Perspective

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China
Strategies for the New China Landscape

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EXECUTIVE SUMMARY

Once again, China is in the global spotlight. Multinational companies are asking what the recent slowdown in the nation's economic growth rate means for their business—can they still rely on China to deliver growth, do they need to adjust their strategy or business model, and how does China fit into their global priorities given ongoing pressures in core markets? Chinese companies also have their own opportunities and challenges, with some of them building on success in China to grow globally and others under pressure to improve performance.

At Booz & Company, we thought it would be timely to share our insights on what is happening in the country. We explore the economy overall and, more important, how it is affecting the choices for companies in the market. This Perspective draws on the experience of our senior team on the ground in China as well as expert external advisors. We believe that despite the slowdown—caused partly by the global macroeconomic environment but also by deliberate policies the government has been putting in place to make development more sustainable in the long term—the country still offers enormous potential for companies. It can only grow in importance as a key strategic market and a source of global competitiveness.

Strategic approaches, however, must be examined afresh. Across the board, sectors are maturing and undergoing structural shifts. Some industries including high tech, healthcare, and services continue to expand at breakneck rates; others such as property and heavy industrials are seeing slower or negative growth. As demand and supply shift to the inland and western regions of the country, companies must pay greater attention to the growing diversity of consumer segment needs and competitive dynamics in the different regions, as well as implications for their go-to-market model and footprint.

And as Chinese companies grow in strength, more and more multinational corporations (MNCs) are finding their positions threatened by these powerful new competitors, especially advantaged mid-market innovators that produce industrial goods and are able to outperform MNCs both in China and on the MNCs' home turf. These Chinese companies face their own challenges in seeking profitable new growth opportunities and building the right capabilities to capture these opportunities, both in China and globally.

ECONOMIC OUTLOOK

The slowdown in China's economic growth rate—falling to 7.6 percent in the second quarter of 2012, with an annual target of around 7.5 percent—has induced much uncertainty among observers. At one extreme are the negative scenarios proposed by some analysts, with forecasts of a hard landing and speculation on topics such as Chinese banks collapsing under bad debts. There are real concerns about indicators (such as the Purchasing Managers' Index) of falling Chinese manufacturing output, as well as overcapacity, decreasing commodities prices, and other inputs like power consumption data. At the other end are optimistic outlooks suggesting that government stimulus measures will lead to a strong recovery as early as the end of this year. There are plenty of bears and bulls, both in China and around the world.

Given the uncertainty, with the short-term reality quite sector-specific, it is worth understanding the underlying drivers for different scenarios in order to best prepare a strategic response. Government measures to reduce inflation and cool the property market have broadly succeeded, so the focus is on sustainable growth. But with export markets in the industrial countries, especially those in Europe, expected to remain weak, China will have to rely on the targeted shift to domestic demand as a key future driver of growth. As in other countries that have gone through this shift in their economy, this is a difficult transition to make, requiring sustained focus on executing the policy agenda as well as ongoing structural reforms.

The announcements to date include a combination of measures. In late July, the Chinese government announced it would use fiscal spending, tax cuts, and bank lending to support the economy. Separately, however, the government has reiterated its goal of maintaining efforts to cool the domestic property market and inflation and to achieve the structural shift required in the economy. And the country will also see a leadership transition later this year, which is already the source of high levels of speculation both in China and globally given recent events. In general, government initiatives are expected to remain conservative, supporting a smooth transition until the new team is firmly in place—as we have seen in the past.

