

## Doing Business in China The Next Imperative!

By Peter Hanneforth, SpaCom LLC

When China opened up to the world two decades ago, it was initially recognized for being a vast market with more than a billion consumers. While the Chinese market is and will remain attractive in the long run, China has also become known as a global manufacturing hothouse. As we enter the 2001st century, sourcing in China for almost every industry is more becoming an imperative than an option! For many companies the story starts with cost savings on components and finished goods - but this is not where it ends. The overarching objective should be to develop a global competitive advantage, effectively using China's resources and market potential.

Of course, doing business in China, just as in other developing countries, involves significant risks. However, armed with the right strategy, knowledge, experience and support those can be managed. In fact, the biggest risk in regards to China may be not taking one!

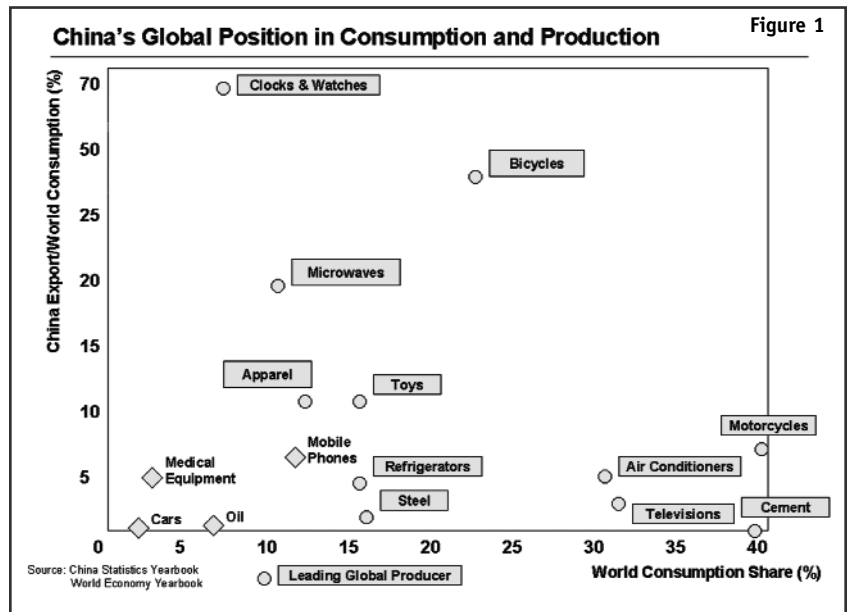
China is already having a great impact on many industries, being either a world leading producer or consumer of goods or both (Figure 1). As a result, companies who are not acting, or not acting as fast as their competitors, are likely to become competitively disadvantaged.

### The Cost Saving Opportunity

For almost every company China offers three fundamental opportunities for savings. The first is in labor and raw materials. The average hourly wage for labor is around \$0.50, well below Mexico's \$2.30. Procurement costs for materials generally run 20-60% below established markets. The second opportunity is capital avoidance, such as lower setup, land and factory expenses. Not only can expensive capital equipment being replaced by cheap labor, but also tooling and repair cost are lower, as well as equipment life can be prolonged for the same reason. A third emerging opportunity is in low-cost product design and R&D activities. China is producing about 450,000 eager engineers every year. A qualified electrical engineer with six years experience can be hired for an annual salary of \$7,000 versus about \$85,000 in the U.S. Companies who can take advantage of these opportunities in China will undoubtedly have an advantage at home.

### The Stages of Market Entry

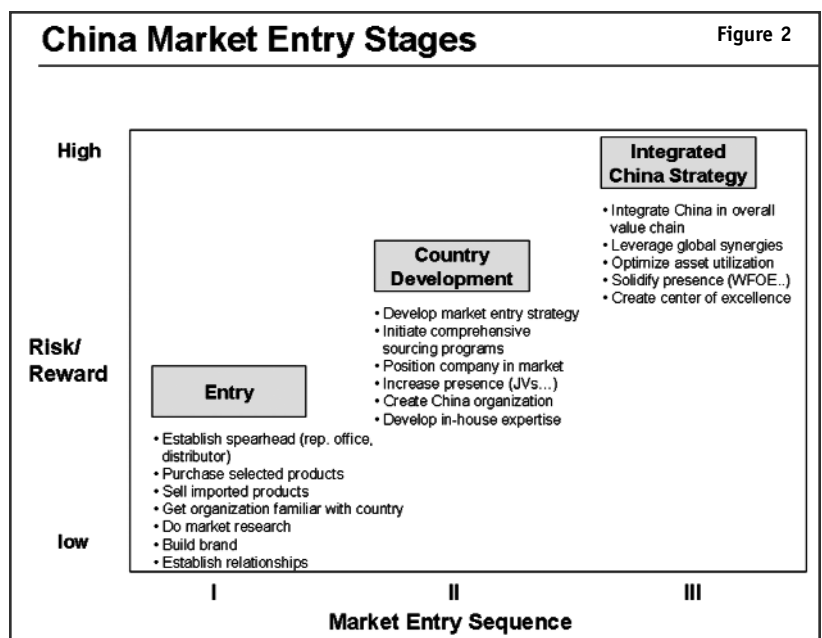
China is certainly a difficult environment and market to operate in. Different business practices, complex laws, unknown consumer habits, heterogeneous market segments, bureaucratic procedures, questionable intellectual property rights, a shaky banking and financial system, communication barriers, logistical issues are only some of the hurdles for foreign companies to overcome when doing business in China. Hence it is vital to for any company depending on its experience, capital



