China Performance Group

Sourcing From a Changing China

Part Two

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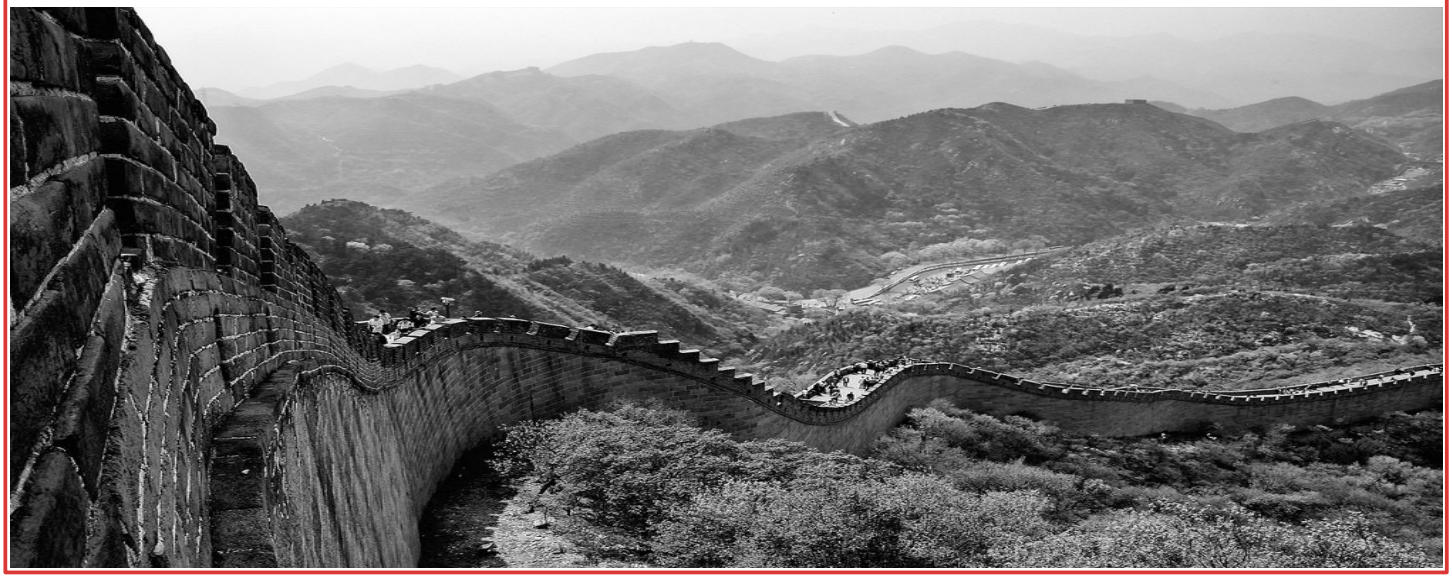

I. **Contents**

AUTHOR's NOTE:

This white paper is the second part in a series of 3 white papers on the subject of "Sourcing from a Changing China: The Changes and Opportunities of China Sourcing" which was based on a conference in 2013 confronting the question: "Is China losing its competitive edge?" This part addresses Chinese Suppliers, who they are and how they are changing.

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The "Sourcing from a changing China" series consists of 3 parts, as follows:

1. **Is China losing its Competitive Edge?** *Historical and cultural background, Chinese labor, country attractiveness and the political will to change*
2. **The Chinese Suppliers**: *Who are they? Are they changing?*
3. **How to Win in China:** *Grabbing the Snake by the Tail*

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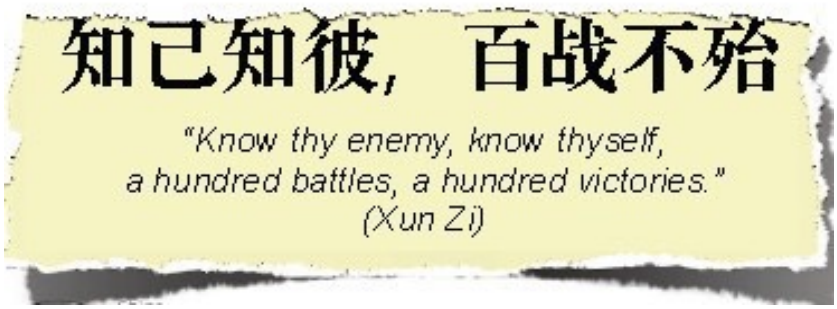
As the world's economies go through some of the most volatile conditions in recent memory, China's emergence as a steady global economic force has made it more attractive as a resource. Serious China importers benefit from an understanding of the context and history of this transformation and this paper addresses the question of whether or not the country's supply chain still has a competitive edge and, if so, whether it will be able to maintain it.

