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*China Report: Studies in
Operations and Strategy*

OVERCOMING THE
CHALLENGES IN
CHINA OPERATIONS



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CEOs and other senior executives at multinational corporations (MNCs) in the U.S., Europe and Asia are focusing more of their time and their companies' resources on China, according to experts at The Boston Consulting Group and The Wharton School. In years to come, MNCs will face new challenges in their China operations: nurturing the growing number of more educated and experienced Chinese managers and leveraging their China operations in a way that contributes to their global competitive advantage.

- ◆ **R&D in China: The Next Frontier or a Sure Bet to Squander Intellectual Property?** Page 6
Low costs may serve as a magnet to attract manufacturing to China, but research and development is not far behind. More and more companies — especially in the high-tech field — are setting up R&D bases in China and figuring out ways to integrate them into their global research operations. Given China's notoriously porous intellectual property regulations, is this a recipe for disaster? Not quite, say experts from Wharton and The Boston Consulting Group.

- ◆ **Sourcing from China: No Longer Just for Shoes, Toys and Clothes** Page 9
Twenty years ago it was widely believed that companies that wanted to source products from China were best off focusing on simple, labor-intensive products such as shoes, toys and clothes. Today, however, high-tech companies such as Dell, IBM, Philips, Samsung and Nokia are turning to China to source parts and products that demand sophisticated technology and considerable R&D. According to experts at The Boston Consulting Group and Wharton, companies that figure out how to take advantage of this trend can reap enormous rewards.

- ◆ **China Is Trying to Cope with Its Logistics Challenges but Gaps Persist** Page 12
A decade ago multinational firms operating in China had to carry higher levels of inventory than comparable firms in the U.S. or Western Europe because the logistical challenge of moving goods around the country was enormous. Today, while matters have improved, gaps still persist as logistics capabilities lag behind the hectic pace set by the manufacturing sector. The bottom line implication: As companies draw up operations plans for China, they need to place much greater emphasis on logistics than they might in a developed country.

- ◆ **TCL's Dongsheng Li: "We Should Control and Own Our Brands"** Page 15
How should successful Chinese enterprises make the leap to become excellent global ones? Following a joint venture with France-based Thomson (which owns the RCA brand), TCL, the world's largest manufacturer of color televisions, is trying to leverage its manufacturing expertise in China while seeking growth in markets such as Europe and the U.S. Will it succeed? A recent conversation between Dongsheng Li, TCL's CEO, and experts from Wharton and China Europe International Business School (CEIBS) explored the issues.



The Changing Face of Management in China

As China's economy evolves — growing larger, more complex and more competitive — so is the way that multinational corporations (MNCs) are managing their operations there. CEOs and other senior executives at MNCs in the U.S., Europe and Asia are focusing more of their time and their companies' resources on China, according to experts at The Boston Consulting Group and the Wharton School.

Research by BCG suggests that the MNCs that have had the most success in China are those whose top managers have gone out of their way to stress the importance of their China businesses in relation to their global operations. At the same time, the managers on the ground in China are also changing. Expatriates still hold the most senior positions in China, but Chinese locals are assuming a greater role in both middle- and senior-management ranks.

In years to come, multinationals will face new challenges in their China operations: nurturing the growing number of more educated and experienced Chinese managers and leveraging their China operations in a way that contributes to their global competitive advantage.

In past years, the typical general manager in China was assigned the relatively straightforward task of either selling his multinational's products in that country or helping the parent firm establish operations to leverage China's strength as a low-cost producer. To be sure, these remain important responsibilities; indeed, the number of companies that wish to outsource to China is accelerating. But the demand on China managers has become more mul-

tifaceted, according to Jim Hemerling, senior vice president and director in BCG's Shanghai office.

For one thing, China managers still have to address significant growth in demand in China and all of the challenges inherent in competing against foreign and domestic companies in what is already a vast, difficult market. They also must deal with the global migration of customers. Industrial companies or suppliers that provide components to assembly plants are finding that more and more of their customers are migrating their manufacturing to China either because of demand or China's attractiveness as a low-cost space. Hence, China managers must

“These global forces are coming together to produce a significant change in the role required of the China GM.”

—Jim Hemerling, senior vice president, BCG

now interact with a constant stream of visits by customers from many parts of the world. Furthermore, general managers of MNCs in China must strengthen their ability to develop managerial talent — as well as engineers and scientists — within China.

“These global forces are coming together to produce a significant change in the role required of the China GM,” Hemerling says. “That person now has to be the impresario or orchestrator of a much more complex set of management demands. You already have a GM working hard to compete against foreign and domestic competition, to grow his domestic

business, arranging visits, meeting customers, setting up large outsourcing organizations. Now he has to make sure his company is getting its share of the talent. That's quite a change in role. It's one thing if you're a company like General Electric that has tremendous resources and can put in place a China CEO who orchestrates those processes. But for many companies, the China GM or CEO is really stretched to meet this change in complexity."

Benchmarking Best Approaches

In 2003, BCG conducted a survey to benchmark the best corporate approaches to China. The study focused on ways in which 14 MNCs manage their overall presence in China from a broad corporate perspective, as distinct from the level of individual business units. BCG also looked at how MNCs ensure sufficient global visibility of their China operations and how functions and processes are carried out. Specifically, the consultancy analyzed the MNCs from a number of perspectives: how the multinational manages its China operations; target setting and management processes; government and public relations; localization and human resources development; the role of the China operation; the relationship of sourcing to sales and marketing; and the extent of cross-product development activities.

least once a year.

- ◆ The MNC is willing to change its rules regarding global priorities and norms to favor China; Kodak moved its Asia headquarters to China.
- ◆ China-specific products are pursued; virtually all major MNCs have China-specific products.
- ◆ The MNC works aggressively to bring the industry value chain, including R&D, into China; Samsung set up a 300-person handset R&D laboratory in Beijing.
- ◆ Managers are nurtured for the long term; Motorola University runs management development programs in China.
- ◆ Government relations and public relations are strongly emphasized; Pepsi has stepped up its government-relations focus on the central government and less on provincial governments.
- ◆ The China operation is given a truly "value-added" role; Kodak's China organization prepares an integrated strategy across six businesses.
- ◆ China is made a global or regional center — or both — for key responsibilities; Nike says its China operation will become increasingly important in the build-up to the 2008 Olympics.

"With the survey, we tried to look at some general ways in which these MNCs, despite being large, complicated, global organizations, were able to achieve some sustained focus on China and orient their companies toward accelerated activities in China," says David Michael, a vice president in BCG's Beijing office.

"To accelerate investment successfully in China over time, you need to bend the rules that otherwise might prevail inside your company."