Nonetheless, companies should not underestimate the government's ability to respond decisively to events. Indeed, most reassuring is the sophistication that Beijing has demonstrated in simultaneously reducing inflation, managing interest rates, and sustaining growth at levels several times higher than that of most major economies around the world. China has a solid track record of "getting things done." Despite the very real challenges ahead, a soft landing for the economy continues to be seen as the most likely outcome. This year's export growth may be less than 10 percent—half of the 2011 growth rate—but offsetting this, retail sales growth is seeing smaller declines, and real wages continue to rise strongly in both

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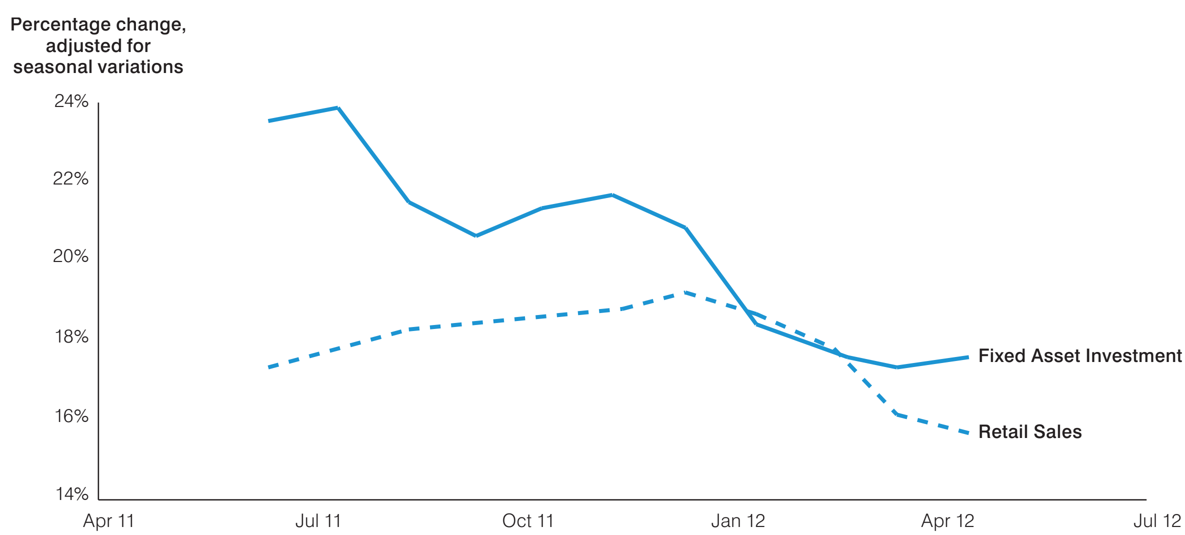
urban and rural areas, which is clearly important to support domestic consumption and demand (*see Exhibit 1*).

Beyond the next several months, however, companies should not expect a total collapse in the rate of growth. China will remain one of the world's main expansionary drivers in the coming years, but for several reasons, growth will not return to the heady double-digit rates of the past three decades. The principal reason is simply that China's economy is maturing. Having boomed through the years of globalization following the opening up of the economy in 1980, and especially after joining the World Trade Organization, China has now reached a stage where it is shifting gears to long-term sustainable growth, moving away from low-cost manufacturing to higher-value-added business, with extensions along the value chain. This will in turn increase the quality of both the economy and life for the Chinese people.

Though the government has yet to achieve the structural transformation from an export/manufacturing/investment-driven economy to the domestic consumption–led economy that it desires, its long-term commitment and regulatory alignment should not be doubted. Clear goals include sustainable growth, improved healthcare, education and social security provisions, wealth shared more fairly across all parts of society, and environmental improvements, all of which will be helped by the continuing rapid rate of urbanization and the development of inland and western China. And after years of investment, such development appears to be paying off with the emergence of Chongqing, Chengdu, and Xi'an as major technology and manufacturing centers.

Amid such change, the average annual expansion will settle down to a single-digit rate from now on, likely several percentage points below the 10 percent average of the last 30 years. This is far from a disastrously slow rate, but it does mean companies need to recheck their strategies. Instead of fretting about short-term growth rates, they should concentrate on gaining a strong understanding of how structural changes will rework the competitive landscape, and what this means if their China strategy and capabilities are to succeed.

