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Building a second home in China

Jeff Galvin, Jimmy Hexter, and Martin Hirt

Multinational companies hoping to succeed in China can't treat it as an interesting side bet any longer; they need to take China as seriously as they do their home market.

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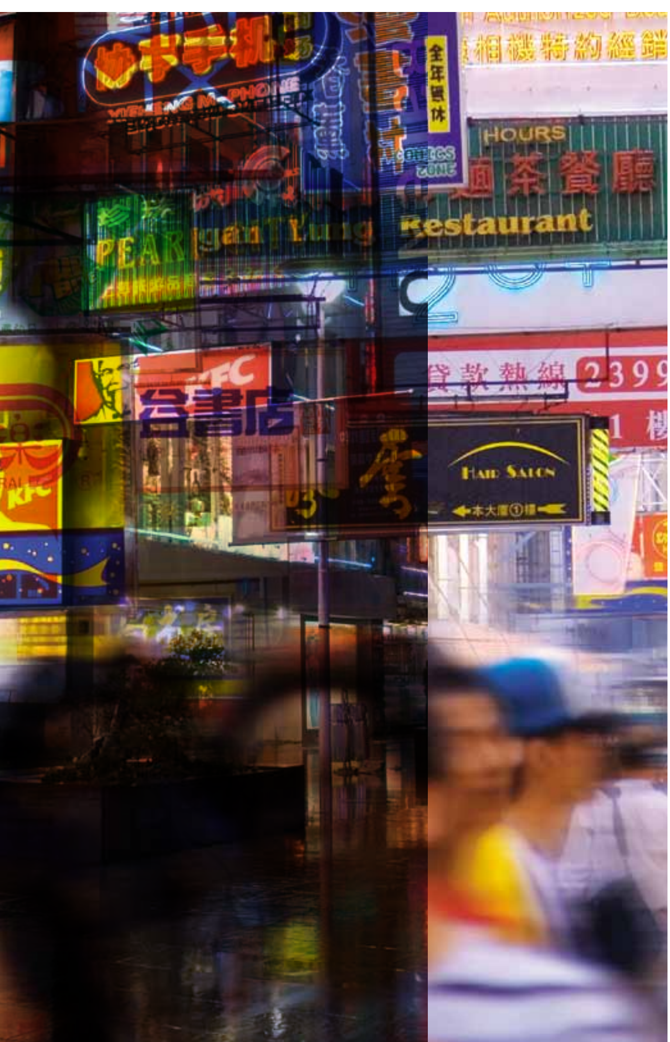
The problem
Few multinationals are committing to China a level of resources and management attention commensurate with the country's importance.

Why it matters
China is becoming the competitive battlefield where global winners are determined. Companies that succeed in China will create competitive advantages they can exploit in other markets. Companies that fail to do so may be vulnerable in their own home markets to attacks from Chinese companies and other multinationals that succeed in China.

What you should do about it
Even if you have been operating in China for years, challenge yourself to raise your organization's game in China by treating it as a second home. For example:

Rethink your aspirations for China with regard to market share, sourcing volumes, productivity, performance, and R&D activity. **Focus as much management attention** on China as you do on your home market, including placing critical senior executives there. **Stop thinking about China as a market that's too nascent** to require the same sophisticated approaches you employ elsewhere. **Instead, bring your best practices** to China, in areas ranging from technology and product strategy to marketing, distribution, service, and supply chain management.



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The past two years have underscored China's resilience and dynamism. Its economy has been booming against a backdrop of global stagnation. China's business environment, in particular, has been changing fast, with new regulatory policies and a rising cost of doing business affecting the playing field for multinationals (see sidebar "Cautious sentiments").

But the real story, in our view, isn't China's continued, rapid evolution. It's the fact that, in far too many cases, executives still aren't making China as central as it should be to their global strategy. In sectors ranging from auto parts to consumer electronics, semiconductors, aviation, and electricity transmission equipment, China is fast becoming the competitive battlefield on which global winners are determined. Even when companies are not competing in China, their Chinese and foreign rivals may soon be exploiting advantages earned there to compete in global markets.

