# Case Studies on

# MNCs in China – Vol.II

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## OVERVIEW

"There is no nation which does not need to borrow from others."

– John Stuart Mill

China's rich market potential and rapid economic reforms have made the country a prime target for MNCs, a growing number of which may be characterised as strategic—or "second generation"—investors.[1] No longer content with establishing a beachhead in a single product or in one region of China, these second-generation MNCs are committed to pursuing ambitious investment programmes and building dominant, nationwide market positions and world-scale businesses.

But translating commitment into reality in China, as leading investors have found, takes far more than a blank check, a good product and a careful strategy. For one thing, it demands that MNCs understand and deal effectively with the complex, often confusing, web of government entities that approve and facilitate business development—especially in such highly regulated sectors as telecommunications and energy.

Internally, multinationals face the equally daunting task of coordinating business units, regional and country organisations, and support units – to realise synergies, maximise impact and contain cost duplication. Moreover, enormous time and energy is needed to manage multiple Joint Ventures (JVs) – still the principal means of market access for foreign investors – with local partners, who typically lack product and market knowledge, distribution reach and financial resources to match MNC aspirations. Yet skilled local managers and experienced expatriates, capable of leading China initiatives, are woefully scarce.

China's unique opportunities and challenges are prompting many multinational pioneers to rethink their established ways of building businesses in new markets as they seek to increase the pace and pay off of their China investments. While the specifics vary and implementation is still in its early stages, there is mounting evidence of innovative organisational approaches to improve the coordination and control of business development – by cutting across traditional global business-unit boundaries, centralising key functions and developing local structures and staff that will allow MNCs to better shape their own destinies in China. How can companies capture the China mass-market opportunity profitably? What are the business model implications and how will changes impact their China and global operations?

McKinsey[2] (through its discussions with leading MNCs) has identified these emerging organisational solutions to four critical requirements, for success in China. Although these ideas were set forth in 1995, their relevance is not lost over time:

1 Shaw Stephen M. and Meier Johannes, "Second generation MNCs in China", *The McKinsey Quarterly*, 1993 Number 4, pages 3–16

2 Meier Johannes, et al., "Solving the puzzle: MNCs in China", *The McKinsey Quarterly*, 1995 Number 2

- Achieving effective coordination of external relationships and investment decisions by establishing a strong China corporate centre, with a clear mandate to lead strategy development and implementation.
- Gaining control of inherently weak JVs by taking majority equity stakes, deploying expatriates in key management positions and providing outside support.
- Coordinating multiple JVs by creating China business units – to provide focused management leadership and share services and product expertise across ventures.
- Strengthening local human resources by bringing in expatriate managers/ trainers, investing heavily in training local staff, establishing China career paths for them and instilling corporate values.

While these organisational solutions obviously must be tailored to the needs of individual companies, experience suggests that they are likely to steer MNCs away from their characteristic hands-off, JV-driven approach and toward more integrated business development and management in China.

In recent years, however, most established foreign MNCs have enjoyed strong revenue growth and profitability by riding on the back of China's spectacular economic growth. China already contributes on average nearly 10% of global revenues of 180 MNCs, as per IBM Global Business Services study.[3] At the same time, in 2006, the American Chamber of Commerce in Shanghai reported that 64 percent of its member companies were profitable and 65 percent had profit levels in China equal to or higher than in other countries.[4]

MNCs are moving to restructure their business in China into holding companies, given new relaxed rules on investment and the country's rising position in their global strategy, an authoritative report[5] stated.

The report, released by the Chinese Academy of International Trade and Economic Co-operation under the Ministry of Commerce, said multinationals will centralise management, to enhance their competitiveness in the large market.

Previous government rules on foreign investment forced MNCs to set up separate legal entities with every investment, said Wang Zhile, author of the report. Wang adds that the need to form joint ventures with different partners at different locations, limitations on business scope approvals and local registration requirements, have made MNCs have sizable management teams in finance, sales and human resources. In certain cases, some MNCs have over 50 separate legal entities in China.