—David Michael, vice president, BCG

One of the key takeaways from BCG's research is that MNCs grow their China

The study found that leading MNCs treat China uniquely in at least 10 ways:

- ◆ The China operation has a very senior, accountable sponsor at the global level; at Samsung, for example, the China CEO is one of three top group executives.
- ◆ Clear, bold targets are set internally, and sometimes externally; GE has goals of \$5 billion in sales and \$5 billion in sourcing by 2005.
- ◆ A continual, top-down management push is reinforced with management processes; Michael Dell of Dell Computer and other CEOs visit China at

operations from the top down, not the bottom up. "It needs to be top down because you need to reallocate global-level resources and activities if you are to really make a commitment to China," says Michael. "To accelerate investment successfully in China over time, you need to bend the rules that otherwise might prevail inside your company. You need to be able to allocate more management talent, more senior time and attention, and more investment than the near-term financial returns might otherwise warrant. If the regular rules say you need a two-year payback from the day you set up operations, you have to understand that a China

investment probably won't achieve that goal. Companies that have achieved breakthroughs in China — establishing a presence in places other than Beijing and Shanghai, achieving more product customization and localization, establishing deeper distribution channels — bent the rules to make China a priority. Not every company makes it past that threshold."

Another important finding: Bringing the industry value chain to China and building for the long term are also important. "You can't just have a little sales arm here," Michael explains. "You've got to be ultimately customizing and modifying your products for the local market. And you need enough value-added activity, like R&D, so that you can establish closer relationships with local suppliers and demonstrate commitment to local customers."

The View from Europe

Paris-based Xavier Mosquet, senior vice president and head of BCG's operations practice in Europe, says Volkswagen and Michelin are two examples of European companies that understand the importance of China, both locally and globally, and have established well-oiled operations there. Though Volkswagen later ran into difficulties, it was ahead of the curve in recognizing China's potential role in its operations.

"Volkswagen saw very early on that the Chinese market would be demanding and sophisticated, so the cars it sells there are up to European standards," says Mosquet. Michelin, the number-one player in the tire business in China, established a joint venture with China's top tire maker, and in doing so struck one of the first initiatives of its kind that gave the non-Chinese company a controlling stake (51% in Michelin's case). Michelin also has been able to upgrade the standards of tires sold in China and educate consumers about the advantages of such improvements.

Mosquet says CEOs of European MNCs are catching on to China's importance as a market. "I think most of them are getting organized, if they are not already totally organized. Are they putting enough effort into it? That's something that could be challenged. I think not all have upgraded the level of resources needed, given the challenge, but they understand it's an important issue of a strategic nature. They also

understand it's not easy. China is a complex market. Those who know most about it understand there will be ups and downs. Not all of them think about the downs, and that makes a big difference."

Additionally, do European CEOs fully understand the broader role that China can play in their global operations? "There is a general understanding of that," Mosquet explains. "For many CEOs, however, it is still an abstraction. They don't necessarily have a full-blown plan of what it means in terms of the scale — the role of manufacturing or the role of China in terms of technology — and how and to what extent they can and cannot rely on that country to provide shared services for their operations in the rest of the world."

The Role of Expats

Expatriates still make up the majority of CEOs and other top executives in China. Increasingly, however, MNCs are turning to Chinese executives to fill the ranks of senior and middle managers. One reason is that Chinese managers have the natural advantage of knowing the language and the culture. Another is that the cost of transferring managers to China and supporting them and their families can be expensive. John Wong, chairman of Asia Pacific for BCG, says a typical expat manager may earn \$200,000 to \$300,000 a year in base salary and receive a \$10,000 housing allowance each month. His firm may also give him \$20,000 to \$40,000 annually to educate his children in private schools, pay \$20,000 to \$40,000 a year to cover the cost of trips back home, and also pay his taxes. "You can find really good managers in China for a lot less," says Wong.

"Multinationals are relying on expatriates less and less," notes Wharton management professor Marshall Meyer, who has studied Chinese companies extensively. "I've seen some companies that are down to one expat manager; in one case, even the chief financial officer was not an expat."

BCG's Michael sees the issue differently. "The reality is that the flood of expats coming to China has never been greater," he says. "The tight integration of China into global business necessitates expat participation. It would be wrong to believe that the era of the expat is over."

Indeed, even those who point to the generally diminished role of expats in European and U.S. multinationals admit that there are exceptions. Most of the companies with which Mosquet has worked have made strides in local integration and have reduced the number of expatriates. He adds: “Where this is less true is among companies that were using China as a place where they produce for the world, not just local markets. Both in R&D and engineering they have actually, at least temporarily, increased the level of expatriates, and that may be more permanent. That’s because they want to make sure what’s happening in China is integrated with the rest of the world — in the same way that European multinationals have Americans in their operations. In a plant serving the China market, you’re likely to find fewer Europeans. They are too

expats who have a commitment to being in China for longer periods. The reality is you just can’t manage a business by rotating a succession of people for two- or three-year time periods.”

Michael adds that the role of expats has narrowed. The local China operations of many multinationals have become very large and complex. By necessity, as they grow, they must rely on local teams of managers. Expats play a particular and relatively narrow role in most major MNC operations. The MNCs that are in more of a start-up or exploratory mode are usually expat-driven, but companies that have mature operations in China rely predominantly on local Chinese managers.

Wanted: Young Managers

Educated, experienced managers from the People’s Republic of China are, like good managers anywhere, worth their weight in gold, and the war for Chinese talent is being waged vigorously, says Harold Sirkin, senior vice president and director in BCG’s Chicago office and head of the firm’s global operations practice. “Multinationals rely on Chinese managers who may have worked for several years for Western companies — maybe even for one of their own divisions — or at least have been trained in the West.”

The demand for talented Chinese senior managers outweighs the supply, in large part because people in their 40s and 50s, who would be expected to assume such positions, were in school during the country’s cultural revolution and were not well educated, according to Wharton’s Meyer. Another reason for the dearth of managers with more than 10 years’ experience is that it has only been in the past decade or so that China’s economy has exploded. “There is just a scarcity of people with 10-plus years of experience working for MNCs in China,” notes Hemerling. “The scarcity applies to manufacturing, marketing and sales — although less so — and in technical functions like engineering.”

Educated younger people — those in their 20s and 30s — are in a much better position than their elders to attain positions with MNCs. Many have earned degrees from top business, engineering and science programs, and many are being trained by the multinationals themselves. “There are huge numbers of grads coming out of engineering and business

“Multinationals rely on Chinese managers who may have worked for several years for Western companies....”

—Hal Sirkin, senior vice president, BCG

expensive, they’re not there to stay, and their language skills are not sufficient. If you want to become a more sophisticated manager, you need to be able to speak to Chinese at a level that allows for subtlety and quick interaction.”

For many years MNCs would assign expats to China for a period of perhaps three years and then transfer them. It was a cumbersome approach to managing China operations because the expats would be taken out of China at just about the time they had gained the experience to do their jobs well. “The MNCs have treated China as a training ground,” says Wong. “Expats bring a huge amount of value. But changing people every three years is not the most productive thing to do. But some MNCs say it’s important for that manager to have mobility. And often the only way to get them to go to China is to promise them a bigger and better job.”

Smart MNCs have discovered the disadvantages of the three-years-and-out formula and have adjusted accordingly, says Michael. “Big MNCs are beyond the strategy of rotating people in on a short-term basis. They are seeking people for longer periods of time, and they are also relying on local managers or

schools who have zero to five years experience,” says Hemerling.

