

# Doing Business in China

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*As China evolves rapidly into a powerful market force, many companies are looking for ways to protect their margins and market share at home—and seize new market opportunities in China. To develop their strategies, CEOs need answers to some basic questions about China's business climate.*

### PREFACE

Roger Heng, BMO's Managing Director in China, is leading the Bank's expanding presence in China. From his office in Beijing, he monitors first-hand China's evolving political, economic, regulatory and business landscape. And he studies the implications of these changes for both his native country and for North American companies pursuing business opportunities in China. A well-respected business leader, Roger serves as a member of the International Business Leaders Advisory Council to the Mayor of Qingdao and his Municipal Government.

Roger was born in Hingling, Guangdong Province, China, and received his Bachelor's Degree in Economics from the University of Western Ontario and a Commerce Degree in Finance from the University of Windsor, Ontario. He remains extremely active in community affairs on both continents, working on behalf of several nonprofit organizations and business groups to promote Sino-North American cultural exchange and trade cooperation.

Roger addressed the following questions and issues in recent meetings with BMO Nesbitt Burns clients.



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*What do you consider the most critical component of any successful trade strategy involving China?*

## CHINA TRADE STRATEGY

Companies need to study the changes underway in China very carefully and develop a coherent vision of where the country is going—and what business opportunities and risks these changes create. On the one hand, shifting demographic trends, growing consumer purchasing power and advances in technology can stimulate greater demand for goods and services. At the same time, variables such as policy decisions and changing legal, regulatory and financial frameworks can affect current strategies for investment direction, market distribution and cost structure. The companies that do the best job of reading and anticipating these changes—and identifying the development gaps that result—will profit most from their business activities in China.

*What new markets/platforms are likely to open next for North American investors in China? In other words, what will the next "development gaps" be?*

Many of the recent development gaps are directly tied to China's growing middle class. These consumers have strong appetites for products and services that are very familiar to most North American consumers. For example, 400,000 new cars were delivered in Beijing alone last year, and consumers are paying premium prices for cars available for immediate delivery. The construction industry is also booming as consumers set their sights on private home ownership. These trends in turn create opportunities to supply everything from energy, cellular phone and Internet services to engineering, environmental and financial services.



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## TRENDS

### Trade with China: A growing phenomenon

Canada's exports of goods to China have grown from \$2.7 billion in 1999 to about \$4 billion in 2002 and have become more diversified. The top four export categories were wood pulp, automotive parts, fertilizers and organic chemicals, accounting for 46% of Canada's total exports to China. In 2002, automotive parts displaced the grain, seed and fruit category to become Canada's second largest export to China with an 88% increase over 2001.

As consumers continue to display their greater spending power and cultivate more sophisticated tastes, North American companies may have growing opportunities to support education, travel, recreation, media and entertainment. There will also be increased demand for environmental technologies; fire prevention and security; food packaging equipment; housing and building products such

*What are some of the better purchasing opportunities for North American companies seeking to procure low-cost raw materials, finished goods and parts manufactured in China?*

as plastic materials, scrap metals and resins; power generators; telecommunications equipment; and waterway, railway and highway construction, transportation and infrastructure. Traditionally, China was known principally as a manufacturer of labor-intensive manufactured goods such as textiles, leather goods, toys and sporting goods. But China's product mix has been shifting steadily toward electronic consumables. In fact, China is trying to pattern itself after India, which has become a leading source of value-added and high-tech products. For example, China is now a leading global producer of televisions, telecommunications equipment, personal computers and parts used in a broad range of consumer products.



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*How do you gather the market intelligence necessary to develop a sales and distribution strategy for China—and stay a step ahead of change?*

Psychologically, many North American companies feel uncomfortable or uncertain executing a trade strategy in China if they don't have all the market intelligence they believe they need. Though market intelligence can be difficult to gather, there are many reliable sources of information available:

- **International Trade Canada (ITCan)** supports the development of trade by providing services to exporters, developing policy, and by attracting investment in the Canadian economy.  
<http://www.itcan-cican.gc.ca>
- **The Canadian Chamber of Commerce** has been the largest, most influential advocate for business in Canada since 1925. Founded with the aim of creating a strong, unified voice for Canadian business and a set of values from which policies encouraging prosperity would emerge, it continues to be the only voluntary, non-political association that has an organized grass roots affiliate in every federal riding.  
<http://www.chamber.ca/>
- **Canadian Manufacturers and Exporters**, formed through a merger in 1996 of the Canadian Manufacturers Association and the Canadian Exporters Association, has represented the interests of Canadian business for

more than 130 years, keeping members on the competitive edge of world-class manufacturing and trade. With strong divisions in every province, CME is a truly national association and the undisputed champion of business issues in Canada.