With the stakes this high, the implication is clear: it is no longer possible for most companies to succeed in China while treating it merely as an interesting side bet. Instead, they need to start building a second home in China. At the core, this means committing a company as seriously to success in China as in its home market. The starting point is to set targets for performance in China that are on par with those at home: companies need to raise their aspirations for, and rigorously measure, a variety of targets. Some of them, such as senior-executive time spent on China and knowledge of Chinese customers, are challenging to quantify but no less important than more straightforward metrics regarding market share in China or sourcing volumes. Then companies need to deliver against those targets by bringing to China their global best practices across the value chain, adapting them as needed to local conditions, and executing against them. This sounds easy but happens so rarely that it's a powerful competitive differentiator.

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Why you may need a second home in China

For a simple illustration of China's long-term importance, let's consider a relatively modest industry: piano manufacturing. By some estimates, China has at least 50 million piano students among its

650 million urban residents. As China adds 20 million urban residents every year and average incomes in cities rise, the number of piano students will surely grow in unison. It is not hard to imagine a time in the near future when China has 100 million piano students.

While the parents of these piano students will want to purchase pianos for their children, it is unlikely that the large and expensive pianos in many North American or European homes will be well-suited to smaller, multigenerational Chinese homes. Some company will develop and bring to market a value-priced, more appropriately sized piano that sells well in China. It may be Pearl River Piano; it may be Great Wall Instruments; it may be Steinway & Sons or

Cautious sentiments

An AmCham-China[1] survey published in March 2010 found that 38 percent of US businesses now feel foreign companies are “unwelcome” in China, up from 26 percent just two months earlier and the highest percentage recorded since AmCham began conducting the survey four years ago. The European Chamber of Commerce is reporting similar concerns among its members. The explanation for these cautious sentiments goes beyond recent tensions between China and Google or concerns about the value of the renminbi and China’s role at the 2009 Climate Change Conference in Copenhagen.

For starters, there’s a perception that efforts are under way to limit foreign companies’ access to the Chinese market. In 2009, China announced a National Indigenous Innovation Product (NIIP) accreditation policy that would give advantage in government procurement to products certified as containing “indigenous innovation.” Fifty-seven percent of foreign technology companies surveyed recently said the policy would hurt their future business, and 37 percent said they were already feeling the impact, even though the policy was not yet officially in place. Similarly, in 2009, a new antimonopoly law was created to prevent any company from gaining a dominant position that would affect the competitive landscape in China. The first use of this law was to block Coca-Cola’s acquisition of China Huiyuan Juice.

What’s more, the cost of doing business is rising. Wage growth has averaged 15 percent annually since 2000. The renminbi has risen, and most multinationals expect this trend to continue. Tax law changes in 2008 reduced certain investment incentives and imposed

Yamaha. Someone will do it. Once that company's piano wins in China and gains the advantages of scale, it will have a good chance of being successful, first, in other emerging markets (such as Brazil, India, and Turkey) and, soon thereafter, in Germany and the United States. While this may sound far-fetched, two-thirds of the world's violins are already made in China.

Pianos exemplify the impact China will have on the structure of many industries as its role in the global economy expands far beyond low-cost manufacturing. Now, in industries ranging from musical instruments to semiconductors to auto parts to electricity transmission equipment, competition in China is leading to the

a 10 percent withholding tax on repatriated dividends. All these factors reduce China's cost advantage versus other low-cost countries, while high stock market valuations of Chinese companies make it more expensive to grow through acquisitions.

Although we don't know how these trends will evolve, our experience—and the private reflections of executives who logged many miles in China—suggest that multinationals should take a long-term and comparative perspective on recent events. For example, some of the new tax rules represent, to a certain extent, a leveling of the playing field, which previously favored multinationals. Similarly, some new regulations, such as the antimonopoly law, have long-established analogues in the European Union and the United States and in fact represent China's own attempt to move toward developed-market norms. A top executive at one large multinational recently mused that many of China's policies today remind her of France's industrial policies 30 years ago—and German and US companies did not abandon the French market.

To repeat: there is a broad consensus that the introduction or application of new regulations appears to be disadvantaging some non-Chinese companies. But what seems equally clear is that China is going through an evolution in its business environment, and the end game is far from certain. Given the importance of the market, rather than turning away, prudence suggests looking hard for ways to navigate this dynamically evolving business landscape.