[3] "Winning in China's Mass Markets – New Business Models, New Operations for Profitable Growth", (a Survey in cooperation with Economist Intelligence Unit), *IBM Global Business Services*

[4] "The AmCham-China White Paper: American Business in China", The American Chamber of Commerce of People's Republic of China, http://www.amcham-china.org.cn/amcham/show/content.php?Id=1570&menuid=&submid=, May 16th 2006

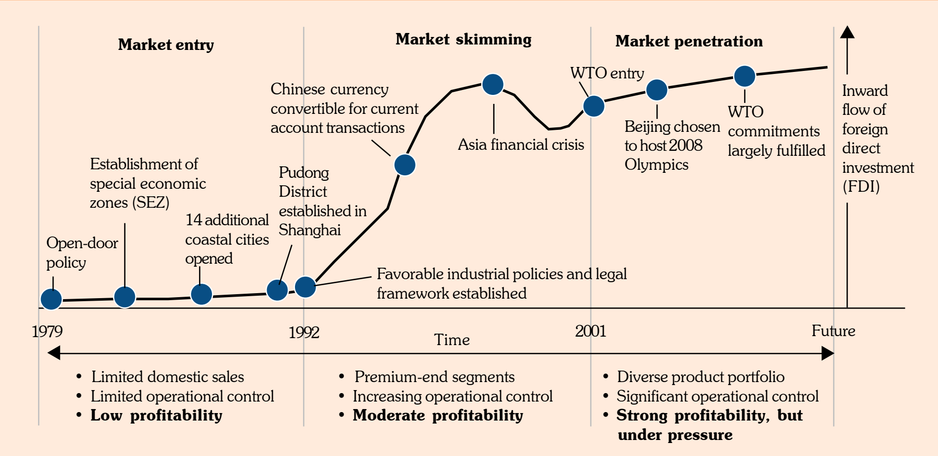
[5] "Multinationals reshape operational model", http://english.peopledaily.com.cn/200404/08/eng20040408_139813.shtml, April 8th 2004

With their investment in China increasing, more MNCs plan to restructure their fragmented management system by setting up a holding company, Wang asserted. Unlike other manufacturing and trading foreign companies, which are limited to conducting business where they are registered, holding companies are permitted to invest in projects all over China. "The latest government policy also supports these MNCs moves", Wang said. China allowed the establishment of foreign holding companies in 1995, but numerous limitations made the corporate structure impractical.

The situation changed after China implemented its promises to the WTO in 2003, Wang said. The past quarter century has been – until recently – an uncertain quest of profitability for most foreign MNCs in China. MNCs' long march to profitability has been marked by both spectacular successes and failures, as companies navigated through China's opaque pre-WTO regulatory environment. This journey can roughly be divided into three stages: market entry, market "skimming" and market penetration (Exhibit I).

**Exhibit I**

**Multinationals in China – The Long March to Profitability**




Source: "Winning in China's Mass Markets – New Business Models, New Operations for Profitable Growth", (a Survey in cooperation with Economist Intelligence Unit), *IBM Global Business Services*

Holding companies now can conduct domestic and international trading, by selling products manufactured by their affiliates and by providing after-sale services. Holding companies are also permitted to provide inter-company financial services. A regulation issued by the Ministry of Commerce last June allows holding companies to take part in a broader range of industries. Japan's Matsushita has begun the move to transform Matsushita Electric (China), from a support firm for Matsushita China businesses to a holding company. The company will assume control of Matsushita's shares in its 50 subsidiaries and factories in China, which previously belonged to different departments of the Japanese parent company.

Besides the policy incentives, China's rising position in MNCs' global strategy highlights the need for improved local management, Wang affirmed. MNCs are changing their assessment on China from a world factory to a world market, Wang felt. He adds, "Besides having investments in China to produce for exports, they find China is actually emerging as a large consumer market." Further, to support the change, MNCs are setting up R&D centres and service departments, especially for the market. Wang stated that the change also requires stronger local management, by setting up a holding company. Different departments of the overseas parent company, which often results in slow response to market change, usually manage the separate ventures in China. Samsung Group, which has strong centralised management in China, topped the MNCs in China in terms of revenue by US$10.5 billion, according to Wang.

In China's rapidly changing environment, recent success cannot guarantee the future. Industrial and consumer products companies alike will have to re-evaluate their business models and operations, to sustain rapid revenue growth and profits. In industries, ranging from automobiles to electronics, lower-end product segments often account for the largest portion of the total market and these segments are typically growing fast. MNCs counting on China for strong revenue and profit growth – or simply hoping to maintain market share – will need new approaches to win in price-sensitive mass markets, while preserving their market leadership in higher-margin, premium-end market segments.