It may be that the young managers are coming along just in time. Competition among companies in China is growing ever more intense, and managers who cut their teeth on Chinese operations 10 or 15 years ago may not be up to handling a new environment in which MNCs demand so much more from their managers in China. According to Wong: “Ten years ago, managers of MNCs that came to China didn’t always know what they were doing. But they hung out a shingle and headquarters said, ‘You’re growing from a base of zero by 10%, and you’re doing well.’ Today, sales have grown, and managers have to pick up where the previous guy left off. So the job is much more challenging. Now you have young guys who have to get up to speed from a higher level. Before, there was a lot more tolerance for a lack of profitability and mistakes.”

One major issue that lies ahead for executives of MNCs in China is having the foresight and steadiness to manage the ebb and flow of business cycles. As it develops, the China market will inevitably experience downturns — perhaps lengthy ones — to counterbalance the era of rapid growth that has captured the world’s attention in recent years, Mosquet predicts. This will mean planning manufacturing capacities aggressively enough to meet demand in what is the biggest market in the world but also being able to cope with a slowdown without being hurt by overcapacity. Are U.S. firms better prepared to handle downturns than European MNCs? One slight difference is that American companies tend to be larger than European companies, and in that respect, they will have an advantage, notes Mosquet: “Sales in China might not constitute as big a share of their overall U.S. corporate revenues as they do for European companies. But for companies of equal size, U.S. and European firms will be in the same situation.”

Another major challenge for MNCs is achieving an even greater level of integration of their Chinese business activities into the global company.

“In the past it’s been simple to have, let’s say, a global manufacturing platform in China,” Michael says. “You have 10,000 assembly-line workers helping you make products you sell all over the world. That’s now a relatively straightforward thing to do. It’s another

thing to have 10,000 R&D engineers, software engineers and programmers integrated into your global operations. The next wave for companies will be to truly make a China-based capability and leverage it for the benefit of their global competitiveness, not just in manufacturing but in a variety of other aspects of the company. The talent is available to achieve this goal. It requires some development, but it is available. It’s an internal challenge for large companies to manage the change in the norms of the way they do business to achieve that result. The best companies will be able to do this, and the worst companies will never be able to do it. How long it takes is in the hands of the companies.” 



R&D in China: The Next Frontier or a Sure Bet to Squander Intellectual Property?

Hot on the heels of the manufacturing boom in China, expansion in research and development is the next frontier. As multinational corporations seek to cut costs and to develop indigenous products for this growing market, and the Chinese government attempts to attract technologies that can help Chinese companies compete on the world stage in a variety of industries, an R&D explosion is underway in China, with high-tech at its forefront.

Why R&D Thrives in China

David Michael, a vice president in the Beijing office of The Boston Consulting Group, has been following China for more than 15 years. He cites three primary reasons for the recent surge in R&D activity in China.

First, “during the last couple of years the size of the domestic market opportunity in China has become apparent, and the needs in terms of what it takes to stay competitive have become clear,” he says. “That realization has driven companies to have more products customized for the China market. This approach requires more research and development capability closer to the ground.” Michael points to mobile phones as an example. “China is one of the world’s largest markets for mobile phones — and companies like Siemens and others have moved a lot of R&D close to the market in order to have product ranges that are competitive.”

Second, Michael notes that “a critical mass of manufacturing and sourcing activity is emerging in China, and R&D is complementary to these activities. If you’re going to rely on more Chinese suppliers, you need R&D to help those companies comply with your standards, to understand how they fit into

your development and production processes. The R&D department may play an important role in actually vetting and qualifying those suppliers.

“The way a lot of companies work, the supplier needs to be properly certified in order to be the supplier. Often, the R&D function is intimately involved in the certification of a supplier. Especially in the high-tech sector, which has rapid product cycles, you need suppliers directly involved in product development processes. A supplier is only going to be able to perform its function if some of the development activity is located close to that supplier.

“The third driver of this trend,” according to Michael, “is the availability of talent at a low cost.” He argues that countries like China have talented engineers. “There’s a global war for talent and...you can’t find the talent you need in sufficient numbers just by getting it from traditional sources in the West.”

Protecting Intellectual Property Rights in China

A major problem that companies moving into China have had to deal with is ensuring the protection of intellectual property. China’s record in this area has been poor, and companies contemplating setting up R&D facilities have been leery about reaping short-term gains but long term losses, as they, in effect, train their own competitors to innovate in ways that are quickly used against them.

Kevin Rivette, an executive adviser for intellectual property in the San Francisco office of BCG and the author, with David Kline, of *Rembrandts in the Attic: Unlocking the Hidden Value of Patents*, stresses the importance of working out a strategy before going into China. Companies which fail to do this, he says, are setting themselves up for trouble.

"Companies go into China," Rivette says. "They establish a manufacturing facility. Inside the manufacturing process, there are trade secret machines and trade secret processes...The first and biggest flawed assumption [they have] is that there are trade secrets laws." According to Rivette, these companies end up saying, "My God, what are we going to do? We're going to be competing against our own technologies in our own markets. We just created a competitor!"

As the title of his book might suggest, Rivette's first line of defense is patents. He concedes that in the past, the Chinese government has not been a stalwart defender of patent rights; he's confident that this will change. "I am not a doomsayer; I've read so many articles where 'the sky is falling.' My opinion is we're going to do business with China. China will come under the rule of law approach to this issue. We had the same problem with the Japanese back in the 1950s and 1960s - this is not unknown territory - and now the Japanese happen to be some of the biggest patent holders and enforcers on the planet."

The idea that China, as its own companies continue to grow and innovate, will rapidly develop its own interest in enforcing patent law is one reason to be hopeful, according to Rivette. But, concretely and right now, he says, foreign patents are being leveraged to force Chinese companies to obey the law.

This is most easily explained via a metaphor commonly used in U.S. law: "The Fruit of the Poison Tree." This means that, in the event of an illegal search, for example, a court will throw out the evidence that has been obtained: If the root of the evidentiary chain has been corrupted, the fruit of the search may not be used. The same logic obtains in patent law: If the process used in manufacturing a product is not the legal property of the manufacturer, the product is not a legal product. Enforcement in this case need not rest with the Chinese government; goods can be stopped at the border of the country of destination. "If the original manufacturer is infringing," Rivette says, "then the whole value chain gets to be tainted."

In support of this strategy, he cites a recent case that is likely to have powerful repercussions: "Phillips, with a couple of patents, caused Wal-Mart to stop importing Chinese DVDs and turn to second-tier suppliers out of Taiwan that were properly licensed."

The Education & Innovation Pipelines

In the past few years, China has more than quadrupled the percentage of high school graduates who can now find university spots, from 4% to more than 17%. This has resulted in an explosion of college graduates from 1.5 million in 2002 to just under 3 million this year, projected to reach 3.5 million in 2005, according to the Education Ministry. This has meant a huge oversupply of applicants for R&D jobs. In 2003, when Oracle sought to hire 23 new graduates for software development centers in Beijing and Shenzhen, it was deluged with more than 4,800 applicants, reported BusinessWeek in October.