[1]The American Chamber of Commerce in the People's Republic of China.

creation of new products that have the potential to win in global markets—and, importantly, the winners can be either Chinese or foreign companies. One US company found that to be competitive in China, it had to redesign a semiconductor product to bring its cost down dramatically. Once the company was able to deliver such compelling value, its factory in China, which had been built to supply the domestic market, ended up exporting nearly 80 percent of its production.

In 2009, China became the world's largest market for cars. Here again, the initial game is local. But once the "value for money" cars now on sale in China reach a certain quality level, the global auto industry will likely be changed profoundly. It's only a matter of time: consider, for example, the relentless pursuit by Chinese companies of Western automotive assets—typified by Geely Automobile's recent acquisition of Volvo—and of capability-enhancing joint ventures, such as the two, involving Chinese companies and GM, that together expect to sell over two million vehicles this year. Meanwhile, BYD Auto, a Chinese battery maker that has been focusing on making an electric car, recently announced that it will have one for the US market in 2011. Warren Buffett is a believer: he bought a 10 percent stake for $230 million last fall.

Too few executives focus on China's long-term impact in a serious way—and when they do, most conclude that China is more important than they previously imagined.

Of course, it would be naïve to suggest that China must be a second home for every company or product line or that it will be possible in all cases to capture significant market share and scale advantages there and to exploit them globally. In some industries with dominant incumbent players or significant regulation (such as power generation or electricity transmission and distribution), it may not be feasible in the foreseeable future to gain significant Chinese market share.

Even where local market opportunities are limited, though, it's still possible to gain global advantages by leveraging China effectively. A company might, for example, develop a Chinese sourcing program that gives it a leg up on competitors in other markets by providing access to the lowest-price, high-quality components. Or it might establish a leading R&D center, become an extremely desirable employer, and leverage China's abundant pool of low-cost but high-quality engineering talent for global product development.

Determining the role and importance of China is an industry- and company-specific exercise that requires a combination of competitive analysis, market research, war-gaming, and creative scenario planning (for an example of forward-looking industry analysis in the Chinese automotive sector, see "Applying global trends: A look at China's auto industry," to be published in late July on mckinseyquarterly.com). In our experience, too few executives focus on China's long-term impact in a serious way—and when they do, most conclude that China is more important than they previously imagined.

Measuring your second home

We've written in the past about how Danfoss, a European industrial-controls manufacturer, overhauled its operations in China after deciding that a focus on market share, as opposed to revenue, was the only way to avoid being eclipsed by competitors.[1] Danfoss illustrates the importance of translating bold aspirations into metrics, which can be either quantitative or qualitative.

Quantitative metrics

Danfoss focused on market share, but that's just part of the equation. The key is to review the entire business model, understand where China's impact will be greatest, raise the relevant aspirations accordingly, and then measure them rigorously. For example, what percentage of a company's sourcing should come from China, and what should be the cost of the items sourced there? In our experience, when companies—whether they are retailers or electronic-component manufacturers—assess the economics of their Chinese suppliers as rigorously as they assess suppliers at home, they often find that

[1] See Jimmy Hexter and Jonathan R. Woetzel, "Bringing best practice to China," mckinseyquarterly.com, November 2007; and William E. Hoover Jr., "Making China your second home market: An interview with the CEO of Danfoss," mckinseyquarterly.com, February 2006.

It's not impossible for a US-based executive to develop the mind-set, gain the exposure, and stay sufficiently current on the Chinese market to make good, timely strategic and operational decisions.

despite how low procurement costs in China seem, they still are overpaying significantly by local standards. Manufacturing productivity is another area worth measuring seriously. In many industries, Chinese factories today can achieve the same levels of productivity as those elsewhere in the world. Or consider this: how many PhDs in Xi'an might be worth hiring to support global product-development efforts?

All that said, market share is not a bad starting point for many companies. Conducting "how big could we really become?" exercises can be eye opening. For example:

Medical equipment. One medical-equipment company found that the potential market in China for its products was 35 percent larger than it had thought, simply because it had not previously considered a large group of customers whose budgets, it wrongly perceived, were too small to be worth targeting.

Infrastructure. An infrastructure company found that the market for its existing products was 140 percent larger than it previously estimated, largely because it had been considering only the same industrial-customer segments it served outside of China.

Industrial automation. An industrial-automation company found that the premium segments it had initially targeted constituted just 25 to 35 percent of the potential market opportunity for its products. And while the gross margins in the segments it served were indeed higher (around 40 to 50 percent), those in the value segment it was neglecting were still 25 to 35 percent, on average.