<http://cme-mec.ca>

- **The Canada China Business Council (CCBC)** is a private-sector, non-profit membership organization incorporated in 1978 to facilitate and promote trade and investment between Canada and the People's Republic of China.  
<http://www.ccbc.com/>

The information you gather from third-party sources will only take you so far, however. You will gain a much better perspective by visiting China yourself, and tapping the many local resources available. While you're there, you may consider recruiting and hiring a Chinese-speaking employee who can help you perform local due diligence and build and manage relationships. There's a fast growing pool of Western-educated Chinese who are returning to China with good language skills and a solid understanding of modern business practices, and who have adopted Western business values. Employment agents in major Chinese cities can help identify and screen qualified candidates.



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## *What's wrong with waiting until conditions stabilize and become more predictable?*

I believe the best time to invest in China is right now, for a number of reasons. 2004 is shaping up as an exceptional year. Manufacturing costs remain low in many areas. The Chinese labor pool is more skilled than ever. It's easier to do business in China than ever before. Tax incentives are still attractive, in part because economic growth is a high priority for the Chinese government. Political relations between China and both the U.S. and Canada are stable. And most importantly, China is ready for a period of explosive growth and change that will include fewer import restrictions and fundamental changes to the country's financial structure.

The earlier companies gain a foothold and begin to educate themselves about the local landscape and market potential, the better positioned they will be to begin developing a vision—and begin to put the pieces in place to capitalize on this change.

### Trade Strategy: Further Reading

#### Articles:

“Behind the Mask—A Survey of Business in China: A Billion Three, But Not for Me.”

The Economist 370 (March 20, 2004): 5-6.

Hale, David and Lyric Hughes Hale. “China Takes Off.” Foreign Affairs 82

(Nov.-Dec. 2003): 36-54.

Walton, Julie. “WTO: China Enters Year Three.” The China Business Review 31

(Jan./Feb. 2004): 10-17.



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*What is a reasonable ramp-up strategy for a middle-market company looking to establish sourcing relationships or an export base?*

## OPERATIONAL STRATEGY

There's no easy blueprint to follow, in part because every business strategy requires a different approach. And depending on the scope of a company's operations, it may be appropriate to develop a separate strategy (source direct, partner, acquire) for each individual product category and industry segment.

In developing a strategy, it's important to develop a checklist that should include the following issues:

- Mode of relationship you prefer;
- Geographic area to target;
- Market intelligence;
- Specific level of investment;
- HR support required;
- Logistics and distribution support.

Investment in China is not a one-time decision, and divestiture is difficult because the Chinese currency is not convertible. Therefore, many companies prefer to start with a smaller investment or a simple outsource agreement—then build from that once they have more knowledge of and confidence in the market. If you're making products that target the North American market, consider forming an outsourcing agreement and hiring a local quality inspector to oversee and evaluate manufacturing processes. If targeting China and other international markets, it may be best to set up local operations within a Chinese organization that also offers distribution capability. Creating a wholly-owned entity provides you the most control in terms of intellectual property, quality and financial controls. But it also requires the largest up-front investment, and you may encounter distribution challenges unless you find a Chinese partner that covers your important domestic markets.



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## *What are the hurdles for companies that wish to construct manufacturing facilities in China?*

In most cases, it's also important to establish a full-time base of operations in China. As your operations grow and change, an observation post will help you build and maintain relationships, measure progress, identify new opportunities, resolve payment and employment issues and track the reputation of your company and your partners.

Each region in China has its own economic base, growth strategy and competitive landscape. And each offers its own unique opportunities and challenges. For this reason, finding the right location for your operations is critically important. China's high-tech workforce is located around major coastal cities, and the Pearl River Delta and North Region are experiencing rapid growth as well. But manufacturing costs are rising in these areas, and this can lead to lower profit margins over time. Beijing, on the other hand, is closer to the political decision making process—and closer to major banks, insurance companies and corporations with international operations. In remote areas, unemployment is high and labor is cheap, but the workers are less skilled, and a higher level of cultural variation also means higher risk.

The Chinese government understands the importance of foreign investment to its long-term economic growth. At the same time, China has a long history of protectionism. The real trick is reading the signs of protectionism at work—and knowing your rights under WTO guidelines.