This ramping up of the educational infrastructure has not yet translated into the kind of R&D progress that the Chinese government seeks. Using U.S. patents as a measure of innovation, looking at 2003 (the most recent year for which numbers are available): Chinese inventors secured less than 400 patents; by way of comparison, Taiwanese inventors secured more than 5,000. That is to say, although Taiwan has less than 2% of the population of China, Chinese inventors got less than 8% as many patents as did their Taiwanese counterparts.

"The prominent role of Taiwan reveals the country's prominence in global high-tech oriented supply chains," according to David Michael, adding that, "Taiwan is one of the hubs of the global high tech economy." He also suggests that China may benefit from Taiwan's strengths. "China can leverage activities in Taiwan. It's clear that there's a whole lot of high tech activity in Taiwan that is migrating to various parts of China."

BCG's Sirkin also sees a bright future for R&D in China and puts things in historical context, comparing what's going on in China today with the development curve that was evident in Japan several decades ago. "China is making phenomenal progress in R&D. Mostly, though, it's where the Japanese were in the 1960s and early 1970s, as they focused on copying and learning. I would expect the innovation to continue to push forward." Sirkin also sees growing opportunities for Chinese engineers, businesspeople and entrepreneurs who have been educated and/or have worked in the U.S., which does something to explain the (so far minor) reverse brain drain that has been noted in recent years in the U.S.

“There’s a tremendous opportunity for them. A lot of Western companies would like to hire U.S.-trained Chinese nationals to help run their businesses [in China]; they understand both areas. A Chinese person trained in the U.S., who has worked in America for five years or so, is a hot commodity. A good manager who wants to go back is a very hot commodity. And there are lots of opportunities for those who go back.”

The political environment in China has been cause for some concern: Government restrictions on the Internet, for example, have been an ongoing issue. In a business context, Sirkin doesn’t see this as a significant problem. “The reality is I don’t think there are a lot of restrictions...Information on those kinds of things [R&D] moves reasonably freely.”

Integrating R&D into a Global Strategy

An R&D strategy for China requires “looking both ways first,” both forward, toward how you want to set things up on the ground in China, and back at existing global operations with which the new operation will need to be integrated.

According to BCG’s Michael, one of the more difficult issues may be internal to companies that want to set up global R&D operations. “If you’re a German company,” he says, for example, “the guys in the R&D lab in Germany might resent your expansion activity in China. They might feel that their own jobs are under threat. They might be reluctant to cooperate. That requires an internal cultural change, process change and organizational change. It’s much easier to integrate a thousand assembly line workers in China into a global operation than it is integrating a thousand R&D workers into your global operation ... The assembly line workers focus on the assembly line work and there’s no problem with them having an arm’s length relationship with the rest of the company. But if you are talking about high-value knowledge workers whose value added inherently depends on tight links with the rest of the knowledge workers in this global company, that’s a more difficult thing to do. But it also means,” he adds, “that doing it well will be a source of competitive advantage in the future.”

From the perspective of the Chinese workers, he says, “One issue is, is our activity truly going to be something of global importance? That will be important ultimately in the company’s ability to attract

and retain the top talent in China. They’re going to want to feel that what they are involved in is strategic and of global importance.”

Michael points to Motorola as a company that has done a good job of integrating its Chinese R&D operation. “Motorola does quite a lot of R&D, and it is among the most successful and well established foreign companies in China. It is among those who have gone the farthest in migrating a lot of value-added activity to China. Motorola has 16 R&D centers in China, and it has a broad range of China-specific products. Motorola University helps the company develop management talent in their customers and suppliers as well as in their own employees. The company has an aggressive supplier development program; it identifies potential suppliers in China and then educates them on what it takes to supply a company like Motorola over the long term. Such suppliers might have low costs, but they might be lacking or deficient in other areas. Motorola helps them to understand that and to develop those capabilities further.”

Wharton management professor Marshall Meyer stresses the need to be aware of what government, at various levels is interested in, as well. “There’s an old expression that goes, ‘Who owns the road?’ You have to be sensitive to the local government if you are doing business in China.”

A good understanding of both local and national needs and intentions can open doors. Michael points to the recent experience of General Motors. “General Motors is very successful in China at the moment,” he says. “The company used aggressive technology transfer as one of the ways to get ahead...It was the winner in a very selective and competitive process to become a major joint venture partner with one of the largest automotive companies in China. One of the ways GM succeeded was by committing to put its most advanced products in the China market.” That was just what the Chinese government wanted. “As it turned out,” he adds, “those relatively advanced products became critical in attracting consumers. They hit a sweet spot in the market. Now General Motors is launching one of its high-end Cadillac models in China and is actually manufacturing it in China.” Going forward, that trend should continue. In mid-September, Toyota announced that in 2005, it would both sell and assemble its cutting edge Prius hybrid in China in a joint venture with the China FAW Group. 



Sourcing from China: No Longer Just for Shoes, Toys and Clothes

Twenty years ago it was widely believed that companies that wanted to source products from China were best off focusing on simple, labor-intensive products such as shoes, toys and clothes. That was true — and it helped drive tremendous success for companies such as Perry Ellis, which targeted these product categories. Today, however, the sourcing landscape in China has changed. High-tech companies such as Dell, IBM, Philips, Samsung and Nokia are turning to China to source parts and products that demand sophisticated technology and considerable R&D. According to experts at The Boston Consulting Group and Wharton, companies that figure out how to take advantage of this trend can reap enormous rewards.

“Sourcing in China started with low-tech products but it has evolved beyond that,” says Jim Hemerling, a senior vice president in The Boston Consulting Group’s Shanghai office. “Now, in addition to traditional products, another huge area is consumer electronics. I believe the next big wave will be industrial goods, with companies like ITT, Siemens, Honeywell and ABB leading the way.”

Statistics about China’s export trade show that Hemerling has a point. According to figures announced in January this year by the Beijing-based Ministry of Commerce, China’s exports surged 35% last year to reach \$593.4 billion. Technology exports have begun to command a growing share of these exports: They accounted for 27% in 2004, compared with 23% in 2003. According to a Bloomberg report, exports of technology products rose 72% to \$45.4 billion.

The fact that companies are starting to focus on sourcing high-tech, research-intensive products from China does not imply, however, that demand for traditional products is dead. Take Wal-Mart, for example. The retailing giant, which rose to the top of the Fortune 500 list three years ago and had net sales of \$256 billion in fiscal 2004, is still sourcing lots of traditional products from China. In fact, it has become the largest single company to procure goods from that country, sourcing products worth a staggering \$15 billion in 2003.

“Now, in addition to traditional products, another huge area is consumer electronics.”

—Jim Hemerling, senior vice president, BCG

Miami-based Perry Ellis International, which designs and sells apparel, is another company that has been proactive about sourcing purchases from China. It set up shop in China in 1976 and has since opened four offices there and employs about 60 people in the country to manage relationships with local manufacturers. George Feldenkreis, the chairman and chief executive, notes that his company, which has annual sales of about \$500 million, makes 28% of its purchases in China. “This number keeps growing and will continue to grow as the U.S. removes all of the apparel quotas,” says Feldenkreis, who spoke at the Wharton School’s China Business Forum in 2004. “China is the largest textile producer in the world, and it’s becoming the largest fiber and yarn producer. So manufacturers can buy supplies at prices that are the same or lower than those in any other country in

the world. And the labor cost is among the lowest in the world, while productivity is among the highest.”