Qualitative metrics

Alongside such quantitative metrics, companies seeking to build a second home in China need to pay at least as much attention to softer measures of their commitment to the country. Surprisingly, many European and US executives who ask themselves questions like the ones below identify a significant gap between the stated importance of China and its actual place on their priority lists:

Time spent in China. How much time each year do your global CEO, CFO, and other C-suite executives actually spend in China? When was the last time the company held a board meeting in China? How does this compare with the number of trips or board meetings in Europe, Latin America, or North America? Is this the right balance?

Visibility into China operations. Do any of your China business leaders, within either corporate functions or business units, report directly to the CEO? Is the person reporting to the CEO about China based there? Are your China operations important enough to your company's future that the CEO should hear about them firsthand?

Chinese representation in the senior team. How many of the company's board members are from China? How many top executives are from China?

Knowledge of Chinese customers and suppliers. In the home market, most CEOs and business unit leaders know the CEOs of current (and potential) customers and suppliers quite well. Does your CEO have similar personal relationships in China?

Relationships with government leaders and regulators. In home markets, top business leaders know government leaders and regulators well and often join government advisory boards. Does your CEO have the same level of familiarity with government leaders and regulators overseeing your business in China? Do you play any advisory roles in China that are similar to those you play in your home market?

One multinational was so disturbed by its answers to questions like these that it immediately promoted the leaders of its major business units in China to the same executive status as the leaders of businesses in Western Europe. Another company, after investigating why it had identified many promising acquisition targets in China yet never followed through on them, found that nearly all of the acquisition ideas were being vetoed within its business units before reaching the CEO. In response, the CEO created a monthly China M&A review.

These examples highlight an organizational issue. Many multinationals have a "China CEO" who is the public face of the company there and tries to develop or influence overall China strategy. But line operations in China often roll up into global business units or functions headquartered in Europe, Japan, or the United States, where most of the P&L responsibility typically remains. The home market also continues to "own" and make decisions for global R&D, product development, IT, and other functions. In this way, business unit leaders in China effectively become sales managers—several steps removed from real decision making about what they are selling and sometimes even how they are selling it.

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It's not impossible for a US-based executive to develop the mind-set, gain the exposure, and stay sufficiently current on the Chinese market to make good, timely strategic and operational decisions. But it's hard—which is why we believe more companies will need to place significant global leaders in China, as Wal-Mart Stores did several years ago when it moved to Shenzhen the company's head of sourcing, who has made major contributions to Wal-Mart's Chinese sourcing efforts. IBM, too, recently moved its global sourcing leader to China. (See sidebar "How one company is making China its first home" for another example.)

Making your second home as strong as your first

While it may sound obvious that companies should bring their best practices to China, too often that's the exception rather than the rule. Few multinationals conduct anywhere close to the same level of primary customer research in China as they would in Europe or the United States. Many distribution systems have insufficient reach or are outsourced to third parties purely on the basis of cost or ease of setup. After-sales service is rarely as good in China as it would

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How one company is making China its first home

Julian Birkinshaw

Irdeto Access, a Dutch software company, recently moved its CEO and global headquarters to China. In 2007, the producer of content security solutions for media operators in digital pay-TV, Internet, and mobile communications was a 700-employee company headquartered in Amsterdam. Most of its sales had historically been in Europe, but the growth opportunities were primarily in Asia. As CEO Graham Kill recalled, "A mother ship in Holland, with satellite regions elsewhere, was not going to provide us with the growth we wanted." Nor did Kill feel "well placed to respond" to Chinese competitors, such as China Digital TV, that "had emerged from nowhere and were eroding our positions."

After considering a number of options, the company decided to replace its Amsterdam headquarters with a "dual-core" headquarters split between Amsterdam and Beijing. This meant that decision making and traditional headquarters functions would be shared across the two locations. To show commitment to the change, Kill moved himself and his family to Beijing in August 2007, with two other members of the executive team following in 2008. Over the next two years, Irdeto's business in Asia grew dramatically, and many customers pointed to the CEO's Beijing location as a factor in their decision to work with the company.

