to the volume game. As they develop expertise with crucial technologies, they migrate to specialized, high-value segments. They aren't shy about striking partnerships or acquiring rivals to move up the value chain. For instance, CIMC set up six plants along China's coast in the 1990s to manufacture shipping containers. Because of its cost structure and the boom in China's trade, the \$1 billion company became the world's largest producer of standard freight containers by 1996. In 1997, CIMC bought Hyundai's container-making operations in China, primarily for Hyundai's refrigerated-container-manufacturing technology. Over the next five years, CIMC captured half the world market for refrigerated containers. By 2002, the Chinese company had developed the ability to design and manufacture a full range of refrigerated containers—for air, sea, road, and rail—and is still the only company in the industry to have done so.

The speed at which China's dedicated exporters are able to master important technologies and component designs is impressive. The \$1 billion Galanz, for example, started out in 1997 producing microwave ovens for the local market

and for a few Japanese and European companies. Two years later, the company produced 200,000 units, and in 2002, it manufactured 15 million microwave ovens for more than 200 brands worldwide. As it moved up the learning curve, Galanz invested \$100 million in R&D and bagged 600 patents in microwave-related technologies. Many customers depend on the company not only for manufacturing capacity but also for technological innovations and product-engineering skills. Having mastered microwave technology, Galanz launched its own brands in Europe, where it held a 40% share of the market last year. Likewise, it is only a matter of time before Chinese suppliers like Midea and BYD Battery, two of the world's largest manufacturers of fans and rechargeable batteries, respectively, start building their brands.

China's dedicated exporters have thrived in industries where competition centers on manufacturing excellence, low costs, and high economies of scale. However, these companies are at a disadvantage when product choice or service is critical for success. In such markets, the lack of experience in global marketing and service delivery has proved to be a handicap for these companies. But the exporters are trying to acquire the capacity to enter specialized segments by outsourcing brand-building skills and by striking alliances with distributors outside the country rather than going it alone.

Competitive Networks

In the city of Wenzhou (population about 7 million) in Zhejiang province, south of Shanghai, the manufacture of cigarette lighters began in the mid-1980s, when locals brought them back from Japan as gifts. The enterprising Wenzhouers broke the gadgets down into components and learned to produce replicas. By 1990, more than 3,000 families in the city were making lighters. The intense competition among them soon forced a shakeout. The smaller family businesses switched to making components for the lighters, and the larger companies focused on assembling them. That's how the Wenzhou network, about 700 private companies that operate as a single unofficial entity, came into being. This specialization drove down their manufacturing costs; the cost of an igniter, for instance, fell from \$1 in 1990 to 25 cents in 1999. That allowed the Wenzhou network to enter the international market. It sold based on price at first but earned higher margins as it learned to produce new designs faster. Last year, the Wenzhou network manufactured 750 million lighters and enjoyed a 70% share of the world market. Because of the Wenzhou network's dominance, most of the Japanese and South Korean companies that used to control the lighter business are gone.

There are a number of competitive networks, or clusters, in China, each made up of hundreds of small entrepreneurial companies (and their families) located in one geographical area and operating as a cohesive, interdependent entity. Since the networks have few, if any, bureaucratic systems and little, if any, corporate overhead, they are highly flexible, low-cost producers. They thrive in markets that require quick responses to changes in demand. Foreign executives usually ignore them because the networks don't conform to the conventional notion of a globally competitive organization. But their power shouldn't be underestimated. China's networks have taken the markets for watches, socks, shoes, toys, pens, and Christmas decorations by storm, capturing market shares of as much as 50% in some of these industries. Indeed, in these markets, the "made in China" tag has itself become a powerful brand among distributors and retailers.

Many of China's networks operate in industries where changes in style affect demand. They've hired fashion houses in Asia and Europe to fill the gaps in their knowledge and to help them anticipate trends. For instance, a 1,000-unit network in Shengzhou, a rural county that is also in Zhejiang province, produces 250 million neckties a year. The network is in a mountainous area where the average per capita income is less than \$1,000 per year, so its manufacturing costs are low. Over the last two years, the network has invested \$40 million to improve the technology it uses and has hired several experts from Europe to improve product design and quality. The network has also become a supplier to international fashion houses like Armani and Pierre Cardin. The Shengzhou network codesigns ties with the fashion houses—using collaboration software over the Internet—and turns the designs into products in just 24 hours. The network supplies the bulk of its products to European retailers. Its product quality and designer links have enabled it to challenge the Italian, French, and Spanish incumbents at the top end of the market.