strength and appetite for risk to choose the right market entry strategy. In a classical sense there are three fundamental stages for your China market entry (Figure 2).

**Entry:** During the first phase a company should test the waters by establishing a spearhead in the form of assigning a distributor, an agent or opening up a representative office. While there are certain restrictions for representative offices, it can be a great vehicle for doing market research, building local knowledge and relationships and starting to build a presence and the brand. During this phase a company typically purchases selected, non-critical products and markets and sells imported goods.

**Country Development:** In phase II a company usually pursues a more comprehensive strategy composed of more complex sourcing programs, market development initiatives and the creation of a China organization. This usually requires an increase in local presence, which can be achieved through equity or cooperative joint ventures. Your confidence in your Chinese venture needs to be fairly high at this point in order to justify the resources required in this stage.



**Integrated China Strategy:** During the last phase a company will take fully advantage of its China presence by integrating its operations within the overall value chain, leveraging global cost synergies, optimizing its asset utilization, achieving significant local sales and including China in its global network of centers of excellence. Typically companies have or are solidifying their presence through Wholly Foreign Owned Enterprises (WFOE) in this stage.

No matter what size you are or what stage you are in, China is and will remain a challenge to any enterprise and executive. A constantly changing environment and many bureaucratic hurdles will require you to stay on top of things and employ your best minds and resources to maximize your success and financial rewards.

**The Cultural Challenge**

In China culture counts. In order to succeed in China, foreign companies and executives must capitalize on its cultural traditions and develop a good understanding of the broader context of Chinese culture and values. The challenge of mutual understanding is great. American and Chinese approaches frequently appear incompatible. Very often, Americans see Chinese as inefficient, indirect, or even dishonest; while Chinese negotiators see Americans as aggressive, impersonal and excitable. Such differences have deep cultural origins and various dimensions (Figure 3).

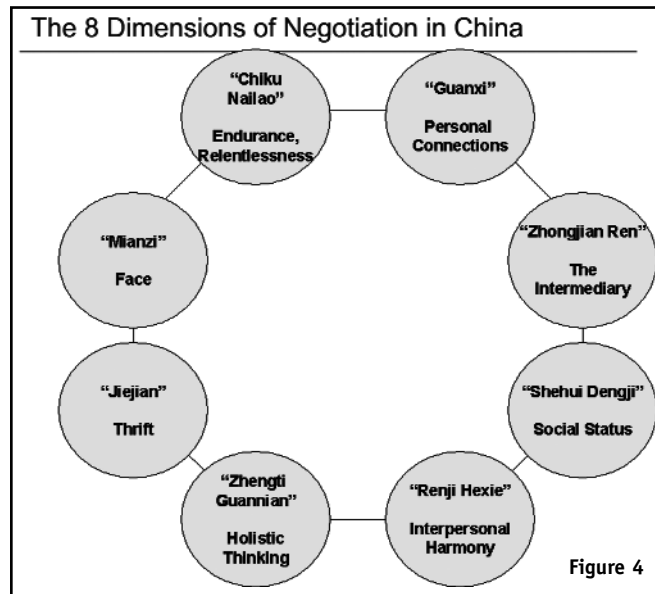


Figure 4

representative to a high level negotiation. Many business deals failed because corporations sent junior people to negotiate with Chinese executives. Interpersonal harmony and friendly feelings (Renji Hexie) are the glue to a successful business relationship. More time is spent in China upfront to build personal relationships than in the U.S., but the wait will pay off later when things go smoother for those who understand the concept than for those who only want "to get the deal done". The Chinese tend to think in terms of the whole and discuss various topics together and at the same time, whereas the Americans want to handle things sequentially breaking up topics into manageable pieces. This holistic thinking (Zhengti Guannian) is probably the biggest point of contention between Chinese and American negotiating teams. Be prepared to discuss all topics simultaneously and to accept that a change in one issue might trigger another change in an issue which you thought had been already agreed upon. China's long history of economic depression has taught people to be frugal and save their money.