In this segment we explore who the Chinese suppliers are, how they emerged and what one needs to know in order to best interact with them.

A. The Birth of the Chinese Private Sector



The Chinese philosopher Xun Zi says "Know thy enemy, know thyself." This is relevant not only in the art of war, but also in the art of supply management. In the wake of the country's entrance into the WTO, manufacturers have become allies and adversaries, if not outright competitors of importers. But this was not always the case.

Thirty-eight years ago, before the Chinese Communist government relaxed its restrictions on commerce in the late seventies and allowed private businesses to operate, the primary Chinese resource was labor, and yet, the main products for export were not labor intensive: they were commodities. Foreign trade corporations were the exclusive interface with importers. They managed things centrally out of Beijing and met buyers twice a year in Guangzhou at the “Canton Fair”.

MACHIMPEX HALL AT THE CANTON FAIR IN 1979. THE ONLY PLACE WHERE

These government agencies could be inflexible and difficult to negotiate with – and they did not allow visits to factories. But they were educated, sophisticated, spoke English, and understood the west better than most. This meant that a buyer was dealing not with a profit-driven manufacturer but instead with a policy-driven bureaucrat. Making a profit was not the main motivation for them at the time: generating hard currency was. They worked closely with importers to achieve this.

But circumstances made it difficult for importers to develop a predictable, repeatable business. Trends were difficult to anticipate, pricing was not necessarily linked with the cost of materials and labor but would fluctuate with policies and the need for dollars. Sourcing from China was a stop-and-go exercise for adventurous people, it could not compare with the more prosaic business as transacted in South Korea or Taiwan. This said, Chinese government agencies were usually honest and honored contracts - even if they were unwritten.

Generally speaking, this meant that the sourcing process at that time was slow but simple. You did not deal directly with manufacturers, you dealt with efficient bureaucrats who were concerned about China's reputation as a country. They were enforcers as well as negotiators. Pricing was good, quality was quite reliable and delivery was predictable - even if it took months between order and shipment. You could get a lot done with a small sourcing team.

Fast forward to today and everything has changed, the atmosphere has vastly improved and business has "normalized". Interaction is now directly with manufacturers or their agents. China evolved into an unpredictable yet exciting arena. With the emergence of a multitude of private companies since the early 1980's, China is no longer a collection of state-controlled manufacturing facilities. It became a bastion of private enterprise because these entities proved to be much more effective in competing in global markets than state-owned firms.

The Chinese government recognized, accepted and eventually embraced this private enterprise trend. A concept that was once taboo turned out to be a success story. Not only did private enterprise enable China's emergence as a global source for a vast range of products, but it also gave the state economic clout as well as political influence in world affairs, and it proved to be a reliable job provider (always a government priority). Good news all around.

So, who were the suppliers? The "leaders of the pack", the early investors, were overseas Chinese mostly from Hong-Kong and South East Asia. They were the ones who first put money into China-based factories and managed the operations. Investing in China in those days of uncertainty was risky and adventurous. It took courage, deep understanding of how to get things done, and a deep belief in success. Most of the early adapters were banking on their cultural heritage as well as on their capitalistic savvy, staking their claim on this emerging supply base through either wholly-owned or joint-venture investments.

Soon, they were joined by indigenous manufacturers who observed and caught on to the emerging opportunity, and when they did this, they did it with gusto. These entrepreneurs were often involved in factories, either as engineers or managers, and they were enlisted because of their willingness to step up, to take over the ponderous,

inefficient enterprise they were working in. This was a process called “chengbao” （i.e. Contract) which gave them control of these government assets in exchange for a fee and/or a portion of the profits, and often lead to an equity stake for the leaders. As a group, these entrepreneurs were daring by definition, very creative, very resourceful, hard working, and not afraid to “eat bitterness” (Chiku). They, of course, were profit-driven and motivated to find and keep customers and markets and to build mutually beneficial business relationships with western importers. They inserted themselves into the fabric of the emerging “China Inc.”.