Exhibit 1
Indicators of Chinese Consumer Demand



Source: National Bureau of Standards, J.P. Morgan; "Global Economic Briefing, July 2012," by Raghuram Rajan, professor at University of Chicago Booth School of Business

CORPORATE OUTLOOK

Multinational corporations must look to the future over two time spans: the immediate six to nine months ahead, and then the several years beyond that. Many companies in China have seen growth slow in the first half of 2012, more so in coastal regions than inland. The level of decline has been dependent on the types of products or services offered by a company. Hardest hit are real estate–related sectors. Construction equipment, for example, saw sales growth turn negative in mid-2011. Caterpillar expects its Chinese sales to fall this year. The automotive sector is also slowing, partly as a result of the market maturing but also due to deliberate government policies, including restrictions on new car sales in cities like Beijing to help manage environmental impacts of pollution and congestion. The software industry, by contrast, has been far more modestly affected. Its revenue growth of 29.3 percent in the first half of 2011 was just 3.1 points lower in the first half of 2012.

The Near Term

The period through early 2013 is likely to see further substantial shifts in demand. If matters deteriorate, most companies expect further measures to stimulate the economy. Executives on the ground in China believe the government still has the will and ability to ensure a soft landing through its control over infrastructure investment, capital controls, interest rates, foreign exchange rates, and other macroeconomic policy tools. Senior Chinese executives in particular comment on the sophistication that will be required to pull multiple levers in tandem to achieve a balanced result that meets the multiple objectives of sustainable growth, low inflation, high employment levels, and reducing inequality in income distribution.

Though any stimulus will not be as large as the one launched in 2008, the view is that it would likely be effective in mitigating the worst spillover damage from the crises in Europe and elsewhere. Moreover, beyond this period, even those companies that are negative about the short-term outlook are confident about China's long-term prospects, especially compared to other parts of the world.

Companies must monitor shifts in demand and then react accordingly, and those that find themselves facing a fundamental shift need to react proactively. In logistics, for example, demand has moved inland—"into

China"—for both multinationals and Chinese companies. These companies need to realign their footprint and operating model with this new demand, which increasingly requires linking inland and western regions to the rest of the country and building genuine nationwide networks. Foreign companies can benefit from partnerships with Chinese players to accelerate this strategy and fill gaps in their reach and capabilities, but they need to develop capabilities to execute this shift successfully.

Other companies, such as those in the consumer goods and industrials sectors, are also seeing a shift in demand from strong positions in coastal regions toward inland regions. For them, this can be an opportunity to gain a lead over their competitors—for example, by expanding ahead of the market through measures such as building brand and distribution. Booz & Company is currently advising many companies on how to expand from the original "top of the pyramid" focus on Tier One and Tier Two markets with which they established themselves in China. These companies are now adopting a "go down" (*xia chen*) strategy of deepening and broadening their channels to enter lower-tier markets. This often requires changes to their traditional go-to-market model as well as to core elements of their customer-value proposition (including "good enough" products delivered at competitive prices). There are also increasing opportunities to leverage digital channels, including e-commerce and social media, as part of these strategies.

Execution remains a key challenge in supporting these strategies, and increasingly companies need to be "fit for growth," with a much stronger focus on having profitable growth in both top and bottom lines. Talent is still the number one issue cited by most of our clients. Given an acute shortage of trained and experienced managers and executives, attracting, retaining, and developing the right people remains the biggest challenge for companies looking to grow rapidly. Success in this area calls for a clear vision and compelling sense of purpose, supported by the right leadership in China and an operating model that balances local flexibility and agility with global control and capability leverage.

The Medium to Long Term

Given the maturation and structural shifts in many sectors, plus the increased diversity of customer needs, greater sophistication will be needed in the medium to long term. Our recent joint study with AmCham Shanghai on 2012 China consumer market strategies highlighted the

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emergence of two distinct consumer buying behaviors ("pay for value" and "choice"), with convergence on how MNCs and Chinese companies see the marketplace and four critical capabilities required to compete. The good news is that we are seeing the emergence of customers prepared to pay for better value, becoming more brand loyal, and increasingly seeking customer experience and service as well as products. The bad news is that the days of winning purely by having the allure of a foreign brand, better technology, and higher quality are drawing to an end. Increasingly, multinationals find themselves fighting on a common battleground with local companies that also have strong brands and fast-improving (or equivalent) technologies and quality standards. The starting point for addressing this narrowing gap is an in-depth understanding of the China context, and especially a stronger grasp of how domestic companies are shaping up—and investing in the new capabilities required to win in the market.