As the experiences of giants such as Wal-Mart and relatively smaller firms like Perry Ellis show, that combination — low costs and high productivity — means that sourcing from China isn’t a choice any more for many multinationals. It’s a necessity. Whether it involves high-tech or labor-intensive goods, China enjoys advantages that many other countries can’t match. While U.S. workers, for example, may be more productive and technologically sophisticated, they are also more expensive. Likewise, people in places such as the Dominican Republic and Romania may be willing to work just as cheaply as workers in China, but they are not as productive.

“In terms of units, it could soon be the largest instrument maker in the world.”

—Marshall Meyer, professor of management, Wharton

The apparel industry isn’t the only one that has begun to rely on China for its sourcing requirements. Some 95% of toys sold in the U.S. and 85% of shoes are made in China, Feldenkreis reckons. The question therefore for many multinationals in the U.S. and Europe isn’t whether to source goods from China or when — the answer to that one is as soon as possible — but how.

China, of course, isn’t without challenges for international companies that want to do business there. In some ways, it has become a victim of its own success. Its rapid growth — some estimates say its gross domestic product has jumped by more than 10% a year for the last decade — has begun to create shortages for a host of manufacturing inputs, including, most critically, electricity, and to strain its fledgling logistics network.

Even so, China’s cost advantages are so hefty that they are likely to endure for at least a decade, perhaps longer. “You start with a labor rate in China that is a fraction of the West’s 1/20th or 1/30th in the case of Germany,” says Hemerling. “Our view is that the low-cost advantage is sustainable for a long, long time. In China, you have a huge pool of rural workers

who aren’t yet in the industrial workforce.” This supply of workers should serve to curb wage inflation.

Thomas Bradtke, a manager in BCG’s Boston office, calls China’s supply of labor “almost infinite.” He points out that 70% of China’s population of 1.3 billion people, or more than 900 million people, is rural. “As agricultural productivity goes up, these people will be freed. Everybody in China wants to move to the cities and improve their standard of living. This influx will keep the supply of workers large.”

In addition, Chinese manufacturers are becoming more experienced and sophisticated. As they master new techniques and technologies, they are able to produce higher-end goods. That has already happened in the furniture industry. In the early 1990s, many American furniture makers believed that, even though China had made inroads into the low-end of the market, it wouldn’t succeed with premium products, which demand higher grades of workmanship and finish. Now, Chinese manufacturers are making this sort of furniture, too. Marshall Meyer, a Wharton professor of management, recalls visiting a piano factory during one of his recent trips to China. “Ten years ago, it was nearly bankrupt, and now it has two-thirds of the Chinese market,” he says. “In terms of units, it could soon be the largest instrument maker in the world.”

China’s Cost Advantage

China’s advantage over western suppliers does not just stem from low labor costs. Other necessities for commerce — land, buildings and machinery — are less expensive, too. “Everything is cheaper in China,” Bradtke says. “If you set up a metal-processing plant or textile plant, the investment required is a lot lower than for equivalent facilities in the West — anywhere from 20% to 80% less,” he notes. “And if you use local machinery — say, a metal-stamping press made in China — your supplier passes on his cost advantage. It is 30% to 40% cheaper than what you might get from a U.S. or Japanese manufacturer.” Constructing an aluminum smelter, which could cost \$1 billion to \$2 billion in the U.S., costs half that in China, he estimates.

Because wages are low, companies can deploy workers where, in the West, they might have opted for machines. Take packaging, which in the U.S. and Europe is typically done mechanically. “In China,

you might go back to a formula from the 1960s, buy some basic equipment and have 30 or 40 people wrapping by hand,” Bradtke says. This factor can create challenging situations for international managers, forcing them in effect to re-learn labor-intensive production techniques that are already obsolete in the West, but which are necessary to keep costs competitive in China.

Before jumping on the China bandwagon, companies must thoroughly analyze the risks as well as the rewards. A BCG report, “Capturing Global Advantage — How Leading Industrial Companies Are Transforming Their Industries by Sourcing and Selling in China, India and Other Low-Cost Countries,” details the myriad factors that a firm must weigh.

Western multinationals must understand that, though they will eventually save money in the long run, they can face big startup costs as they begin sourcing in China, the report points out. Carrier, a maker of air conditioners, collected more than 1,000 quotes before making its first order in China. Perry Ellis, for its part, routinely considers dozens of factories before picking one as a supplier. Once vendors are hired, they have to be monitored assiduously. “Companies will often think they can manage their suppliers from the U.S.,” says BCG’s Hemerling. “But you have to bring senior people and put them on the ground in China. You can’t do this remotely. Until your manufacturing and purchasing folks and engineers have been here, they are not going to embrace the opportunity.”

Power Struggles

Sourcing from China also means exposing a company’s supply chain to disruptions that are uncommon in the West. “Electricity is a huge problem in China right now. You have chronic shortages,” explains Z. John Zhang, a Wharton marketing professor. “When it is crunch time, it is not certain that your supplier is going to have power. So things may not run as smoothly in China.”

China’s economy has grown faster than its electrical grid and generation capacity, so demand for electricity has outstripped supply. The government is working to bring more generation capacity online, and the problem should be resolved within a few years. Until then, though, foreign multinationals

should investigate the local energy situation — some areas have been especially hard hit by black-outs — when picking suppliers. In response, a few manufacturers even have begun constructing supplemental generators.

“The sooner you go the better, because the future is Asia.”

—George Feldenkreis, chairman and chief executive,
Perry Ellis

Another risk is China’s lax enforcement of laws protecting intellectual property. Simply put, copying is rampant. And while a copycat probably would be unable to export knockoff products, such goods could be sold into the Chinese domestic market, which is huge and growing. Western multinationals, therefore, need to be careful about which technologies they share with their Chinese suppliers, say BCG experts. If a technology is especially crucial to a company’s mission, it might best be kept in-house, even if production occurs in China.

Feldenkreis of Perry Ellis acknowledges the challenges of sourcing from China but has no regrets about his decision to do so and would urge other executives to do the same. “The sooner you go the better, because the future is Asia. This is the century of the Pacific Rim, and I include the U.S. in that. That’s where the world activity is going to be.” 



China Is Trying to Cope with Its Logistics Challenges but Gaps Persist

Executives at Germany's auto companies were flustered. They knew that China is among the world's fastest-growing markets for vehicles — likely in a few years to overtake Japan as the second-largest after the U.S. Their efforts to tap its potential, however, were being constantly stymied by factors such as variations in regional tariffs among the country's 27 provinces and the inability of local suppliers to meet quality standards for components. In the spring of 2004, Volkswagen, Audi, DaimlerChrysler and BMW chose to take matters

China is growing so fast that, in some regions, it is straining the capacity of its roads, railways and ports and testing the limits of its still-young shipping companies.

into their own hands. Recognizing that these problems were too massive to tackle individually, the companies formed a joint logistics partnership called Coreteam to deal with logistics and supply chain issues. As a BMW executive told a reporter, though the German automakers competed with one another, it also made sense for them to collaborate and exploit synergies when they could.