The new arrangements also led to measurable changes in internal attitudes and behavior. Irdeto allowed me to survey managers prior to the December 2007 headquarters shift, and then twice afterward, in 2008 and 2009. Among other things, I looked, using network analysis,[1] for changes in the degree to which middle managers based in Asia found themselves centrally involved in and able to influence decision-making processes. The change was dramatic: the centrality of Asian (not just Chinese) managers rose more than 20 percent, and their level of influence increased nearly 30 percent. By the time of the 2009 survey, in fact, the influence scores for Asian managers actually exceeded those for Europeans (exhibit). The quality and quantity of communication between the Asian and European parts of the company also improved significantly.

[1] For more on network analysis, see Robert L. Cross, Roger D. Martin, and Leigh M. Weiss, "Mapping the value of employee collaboration," mckinseyquarterly.com, August 2006; and Robert L. Cross, Salvatore Parise, and Leigh M. Weiss, "The role of networks in organizational change," mckinseyquarterly.com, April 2007.

Of course, Irdeto faces some practical challenges in making its dual-core headquarters work. Not every senior executive is prepared to sign up for a spell in Beijing, and executive-committee meetings are harder to schedule than they used to be. But for Graham Kill, these are problems the company simply needs to work through. And as more Asian executives move into senior-management positions, the model becomes easier to sustain.

After Irdeto shifted to dual-core headquarters with locations in Amsterdam and Beijing, the centrality and influence of its managers in Asia rose dramatically.

Network analysis of centrality and influence
(based on surveys of ~50 senior and middle managers at Irdeto with response rate of ~80%)

	Degree of centrality[1] (higher score = greater average centrality of managers)		**Index of overall influence**[2] (higher score = more influence)	
	Asian managers	**European managers**	**Asian managers**	**European managers**
2007	29.2	36.5	0.87	1.15
Shift to dual-core headquarters in Dec 2007				
2008	35.0	43.8	0.94	1.09
2009	35.4	45.8	1.12	1.10

[1] Degree to which managers reported being centrally involved in decision-making processes; highest possible score cannot exceed number of managers in network.
[2] Degree to which managers reported being able to influence decision-making processes; the measure indicates the influence of the regional office over global strategy, with an average score of 1.

Source: Julian Birkinshaw

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be in a multinational's home market. The same often goes for manufacturing and product development.

One common rationale is that China is insufficiently developed to require the same sophisticated approaches employed elsewhere. Another is that despite China's potential, the current market size makes investments in, say, cutting-edge market research or after-sales service uneconomic. Both views are shortsighted at best. Yes, the functional capabilities of most multinationals outshine those of many Chinese competitors. But the Chinese are catching up fast, and other multinationals are also in the mix. Those who wait for others to develop the market may well find that the game is over by the time they decide to give it their best shot.

Below are examples of simple steps that multinationals are taking to bring their natural strengths to bear in four key areas—technology and product strategy, marketing, distribution and service, and supply chain management. These areas, along with human resources and government relations, are all ripe with opportunity for multinationals to differentiate themselves (see sidebar "Is your second home as strong as your first?" for a set of diagnostic questions for multinationals about each area).

Technology and product strategy

In many, though certainly not all, product categories, Western and Japanese firms still have technology advantages over local Chinese rivals. What's more, our research and experience with Chinese consumers, as well as corporate and government customers, reveal a willingness among some segments—even value-oriented ones—to pay a premium for higher-quality products. Making the right trade-offs between product benefits and pricing levels often requires breaking with a company's single Europe- or US-centered product strategy.

For example, a leading global infrastructure company was frustrated by its inability to win large tenders in China, despite having the best technology and a lower operating cost over time than domestic or international rivals. Interviews with the infrastructure company's customers revealed, however, that their procurement processes promoted lower capital expenditures; total cost of ownership was a minor consideration. In response, the company decided to go to market with two products: the existing, top-of-the-line imported one, which would remain appealing to a subset of customers, and a new value-oriented product featuring technology that was better than any rival could offer but manufactured in China and priced similarly to products from the company's Chinese rivals. This simple, segmented approach to product design, based on straightforward customer research, is something the multinational probably would have adopted long ago if conditions in the EU countries or the United States had demanded it. But with managers in the United States still making product decisions, the opportunity had been missed in China—until the company began paying that market more attention.