Many Chinese companies are focusing on organizing for growth, both domestically and internationally. For the majority of businesses, this means figuring out ways of moving along the value chain without losing the low costs, flexibility, and entrepreneurial spirit that have enabled the best of them to thrive in China's cutthroat business environment. These are companies that have typically grown rapidly with a centralized, top-down decision-making structure. To continue to grow, they now need to make changes to their operating model with a balance of central versus local decision making and control; adopt more disciplined and institutionalized management processes; address the complexity that comes with more customers, products, and geographies; and manage generational shifts in leadership. The more pressing challenge for other companies is transformation to address significant gaps in performance and build long-term sustainable profitable growth.

Though Chinese companies remain keenly in need of "how to" advice on building capabilities, especially around branding and marketing, MNCs need to be watching those businesses that are moving beyond their copycat reputations to become serious innovative competitors. The 2012 China Innovation Survey, conducted by Booz & Company together with the Benelux Chamber of Commerce, China Europe International Business School, and Wenzhou Chamber of Commerce, found that many Chinese companies have already moved beyond their *shanzhai* reputations with an entrepreneurial "need seekers" model (in which they pay closer attention to consumer demand), rather than just being fast followers. Among the MNCs interviewed, 45 percent said they have Chinese competitors that are at least as innovative as they are.

One of China's key objectives is to develop an innovation-based economy, and it seems to be succeeding. With enormous and growing spending on R&D, foreign and domestic companies and the government are scrambling to build advantages in the vast, highly competitive, and quickly developing China market. Though many companies have a long way to go in building a truly differentiated "end-to-end" innovation capability, we do see significant potential, and progress is being made.

The China Innovation Survey's findings are supported by a Booz & Company analysis of a new category of Chinese competitor—

mid-market innovators. These include Chinese business-to-business firms in industries such as machinery and equipment making. The factors promoting mid-market innovators have never before been in place all at once. Able to sell into China's immense market, these companies have taken advantage of the explosive growth in infrastructure investment and the huge supply of cheap labor at all levels to produce high technology and variety at low cost, with a strong home base to build from globally.

Chinese mid-market innovators will find it much easier to expand globally than their Japanese and Korean predecessors did. The earth has become much flatter; they have no need to develop expertise along the entire value chain, due to modularization, outsourcing, and offshoring; and they can tap into the globalized market for talent and other professional services. As a result, we are likely to see Chinese industrial goods join other product categories in establishing themselves in markets worldwide.

But Chinese competition does not come only from the mid-market, business-to-business players. In the business-to-consumer sector, domestic companies' principal advantages are speed and agility, allowing such firms to tailor new goods to customer needs and tastes that are changing month by month. We are also seeing more entrepreneurial innovation and a willingness to experiment, take risks, and then scale successful products—often supported by good capabilities in sales and distribution, particularly to core mid-market and lower-tier customers but increasingly going more up-market.

Meeting these challenges will be hard for MNCs. Local product requirements and price points often prevent international companies from simply de-contenting their world-class products—"good enough" sometimes just isn't, and there are concerns about compliance and brand reputation if corners are cut or quality is compromised. Most MNCs will have no choice but to find a way to win in the Chinese mid-market by developing their own localized products, capabilities, and other resources to compete proactively with innovation. This will allow them to stay out in front of their competitors as new markets open up.

The rise of these formidable, structurally advantaged Chinese competitors on the world stage requires a clear response from Western companies—both in China and increasingly in their home markets. The Chinese companies should not, however, be viewed as unbeatable. The global economic crisis of the last four years has given many of them a major reality check. The entire Chinese solar energy sector, for example, is in deep trouble. Construction equipment maker Sany Heavy Industry, seen just a few months ago as a potentially major threat to companies such as Caterpillar and Komatsu, has started to lay off staff after seeing its sales in China fall. And the financial performance of many industrial state-owned enterprises has sharply declined. Pressure on them has also increased because they are increasingly asked to deliver profitability in the same way as commercial private and public companies. The top priority has now changed from being "big" (*zuo da, zuo qiang*) to being the "best" and delivering optimized results (*zuo qiang, zuo you*).