This attitude is reflected in the concept of Jiejian (thrift). Chinese negotiators are tough and not easily convinced that their price cannot be accepted. Our advice is to be patient and ask lots of questions. Time and diligence invested in price negotiation will pay off. As in many other Asian cultures saving face (Mianzi) is also key in China. If Westerners cause the Chinese embarrassment it can be disastrous for your business relationship. Finally, the Chinese endurance (Chiku Nailao) is something to be aware of in negotiations. The Chinese place a high value on work ethic and endurance, so chances are that your counterparts will have prepared more diligently for the negotiation than your company's representatives and also expect longer working sessions. So, do your homework and don't expect too much sleep during your trip.

The people who represent your company at the table in China will make all the difference when it comes to negotiating deals and forging relationships. If you don't feel you have those capabilities get advice from a third party. What you invest upfront will pay back many times over in the future when it comes to negotiating in China.

<b>Americans and Chinese take a different View!</b>		
<b>Basic Cultural Values and Ways of Thinking</b>		
<b>American</b>	<b>Chinese</b>	<b>Figure 3</b>
Individualist	Collectivist	
Egalitarian	Hierarchical	
Information oriented	Relationship oriented	
Reductionist	Holistic	
Sequential	Circular	
Seeks the Truth	Seeks the Way	
Argument culture	Haggling culture	
<b>Approach to Negotiating Process</b>		
<i>Nontask sounding</i>	<i>Nontask sounding</i>	
quick meetings	long courting	
informal, cold calls	formal, intermediaries	
<i>Information Exchange</i>	<i>Information Exchange</i>	
full authority	limited authority	
direct, proposals first	indirect, explanations first	
<i>Means of Persuasion</i>	<i>Means of Persuasion</i>	
aggressive, impatient	questioning, enduring	
<i>Terms of Agreement</i>	<i>Terms of Agreement</i>	
forging a 'good deal'	forging a long-term relationship	

**The Chinese Negotiation**

The Chinese culture is more than 5,000 years old, and it would be unjust and unrealistic to try to generalize or oversimplify the underlying issues. However, anyone who enters into a negotiation in China should be aware of the eight dimensions which underpin the Chinese negotiation style (Figure 4).

Guanxi is a complex Chinese concept of personal connections involving an individual's social capital within a group of friends, relatives and associates. No business relationship will be formed without trust, and trust can only be transmitted through Guanxi and by a trustworthy intermediary (Zhongjian Ren), who will facilitate the introduction and interaction between you and your business partner. Social status (Shehui Dengji) is another key to Chinese negotiations, so never send a lower level

### **The Chinese Thermal Spray Industry**

The Chinese thermal spray industry with estimated 2003 sales of about \$140 million is relatively small compared to the US and European markets with roughly \$1 billion in sales each. However, it is forecasted to grow at 15% annually or higher and could therefore reach the \$500 million mark by the end of this decade surpassing Japan. Historically, the Chinese thermal spray industry used to be oriented towards more fundamental processes, such as powder and wire combustion, as well as electric arc. Coatings were predominantly used in anticorrosion, wear and repair applications. With the arrival of the automotive and turbine industry, there is an increasing demand for more demanding applications, requiring more sophisticated plasma and HVOF technology. There are about 400 coating shops in China, most of them having less than 20 employees. There are also a considerable number of materials and equipment suppliers whose annual production value is around \$40 million. Factories are being upgraded and new capacity is rapidly coming online as local demand for coatings increases and Chinese companies get more interested in their export business. Western companies need to be on site in order to capitalize on these opportunities and get a piece of the action.

### **The Past, Present and Future**

The jury is still out on what ultimately will happen in China. Can the economy continue its rapid growth without overheating, either through inflation or asset price bubble? When will the Chinese currency be revalued and by how much? Will the banking and financial systems collapse? How stable is the political environment? How will China behave as it becomes an international superpower? These and many other questions have to be put into the equation when considering to invest in China. If we look at the facts, China's performance record since 1979 is dazzling. Annual real GDP has consistently grown 9% p.a., or an aggregate of 700%. Foreign trade grew in average 15% or 2,700% in aggregate.

In 2002 China attracted \$53.2 billion in foreign direct investment, surpassing the U.S. for the first time with \$52.7 billion. At the current growth rate China is supposed to reach Germany's GDP by 2008 and the U.S.'s sometime in the next decade.

### **The Lessons to be Learned**

Every company and industry is different, but there are some overriding lessons when it comes to doing business in China. Our broad advice to executives consists of avoiding irrational exuberance, knowing and using the Chinese cultural environment in your favor, choosing your partners and the form of foreign enterprise for your company wisely, employing your best internal or external resources, as well as recognizing and taking appropriate steps to limit risks. But then remember: The greatest risk in your China strategy might be not taking one!

**For more information**, contact Peter Hanneforth, President, SpaCom LLC, tel: 1 (631) 757-7799, email: peter.hanneforth@spacom.com