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Marketing

Marketing, as practiced by leading Western companies, is a nascent concept in China. Most Chinese companies develop products for the local market primarily on the basis of an intuitive, experience-based understanding of customer needs. Market research, when undertaken, rarely probes for the sort of nuanced understanding that fuels product innovation in developed markets. Coca-Cola, Colgate-Palmolive, P&G, and other global packaged-goods players are competing effectively in many categories by exploiting their sophistication in market research, product development, and brand management. In contrast, few Chinese companies have significant experience to date developing sophisticated brand messages or images.

Nonetheless, in our experience, many multinationals—even leading ones—make mistakes, such as segmenting the Chinese market as they would developed markets, and are astounded at how far off base their underlying assumptions prove to be when they actually conduct deep customer research. For example, when one large consumer goods company applied sophisticated customer research techniques to its distribution strategy for a new product, it completely revamped its rollout plan. Instead of prioritizing high-end customers in widely dispersed large and wealthy cities, it switched to a more targeted approach that focused on customers who exhibited similar preferences but lived in smaller city “clusters” within close proximity. The benefits were twofold: first, these customers were more receptive, on average, to the brand; and, second, the regional approach made it much easier for the company to ensure consistent, high-quality distribution from a single partner in each locality.

Distribution and service

In a country with as many dispersed and hard-to-reach markets as China, third-party distributors are sometimes necessary. But multinationals relying on them need to make sure these distributors don’t underinvest in service levels and quality—which is a common practice for Chinese companies. In an attempt to grow rapidly and at low investment levels, one multinational chose to distribute its products through poorly trained third-party distributors that sold them, alongside rivals’ offerings, on a price-per-kilogram basis. The company, frustrated with its performance—running a distant second to the leading multinational player in the market, with Chinese peers rapidly catching up—began creating a large direct-sales force trained to help solve customers’ problems. For other companies, distributors may still be the right answer, provided that it’s possible to craft a partnership that can tailor sales and service to customer needs.

Supply chain management

In recent years, as sales volumes in China and volatility have increased for multinationals, many have found that their traditional practice—retaining core planning functions at a global headquarters while relying on simple production and shipping requests to guide Chinese supply operations—no longer works. One leading electronics multinational watched inventories explode as planners found it impossible to coordinate production flows. The company first moved three experienced executives to China to stabilize the situation and then began reorganizing its global-planning roles, boosting the number and skill level of local planners and investing

Is your second home as strong as your first?

Technology and product strategy

Do you offer as large a range of products in China as you do in your home market? Have these products been designed based on Chinese customers' needs, or are they simply imported or "de-featured" Western designs? Are your price points at the same level as similar offerings from local or even foreign competitors?

Marketing

Has your company invested to know your customers in China as well as you do those in your home market? Is your market intelligence team in China just as big as the one your home market? Do you conduct as many primary market research studies as you do in your home market? Is your customer segmentation just as rigorous—or have you just applied one you use elsewhere?

Operations

Do you expect the same operational-performance levels in China as you do in your home market? Have you invested as many resources or as much expertise in building and refining your Chinese manufacturing, distribution, supply chain, and service models as you have in the European Union and the United States? Are your customer service centers just as close to Chinese customers as your centers in your home market are to customers there? Or have you taken shortcuts because "China is different"—such as working through third-party distributors, though you go direct everywhere else in the world?

Human resources

Is your HR team in China on the same scale as the one in the European Union or the United States? Do you follow a similarly rigorous process for finding potential hires—or do you rely more on references? Do you invest just as much in professional training and development programs, taught by equally qualified staff, as you do in your home market? Do you offer the same type of global rotational programs to rising Chinese executives as you do to those in other markets? Is your CEO just as aware of a rising star in the Shenzhen office as he is of someone in St. Louis or Munich?

Government relations

Do you have just as many and as capable government relations staff in China as you do in your home market? Do you have a similarly well-thought-through process for communicating with your regulators at the central, provincial, and city levels in China as you would in other markets? Are you helping to shape regulations there in the same way as you would elsewhere?

in more advanced IT support systems. These efforts to bring the Chinese supply chain up to global standards have been so successful that the company is revamping its entire supply chain across 14 of its Chinese factories and 30-odd external vendors.

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China is becoming the world's most important competitive battlefield, with companies that succeed there creating a foundation for global leadership. Multinationals hoping to win this game must recognize that China needs to be much more than a significant growth market; it needs to become their second home.