The experience of the German auto companies serves as a metaphor for the logistics challenge that confronts global organizations seeking to do business in and with China. According to consultants at

The Boston Consulting Group and Wharton professors, today the capabilities of China's logistics sector are much greater than they were in the past. Chinese shippers are maturing, and big western firms such as UPS and DHL have begun to ramp up their activity. Western entrepreneurs also have jumped in to fill gaps between the manufacturing and retail sectors. Even so, China's booming economy continues to outstrip the growth of its logistics capabilities. China is growing so fast that, in some regions, it is straining the capacity of its roads, railways and ports and testing the limits of its still-young shipping companies. The bottom line implication: As companies draw up operations plans for China, they need to place much greater emphasis on logistics than they might in a developed country.

Jeff Bernstein, a Wharton grad who arrived in China nine years ago as a management consultant, has witnessed this evolution first hand. A decade ago, few trucking companies were capable of doing multiple deliveries from a single load. Having grown up in a communist command economy, many were accustomed to taking full loads to where bureaucrats ordered them to, not where customers wanted the goods, says Bernstein. Shippers would pack their trucks haphazardly and secure their freight with a mess of ropes and tarps that could be untangled only at the final destination. As a result, foreign multinationals operating in China were forced to carry higher levels of inventory than comparable firms in the U.S. and Western Europe. While that tied up cash, it also ensured that they would have supplies and products when they needed them. Inevitably, however, it also meant lots of obsolete inventory and wasted money.

“There are chokepoints in the system,” says Marshall Meyer, a Wharton management professor who studies Chinese firms. The highway network has only been partly built out; China’s highways are less than a third the length of the United States’, though the two countries are nearly the same size. Some regions have good roads. Others have sub-standard ones. Trains are more geared to carrying people than freight.

Ports, too, have clogged because so much traffic is flowing through them, says Thomas Bradtke, a manager in the Boston office of Boston Consulting Group. In fact, China is growing so robustly and exporting so much that ports on the West coast of the United States are becoming jammed too. “Everybody is wondering how to improve the thru-put at Long Beach [Calif.] and Portland [Ore.],” he says.

China’s congestion is exacerbated by the fact that the country’s logistics infrastructure is more fragile and disorganized than that of Western countries. “A major issue is poor asset quality,” says Bernstein, who left his consulting job to create Emerge Logistics, a Shanghai-based company that works with western industrial companies. “Trucks are prone to break down and clog roads. On a unit basis, shipping costs may seem lower than in the West, but there’s a huge cost to the macro economy.”

Fragmentation Adds to Costs

Atop that, the logistics industry is fragmented, with more than 2 million trucking companies in a country with between 5 million and 6 million trucks, says Udo Jung, a vice president in BCG’s Frankfurt, Germany, office. Combine delays, red tape and the administrative costs of dealing with scads of small shippers, and Western multinationals can expect about 20% of the costs of their Chinese operations to be logistics-related, compared with an average of about 10% in the West, Jung says.

“If you have to transport something a long way, you often have to switch logistics providers, and they don’t have seamless integration, so there’s lots of paperwork,” he explains. “Also, different provinces have different regulations — you might call them nontariff trade barriers. Some provinces have regulations on how to label your product if it’s imported. These add to the logistics costs.”

Shipping goods from China to the West typically takes about six weeks, says Hal Sirkin, a senior vice president and leader of BCG’s operations practice. That’s longer, obviously, than shipping from Mexico to the U.S. or from Eastern to Western Europe. As a result, foreign multinationals that want to succeed there have to be willing to pony up occasionally for airfreight. “Even if the cost difference is large, you’ve got to be ready for an emergency,” he says. “You can shorten the supply chain to two or three days that way.” One way to ease at least some logistics hassles is to locate a China operation near its suppliers, he points out.

A few Western multinationals have responded to China’s logistics challenges by expending time, talent and treasure to construct their own logistics networks. Take Louisville, Ky.-based Yum! Brands, which owns KFC, Pizza Hut and Taco Bell, among other restaurants. According to media reports, Yum! has built 18 distribution warehouses in China and owns its own fleet of trucks. This system ensures that Yum!’s more than 1,200 restaurants there get everything they need, from perishables to takeout containers, on time.

For many companies, that sort of commitment hardly makes sense. They are therefore left to rely on outside logistics providers. Illinois-based Kraft Foods found itself in that position. Kraft, whose products include Oreo cookies and Maxwell House coffee, owns its China warehouses but contracts with local companies for distribution to retailers, reports the Far Eastern Economic Review. It prefers to hire mid-sized, as opposed to large, vendors to ensure that it gets the best service. With a mid-sized company, Kraft knows that it’s the most important customer and will be treated accordingly.

If a foreign multinational does decide to go with an outside logistics provider, picking the right vendor is critical. The first decision is choosing between a Chinese company and an international one. “A Chinese partner will be cheaper and will have local knowledge and may have at least regional network coverage,” explains BCG’s Jung. “But it can fall short in IT systems, standardized operations and relationships with key international shippers.” Initially, a foreign multinational might want to split its business between a Chinese company and an international one and see which one performs better, Jung says.

Once you find a reliable provider, problems still can crop up. Not all Chinese shippers have worked out the puzzle of delivering partial loads to multiple cities from a single truck, Bernstein says. Ideally, a shipper will consolidate your load with others headed to the same region. Instead, some shippers farm out freight to other companies. When that happens, goods sometimes get lost. Red tape remains a problem, too. “Some provinces won’t let trucks from other provinces enter certain cities, so shippers still have to unload even if they have full loads,” Bernstein explains.

“As you plan your China operations, you have to put more emphasis on the logistics chain compared with what you might do in a developed country.”
— Udo Jung, vice president, BCG

Even if a delivery arrives in the right city and is admitted, obstacles can arise that are rare in the U.S. and Europe. “They may get there and can’t figure out where to deliver to,” Bernstein says. “It’s not like the U.S. where every address is something that you can verify on the Internet. In the countryside, typical addresses may not even be used.” Faced with these sorts of challenges, either your staffers or your logistics contractor have to keep close tabs on your freight and develop good relationships with shippers. “You have to follow up,” Bernstein stresses.

BCG’s Jung elaborates: “As you plan your China operations, you have to put more emphasis on the logistics chain compared with what you might do in a developed country. You can’t take anything for granted. Things that you might not think about in a developed country, like requirements for road transportation, have to be explicitly elaborated upfront.”