CONCLUSION: STRATEGIC POSTURE

We see four main calls to action for MNCs, determined by their sector and position:

1. *Double down:* Many companies have built strong positions (often in coastal regions or higher tiers) but are seeing a shift in demand (mainly inland or to lower tiers) and have anticipated this shift. Some of these companies are using the opportunity to aggressively compete—with pricing, for example—to put pressure on competition. Often these companies have the opportunity to expand ahead of the market (such as by building brand and distribution), but they need to tailor their model and adapt their capabilities to meet the needs of customers in new markets.

2. *Reposition:* Companies that are facing a fundamental shift in demand—in the logistics sector, for example—need to react very proactively. Demand has fundamentally shifted into China for both MNCs and Chinese companies, and they need to significantly realign their business model accordingly. Others need a new "way to play" to win in the market, driven by a China mind-set, and will need to build a coherent set of capabilities aligned to their way to play.

3. *Wait and see:* Companies that can afford to "wait and see" are considering a more careful approach. These are companies that can gain market share in any environment through innovation and/or brand strength. However, they tend to be spurred to act either by a desire to expand faster now that they can or by pressure from headquarters.

4. *Pull back:* Companies with weak positions and a lack of ability to gain market share need a broader strategic rethink. These companies are struggling at the moment and may need to make more radical choices on portfolio strategy and where/how they play. Their options might include a strategic role for partnerships, leveraging strengths of a Chinese partner, and refocusing on parts of the business that best leverage current capabilities. Other companies need to make clear choices on the inherent, structural/systemic, and realized drivers of costs to deliver a step change in profitability.

Beyond such immediate strategic responses, we believe most companies should be looking at defining a clear "one world" strategy, incorporating China's many competitive advantages into their global operations, making them fit to outperform in China and worldwide. To pursue this strategy, companies will need to migrate more and more of their major value-chain activities, such as R&D and product development, to China—while maintaining global scale and leveraging their global capabilities. Their Chinese activities will play more of a role contributing back to the global enterprise, providing the expertise needed for low-cost operations and reverse innovation.

Even though China's growth rate is slowing and uncertainty continues about the country's rate of economic expansion in the near future, China continues to hold enormous long-term sustainable growth potential for many companies as a key strategic market in an integrated "one world" strategy. Through the rest of 2012 and into early 2013, we expect to see companies revisiting their strategies and examining afresh the priorities for their businesses in light of the new China market landscape—both for the next six to nine months, and for the medium to long term. MNCs must have a clear response to win in China and capture its market potential as well as to compete against emerging Chinese competitors. Chinese companies also need to respond to structural shifts in their industries, as well as to capture opportunities for growth in China and globally. Though the call for action will be different for each specific firm, the principal focus should be on long-term growth and performance strategies that make companies "fit for growth" in both China and the world.

Resources

This Perspective draws on insights from other senior leaders in the Booz & Company Greater China practice, including John Jullens, Bill Peng, Simon Sun, Steven Veldhoen, Adam Xu, and Huchu Xu.

This Perspective also draws on the following articles and reports:

- *2012 China Innovation,* by Steven Veldhoen, Anna Månsson, Bruce McKern, George Yip, and Mariska Kiewiet de Jonge
- *China's Mid-Market Innovators,* by Edward Tse, John Jullens, and Bill Russo
- *Managing the Global Enterprise in Today's Multipolar World,* by Paolo Pigorini, Ashok Divakaran, David Suarez, and Ariel Fleichman
- *Is Your Company Fit for Growth?,* by Deniz Caglar, Jaya Pandrangi, and John Plansky
- *China Consumer Market Strategies,* by Joni Bessler, Adam Xu, and Simon Sun, conducted by the American Chamber of Commerce in Shanghai (Amham Shanghai) in cooperation with Booz & Company

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