## *What Western practices, if adopted, have the best opportunity to improve the performance of Chinese companies?*

A perception exists in the West that China remains far behind more industrialized nations when it comes to manufacturing performance. In reality, CEOs are often surprised when they visit Chinese manufacturing facilities and see the level of automation and technology. In fact, China places a heavy emphasis on quality manufacturing, and companies have made significant recent investments in capital equipment. And Western-educated workers are returning to China—bringing new ideas and technologies with them. As a result, the country is gaining a favorable worldwide reputation for quality and productivity.



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## *What supply chain challenges can North American companies expect to confront in China?*

China's archaic distribution system can be an invisible barrier to success in China. North American companies will not find the kind of national distribution system they've built to support the fluid and cost-effective movement of goods. Instead, the Chinese system operates locally and regionally, with companies operating on an enterprise-independent basis. What's more, distribution is part of the power base of many individuals, and they will fight to protect the status quo—a system in which goods flow through many people, all of whom profit from this movement.

Clearly, China's distribution system needs to become more automated—and much more transparent. International companies are taking the lead in building their own supply chains. As they do, however, they're making sure they have multiple suppliers at every critical link. They're also building in incentive mechanisms

that reward reliable performance. Large companies in high-demand industries like auto parts have been more successful to date because of their clout. Smaller players have greater supply chain risks. Some form strategic partnerships with strong regional distributors who are able to control the entire process. Others seek to reduce supply chain complexity—and protect their profit margins—by working directly with manufacturers. Because many Chinese manufacturers have their own export licenses, they can ship goods directly overseas and eliminate the middleman.

### Operational Strategy: Further Reading Articles:

Berghout, Lisa. "China Tomorrow: The Great Transition." *Harvard Business Review* 81 (October 2003): 70-81.

"Behind the Mask: A Survey of Business in China: Bulls in a China Shop." *The Economist* 370 (March 20, 2004): 9-10.

The Boston Consulting Group. "China: The Pursuit of Competitive Advantage and Profitable Growth." (June 2003). (Can be found at <http://www.bcg.com>)

### Online Resources:

The American Chamber of Commerce in the PRC, [www.amcham-china.org.cn/](http://www.amcham-china.org.cn/)



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## PARTNERSHIP STRATEGY

When North American companies first targeted China, many chose the joint venture structure as a starting point, in part because it was a familiar and—they believed—relatively low-risk strategy to them. But too often, these relationships were strained beyond the breaking point by competing interests, differing expectations and communications challenges.

Today, companies can learn from the mistakes of their predecessors by taking a different approach. They can work with their bank to determine government vs. private ownership and gain insights into each prospect's banking relationships, general commerce activity and behavior. They can also control many of the inherent risks by employing a Canadian-educated Chinese national to work as a liaison. This intermediary can help identify the Chinese partner's true interests, and ensure that the negotiating partner has real decision making authority. He can also screen each prospect by raising delicate issues such as labor practices, security, quality, financial transparency and performance measurement up front.

### *How do you identify suitable joint venture partners or suppliers?*

When it's time to structure an agreement, companies should prepare for protracted negotiations. They should hire their own interpreter and local legal counsel. They should push hard for better incentives and terms, be creative and force their prospective partners to deal. They should negotiate clear contract terms that include provisions to protect intellectual property. And they should walk away from the table if the prospective partner proposes a prohibited agreement or asks for a bribe.

Once an agreement is signed, it's essential to keep the lines of communication open and monitor these relationships on an ongoing basis. This means establishing a channel for constant communication between the home office and field. It also means regular in-person visits to the Chinese partner's manufacturing or distribution facilities to monitor quality and cultivate relationships with key decision makers.



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## *How do you know when it's time to walk away from a joint venture relationship?*

It's important to have a realistic understanding from the beginning and find the middle ground between hype and pessimism. If you've done a good job of negotiating clear contract terms and setting milestones, it will be easier to enforce compliance. But companies should always anticipate problems and take proactive measures such as securing payment before shipping. Push for better incentives—be creative, force them to deal. Never agree to pay bribes. Finally, companies should have an exit strategy from the outset that includes an alternative course of action, and be prepared to walk away.

## *How do middle-market companies get on the radar screens of Chinese companies looking to establish business relationships with North American companies?*

There's no question that when I return five years from now, my focus will be much different. Instead of addressing North American companies about how they can compete in China, I'll be introducing Chinese companies to North America and helping them understand how to compete here. The Chinese now have five to seven years of experience in thinking about trade outside their borders, and they want very much to establish a reverse distribution network to North America. Their activities are sure to attract the attention of the North American media. Beyond that, it's useful to cultivate relationships with financial intermediaries and—of course—spend more time in China to learn of these activities firsthand.