Tiers of Wholesalers

Another challenge is dealing with China’s three-tiered system of wholesalers, a vestige of its old state-planned economy, says Wahid Hamid, a vice president in BCG’s New York office who previously worked in Hong Kong. In the past, a foreign multinational that wanted to reach Chinese consumers had to send goods through the state-owned wholesalers, Hamid says. “You had the first tier in the

provincial capitals and large cities, the second tier in the smaller cities, and the third in the towns.” Today, the Chinese government no longer requires that, but many companies continue to use the distributors because they are well established, if inefficient.

When a company turns its products over to the distributors, it can lose the ability to “see” into its supply chain, Hamid notes. “You can’t forecast without visibility. So you can put your factory through huge gyrations. Without good information, it drives significant volatility into the supply chain.” As a result, foreign multinationals in China have to develop their own means of tracking their products and quickly collecting information on consumer demand. “You have to develop systems that work through the wholesalers — you have to train or incentivize them — or teach your sales force to capture the data.”

Though China’s logistical system is byzantine compared with the West’s, plenty of westerners are developing the expertise to make it work to their advantage. For example, at Emerge Logistics, Bernstein recently faced a daunting job. A U.S. motorcycle maker needed to have one of its premium bikes imported quickly into Shanghai. The police force there was pondering the purchase of big, powerful motorcycles for use in motorcades. It already had agreed to evaluate offerings from German and Japanese suppliers as the deadline for consideration neared. “The process should have taken about a month, but we had a couple of days to get all the approvals,” Bernstein recalls. “We were giving our presentation to the Shanghai police even before the motorcycle was completely out of customs. We rushed it in right before the police department closed for the day.”

Interestingly, expediting the import of the motorcycle did not demand skills that were much different from those required for dealing with bureaucrats in any country, developed or developing. It called for a familiarity with the bureaucracy, the anticipation of problems and the refusal to take no for an answer. “We had people go to the agencies and sit there until the thing was done, and if there were questions, we responded immediately,” Bernstein explains. “The key for us is to dissect the process and make sure things don’t fall through the cracks.” Those are words of advice that might well apply to every international organization that has to deal with the logistics challenge in China. 



TCL's Dongsheng Li: "We Should Control and Own Our Brands"

More and more Chinese companies, having won their spurs in their domestic market, are starting to explore new horizons through globalization. In the process, they face strategic and operational challenges centered around one central question: How should they make the leap from being successful Chinese enterprises to becoming excellent global ones?

TCL, the world's largest manufacturer of color televisions, has been grappling with this issue. Following a joint venture with France-based Thomson (which owns the RCA brand), TCL is trying to leverage its manufacturing expertise in China while seeking growth in markets such as Europe and the U.S. Will TCL succeed? In a recent conversation, Dongsheng Li, TCL's CEO, discussed these issues with Wharton's Michael Useem, director of the school's Center for Leadership and Change Management; Jonathan Spector, vice dean of the Aresty Institute for Executive Education at Wharton; Liang Neng, a professor of management and director of the Executive MBA program at China Europe International Business School (CEIBS); and Knowledge@Wharton.

Useem: What personal leadership qualities have served you well in building your company, and how did you learn or acquire them?

Li: That is a tough question. For leaders like me, we have studied a lot and built our leadership abilities through our work. Entrepreneurs like me have to rely a lot on our experience. We do not acquire our knowledge in school or in some other place before we come to work; we have had to build our leadership abilities on the job.

The first capability that is important for leaders like me is that we must have rich knowledge of our business and industry. We need to have very good mastery of opportunities and then develop the capability of setting a proper strategy for the company. The second important capability is having profound knowledge and understanding of Chinese society and economic development. That is crucial to business success. In the past two decades, China has gone through enormous changes. These have resulted in new opportunities, and it is very important for entrepreneurs to grasp them and take advantage of big trends. Yet another capability I consider important is that leaders must know how to recruit good talent for the company. They should be able to create the right environment to attract talent.

Spector: I am interested in TCL's strategy, given its acquisition of Thomson. Is your vision to create a global brand for TCL, or is it to win by creating a powerful manufacturing capability rather than a global brand?

Li: Our strategic objective is to become an internationally competitive player in the global consumer electronics business. We hope to achieve this goal through several strategies. In a big market, we should control and own our brands. I believe manufacturing capabilities are very important for TCL now. Compared to some players, TCL is not the leader in brand and technology, so how can we achieve a big market share? Our great advantage lies in production efficiency — the speed and the cost at which we can make products. Our products have a good price-performance ratio, which is a big advantage for our manufacturing capability. We should make full use of

our manufacturing and supply-chain advantage to gain a position in the market and then try to build an international framework for our business as well as our brand. Ultimately we hope we can improve our technology and brand capabilities to become a leader in the electronics industry.

As far as our strategy for TCL's globalization goes, we have our own special features. We mainly explore new markets by mergers and acquisitions. For now, we think that in the electronics products industry the European and North American markets are very stable and mature, which makes it hard for us to introduce a new brand. In addition to being difficult, the risk may be huge. By going the M&A route, we can acquire an existing company which already has a market position and brand and its own networks. That significantly lowers our cost of pursuing these opportunities.

For restructuring to work, it is important for it to have two features. First, it should march with the company's development and growth, and second, the plan should be in line with the political and legal environment.

Another advantage for us to do M&A is that they allow us to get to our ideal scale in terms of volume. We are already the biggest color TV manufacturer in the world. This brings us a lot of benefits and advantages. A merger with a major international company can also bring about other synergies. For example, it helps improve our R&D and manufacturing capabilities — and sometimes our markets can be complementary.

Neng Liang: I have two questions related to restructuring. The first relates to domestic players. We know that TCL succeeded for two major reasons. The first was its strategy of overseas M&A, and the second was that the company was able to restructure itself. So for other SOEs (state-owned enterprises), what advice can you offer? What kind of difficulties do they face in the restructuring process, and how can they tackle them?

The second question is that TCL has successfully attracted several strategic international investors such as Toshiba. How can such investors select Chinese SOEs in which to invest? What kind of opportunities and challenges would the investors face?

Li: A company can go through many patterns of restructuring. TCL's pattern is just one of them. Our strategy was very useful in TCL's situation, but it is also helpful for the macro environment, i.e., the political and legal environment. Another very important factor is that when we went through restructuring, the timing was right for us.

For restructuring to work, it is important for it to have two features. First, it should march with the company's development and growth, and second, the plan should be in line with the political and legal environment. These two features are both important and necessary. If a restructuring plan cannot enhance business development, then it is useless, and at the same time, if it is not in line with the legal environment, it will not be accepted by the rest of society.

Our restructuring plan initially helped us solidify TCL's assets. In incremental terms, it brought about a lot of benefits that were shared by management, employees and shareholders. In our sharing plan, we set quite a high target for returns on assets (ROA): We wanted to achieve at least 10% ROA or higher before we would share the benefits. This 10% is much higher than the average figure for Chinese enterprises. As for sharing extra benefits, we decided that the major part would be taken by the shareholders and the rest would be shared by managers and employees. When we set up this kind of a sharing plan, we took into account the rest of society and the legal situation.

Liang: Let me clarify a bit about these figures. Actually, the restructuring plan at TCL was launched much earlier, in 1996 or 1997. At that time the company had an agreement with local municipalities and also its shareholders that only if returns on assets were higher than 10% could management share in the incremental part.