It is not easy to get a network to coalesce out of a rabble of competing firms. At first, every family aspires to become an assembler of the final product—the link in the chain that is seen as most prestigious. Over time, however, companies realize they will be better off specializing in activities that allow them to play to their strengths. Local government in China often helps the process by offering incentives, licenses, and approvals in ways that encourage specialization and eliminate internal rivalry.

The weakness of China's networks is their inability to make the investments necessary to build brands. But just as Benetton successfully brought together several of Italy's small knitting firms, a few large Chinese companies are exploring the possibility of linking up with the networks to help them realize their full potential.

Technology Upstarts

Many Western managers believe that high-tech businesses are immune to competition from Chinese companies. That's a dangerous misconception, especially when you consider that, among other things, gunpowder, paper, and the compass were all invented in China. Under the central-planning system, the Chinese government built a large infrastructure for basic scientific research and developed sophisticated military-related technologies. The research could be used only by the government or the military and wasn't commercially exploited for decades. That changed in 1984, when the government shook up the research community and forced state-owned laboratories to obtain most of their funding by commercializing the technologies they developed.

China's research institutes have spawned several companies to take their technologies to market. For example, Legend, China's biggest PC manufacturer, was set up in 1984 by a group of scientists who worked at China's Institute of Computing Technology. Other institutes have encouraged their scientists to turn into entrepreneurs. China's Institute of Biochemistry and Cell Biology, which is funded by the Chinese Academy of Sciences, in 1999 succeeded in generating a DNA array representing 8,000 human genes. The institute encouraged one of its scientists to use the research to develop a protein chip that would allow the diagnosis of several types of cancer through a single test. The scientist floated a company, Shanghai HealthDigit, which used funds from commercial investors to develop the biochip, which was approved by China's FDA in 2001. Last year, the company sold 150,000 units of the chip—still the only one of its kind in the world—to 200 hospitals across Asia.

Several Chinese companies have also used state-of-the-art technologies created in government laboratories to develop products for the world market. Beijing Founder Electronics, which dominates the market for electronic systems that publish Chinese characters, has drawn on several technologies produced by state-funded research projects at Beijing University, for example. That has enabled the \$1.7 billion company to become a challenger in the high-resolution electronic publishing systems market.

Companies are able to buy technologies relatively inexpensively because the Chinese government usually has underwritten most of the costs. The state set up a string of institutes in the mid-1990s for biotechnology and broadband mobile telephony research, and they spawned several start-ups. Datang Microelectronics, for example, has drawn on research done by China's Telecommunication Research Institute to become a major global player in the design and manufacture of integrated chip sets.

China's technology upstarts are enlisting support from the large numbers of people who left the country in the late 1970s to study overseas. In fact, it isn't unusual to find start-ups in China with a local CEO, a CTO groomed in Silicon Valley, and a CFO from Hong Kong or Taiwan. For instance, the Hangzhou-based business-to-business portal, Alibaba.com, boasts a CEO from China, a COO from Hong Kong, a CTO from the United States, and a CFO from Taiwan—all of Chinese descent.

The companies discussed in this article are the forerunners of the globally competitive organizations that will emerge from China in the future. The country's new leaders President Hu Jintao and Premier Wen Jiabao believe that building multinationals will help China become an economic superpower and have started implementing policies that will spur the growth of more Chinese brands. For instance, former president Jiang Zemin announced in March 2001 a "going abroad" policy to encourage Chinese companies to invest overseas. While the Chinese government has been leery about providing subsidies and incentives to companies that want to be global players, it has started removing some of the roadblocks in their path, such as tedious project approval processes, stringent foreign-exchange controls, and a state monopoly over exports.

The Chinese government already supports 22 companies with global potential—six whose goal is to be among the 500 biggest companies in the world and 16 that want to build global brands. They get speedy government approvals for, say, foreign investments; a few subsidies like smaller social welfare burdens; and easy access to bank credit for working capital. The government has also publicly recognized the efforts of CEOs who have set out to build global brands, like Haier's Zhang Ruimin. Moreover, competition within China will become fiercer as the government implements its promise to the World Trade Organization to cut tariffs from an average of 24.6% in 2002 to 9.4% by 2005. At the same time, Chinese companies will find it easier to break into foreign markets because the European Union, Brazil, Mexico, and the United States will reduce tariffs and abolish quotas on Chinese imports. Indeed, China's hidden dragons could be your company's biggest rivals in the next five years.

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