Partnership Strategy: Further Reading

Berghout, Lisa. "China Tomorrow: The Chinese Negotiation." *Harvard Business Review* 81 (October 2003): 82-91.

Clissold, Tim. *Mr. China*. London: Constable & Robinson, 2004.

Kenevan, P. and Xi Pei. "China Partners." *The McKinsey Quarterly* 3 (2003).



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*What can North American companies expect from the Chinese labour pool?*

## LABOUR STRATEGY

Though there are certainly large pockets of highly skilled workers in China, its overall labor market is still in an embryonic state. And because of China's vast size, it will develop more slowly than it has in Korea or Taiwan. Today, every 15 miles a company travels outside of a major center takes it back two years in terms of skill level—and creates additional policy and intellectual property risks. By relying on these workers, companies may also put their local reputations at risk and further compromise the efficiency of their local distribution channels.

On a positive note, however, China still offers the cheapest labor in the world. And today, it is undergoing the largest liberalization of humankind in history. With ten million new workers entering the workforce each year, there's an unlimited amount of inexpensive labor that helps ensure relatively low increases in hourly wages—and helps international companies protect their margins.

China has a long way to go before it transforms into a service economy. At the same time, the steady rise in per capita income means that consumers can now afford—and are motivated to purchase—products that contribute to quality of life. As they come to rely more on these products, customer service will become an increasingly important issue.

*What levels of customer service are Chinese consumers used to, and what opportunities do customer-centric North American companies have to differentiate themselves?*

International consulting firms have positioned themselves in China's major economic centers and are introducing Chinese companies to concepts such as Customer Relationship Management. Customer service can become an important differentiator for Chinese companies, especially for those that compete in overheated industries. In the near term, it can also provide North American companies an opportunity to fill a performance gap—if they can establish suitable incentive/reward systems in China to drive customer-focused behavior. Opportunities may also present themselves to work with smaller and middle-market Chinese companies to help them raise their service levels.



Labor Strategy: Further Reading  
A.T. Kearney. "Making Offshore Decisions." A.T. Kearney's 2004 Offshore Location Attractiveness Index (2004). Can be found at <http://www.atkearney.com>.  
Athreya, Bama. "China's Changing Labor Relations." *The China Business Review* 31 (Jan./Feb. 2004): 20-25.  
"Human Resource Trends in China." *The China Business Review* 31 (Jan./Feb. 2004): 18-19.

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*What tactics can help mitigate the risks inherent in China's current financial and banking system?*

## FINANCIAL STRATEGY

Many companies ask how they can get their money out of China if their strategy doesn't turn out as planned. This has traditionally been one of the biggest risks investors face, because China's currency is still a controlled currency, and convertibility is limited only to a company's current import and export account, not a capital account involving investments and loans. To divest their equity stakes in China, companies must gain approval from the Chinese government to expatriate the funds out of China. Once this approval is granted, the company can convert its funds to foreign currency. This risk is beginning to diminish, however, because investors are now viewing the Chinese currency (RMB) as an appreciating currency, and investors are now willing to hold onto their RMB for further investment. In fact, problems companies may encounter with their investments are more likely to arise from their partners—not from government authorities.

Though the Chinese government has established no timetable for currency convertibility, it is increasingly aware that only a higher level of convertibility will make China's entry into WTO meaningful. As wealth in China continues to grow, Chinese companies will require a convertible currency to make their own investments abroad.

North American companies need an experienced and effective platform to facilitate their operations in China. They benefit from a bank that offers experience and judgment, good sources of information and references. For example, companies considering partnerships can rely on their bank to perform due diligence at the local bank, local corporation and local government levels. They will cross-examine the evidence they collect and provide a good degree of comfort. Banks can also help educate companies and understand the facts as they are.

*What can a strong relationship with a bank contribute to your success in China?*

This education makes it easier to cut through the details and develop and implement strategies in a shorter period. They can also help companies set reasonable expectations—something that's important because North American companies often have higher expectations that can come into conflict with Chinese cultural norms that can be hard to change. Companies are more likely to succeed if they adjust their expectations and mental processes and are willing to entertain special risks.

Financial Strategy: Further Reading  
"Behind the Mask—A Survey of Business in China: Non-Performing." *The Economist* 370 (March 20, 2004): 18-19.  
Bremner, Brian, Dexter Roberts, and Frederik Balfour. "Headed for a Crisis?" *Business Week* (May 3, 2004): 36-44.  
Lo, Chi. "Bank Reform: How Much Time Does China Have?" *The China Business Review* 31 (March/April 2004): 30-33, 41.

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