Li: For example, if our ROA was between 10% and 35%, then we could share about 15%. If it was between 35% and 40%, then we could share 30%. If the ROA was higher than 40%, then we could share

45%. This kind of a restructuring and sharing plan was not against the law at that time. From this case you can see that timing is very important; you have to pick the right time to do things. For example, our stock options sharing plan was instituted in 1997. At the end of 1996, the net assets for TCL were just about 300 million RMB. At that time, maybe such an option sharing plan was feasible; but it is not suitable for the current situation.

In sharing stock options, we know that the government should take the majority, so we mainly paid the government dividends. For the management, we mainly had incremental stock options and kept them in the company.

In the process of restructuring, we also issued some rights to buy stock options to government, management and employees. Further, we changed the proportions of each party's stock options in our business. The government held about 50% of our shares, but on the basis of approval by the local municipality, the local government sold 18% of the shares to overseas investors. This was in the beginning of 2002. After selling some part of its stake to overseas investors, the government held only 40% of our shares. This year we went public, which meant we sold a lot of shares to social shareholders. Now the government holds only 35% of our total shares. Another 35% is owned by our management and employees. Overseas investors hold about 12% of our shares. The rest of the stock is held by social shareholders.

Liang: In a nutshell, that is how TCL went from being a state-owned company to a listed, public company.

Li: The second question relates to how overseas investors can choose the right company to invest in China. There are several criteria, but the most important one is that they should choose the right management team. There are a lot of critical success factors for a company; the most important one is people. The right management team would have a rich and proper understanding of how to operate a business for overseas investors. Another prerequisite for investment is to choose an industry with good potential.

Knowledge@Wharton: Here are two questions. The first relates to how TCL is developing its management structure and processes to manage a global

company. So far the company's management has been extremely entrepreneurial but essentially Chinese. But after becoming the dominant partner in your joint venture with Thomson, how is TCL managing the cultural differences in communications, management expectations from senior managers, and line operations in these regions?

Second, we would like to know what you think about TCL's strategy for turning around the U.S. market. The American market has been in decline for a couple of years now, and it's a competitive market in which no one is profitable except, perhaps, Sony. What is TCL's plan for the U.S.?

Li: The first part of your question relates to a very big challenge and a headache for us. We are also thinking about how to establish an effective management structure all around the world. We are very clear that although we are the dominant party in the joint venture, we should use the tool of resource integration with all our employees. In this merger with Thomson, management teams from the two companies have taken jobs with the joint venture. At headquarters, we have formed an executive committee that is composed of top managers of both companies.

There are a lot of critical success factors for a company; the most important one is people.

This committee is mainly responsible for reorganizing, developing and managing the global business. In this joint venture we believe our major markets are China, emerging economies, Europe and the U.S. Accordingly we have set up management teams to operate these four business units. They are looking at functional areas such as manufacturing, sourcing, supply chain management and product R&D. They are working on coordinating the use of global resources. Our objective in making this global allocation is to maximize our synergies and make the best possible use of our resources. We are now establishing a global information management system and a common legal system, and also a global financial system. We estimate it will take us at least 18 months to complete this integration.

Our toughest challenge as we go through this inte-

gration is how to effectively communicate with other companies, and how to achieve mutual understanding about business values and cultures. To communicate more effectively, we have done a lot of training, and our senior management has organized a lot of meetings. We believe that by conducting such projects, it will push forward our integration while generating a lot of synergies.

As for your second question, regarding TCL's strategy about the U.S. market, we think that in recent years the U.S. market has been tough, especially for consumer electronics products. But the U.S. is a crucial part of our global operations, and it is important for us to explore this market. In the past, even Thomson was not doing very well in the U.S.; it was experiencing losses, and its market share was shrinking. To deal with this situation, we have established two committees: one for cost containment and the other for value creation. The committee on costs focuses on manufacturing, sourcing and supply-chain management to improve our competitive and financial situation. The value creation committee focuses on new products, planning and development, new markets and opportunities, and new customer resources to increase our sales and marginal contribution. We are also considering some business restructuring and reforms for the U.S. market to improve our efficiency.

Spector: You mentioned that TCL's strategy for North America or mature markets will be based on M&A and that in the future there will be more acquisitions. This means you will have to be good at integration. What has been the toughest problem in the Thomson acquisition? And how will that make you do the next acquisition and integration differently?

Li: At the moment TCL does not have any detailed future plans for future acquisitions. We have already invested a lot of our time, resources and energy in the venture with Thomson. We have learned that there are several key issues we should consider when we go through a merger or make an acquisition. The first is that we should see if the assets of both companies are complementary to one another. That is much more important than just looking at their book value. The second is that we should establish an effective communication mechanism for the management teams of both companies, especially in the initial stages. Sometimes when communication is not effective, it leads to many lost

opportunities. How can we make communications effective? We should be fully prepared for our projects and do good homework on due diligence. The third issue is that we should keep high the morale and confidence of our people. That is very important. In the first six months, we should have some deliverable results from the merger to increase people's confidence. There also needs to be a clear understanding of the long-term objectives of the merger or the joint venture, and these objectives should be shared by the management and the employees so they can dedicate themselves to these goals. 🍵

Additional Reading

This is the second of four in a series of special reports on China by The Boston Consulting Group and Knowledge@Wharton. **To view the first report in PDF format, visit:**

<http://knowledge.wharton.upenn.edu/index.cfm?fa=specialsection&specialid=19>

More business insights on China from Boston Consulting Group and Knowledge@Wharton are available at the following Web links:

Boston Consulting Group

- ◆ *Capturing Global Advantage*, BCG Report, April 2004
- ◆ *Building Professionalism: The Next Step for Life Insurance in China*, BCG Report, March 2004
- ◆ *What Is Globalization Doing to Your Business?*, BCG Opportunity for Action, February 2004
- ◆ *Made in China: Why Industrial Goods Are Going Next*, BCG Opportunity for Action, November 2003
- ◆ *Aim High, Act Fast: The China Sourcing Imperative*, BCG Opportunity for Action, February 2003

For these and other BCG publications, please visit

http://www.bcg.com/publications/publications_splash.jsp

Knowledge@Wharton:

(Free, registration is required)

- ◆ "China: Will Asia's 800-Pound Giant Crush Its Neighbors?"
<http://knowledge.wharton.upenn.edu/index.cfm?fa=viewArticle&id=908>
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- ◆ "A Contrarian's View of What's Behind Foreign Direct Investment in China"
<http://knowledge.wharton.upenn.edu/articles.cfm?catid=9&articleid=806>
- ◆ "Intellectual Property Concerns Aren't Keeping Firms Out of China"
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China Report: Studies in Operations and Strategy

OVERCOMING THE CHALLENGES IN CHINA OPERATIONS

For further information or inquiries, please contact:

THE BOSTON CONSULTING GROUP

Chris Mark

china.ops@bcg.com

212.446.2800

 Knowledge Wharton

Jamie Hammond

hammondj@wharton.upenn.edu

215.898.2388