This was an enormous transformation for China and, with its drive for profit, intense competition followed. China became extremely competitive, a place to source a broad range of products. In the process, corners were sometimes cut, reliability suffered and more supervision was needed.

B. Who are the Entrepreneurs?

Keeping in mind the context of anti-capitalist communist ideology from which China's economy emerged; it is useful to examine specific examples of Chinese entrepreneurs and try and understand them. Here are three case studies of people who started from nothing and achieved success against tremendous odds. Observe how they managed to become modern-day business tycoons despite the challenges they were faced with.

	What it took	Where company is today
 Liu Chuanzhi, Lenovo	▪ Trained as engineer at military college; denounced during Cultural Revolution ▪ Started Lenovo with 11 employees and 25K USD total capital in a small rented office	▪ Global leader in the manufacturing of PC's, tablet computers, mobile phones, work stations ▪ $29.6 B USD revenue in 2011 ▪ Acquired IBM's PC business in 2005
 Zong Qinghou, Wahaha	▪ Started company in 1987 with two retired teachers and ~20K USD by helping other companies sell carbonated drinks	▪ China's largest beverage maker with 2011 revenues at $10.5 B USD ▪ Mr. Zong is now China's wealthiest person
 Zhang Ruimin, Hai'er	▪ Family severely purged in early days of PRC and left impoverished ▪ Turned company around beginning in 1984 through diligent studying of western mgmt. techniques, and attention to quality	▪ One of the world's leading manufacturers of consumer electronics and home appliances; world's leading manufacturer of white-goods with 8% of global share ▪ $25 B USD revenue in 2011

Source: Booz & Co.

Liu Chuanzhi began his path towards successful entrepreneurship as an engineer at a military college, a school that was denounced and reviled during Mao Zedong's Cultural Revolution of the 1960's and 70's. He was a frustrated computer scientist who did not make enough money to take care of his family. In 1984 Liu Chuanzhi started a company with a loan of RMB 200,000 (c.$86,000) and 11 employees in a small rented office. Today, that corporation is known as Lenovo: a global leader in the research and production of PC's, tablets, mobile phones and work-station technology. In 2005 they acquired IBM's PC business and by 2011 they reported revenues of $29.6 billion US dollars.


Liu Chuanzhi


Zong Qinghou

Zong Qinghou did not have much in the way of formal education but he overcame this problem through persistence, hard work, and an autocratic style - he did what he had to do to succeed. He allied himself first with the local government and then with a foreign multi-national to build and own a phenomenal business known, perhaps appropriately, as Wahaha. In both cases, he managed to use the system to disentangle himself from the controlling partners and maintain his independence. He started his milk-product company in 1987 with two retired teachers and a government loan of RMB 140,000 (c. $37,600). He then linked up with Danone (a French company) and leveraged that relationship to gain independence from the local government. He entered into a $70 million Joint Venture with Groupe Danone in 1996 by giving them control. This grew into a complicated series of 39 Joint Venture companies by 2007. In that year he dissolved his partnership with Danone and became independent. Wahaha was one of China's best-known success stories. By 2010, Forbes listed Zong Qinghou as China's wealthiest person.


Zhang Ruimin

Zhang Ruimin came from a poor working class family in Qingdao. He, too, was marked by the Cultural Revolution: he was unable to attend university and instead became a Red Guard like so many youths of the time. He self-studied Western management techniques and developed a profound belief in the concepts of accountability, responsibility and quality. He climbed through the ranks of a state-owned company making household appliances and in 1982 was asked to take over the position of General Manager of the Qingdao Refrigerator Plant which was nearly bankrupt. He became famous for the sledge hammering of poor quality goods. Today his company, Haier ("…and higher.") is one of China's best known brands and has a worldwide reputation as a high quality manufacturer of consumer electronics and home appliances. It is the world's leading manufacturer of white-goods with an 8% global market share. They reported $25 billion dollars in revenue in 2011.

We note that what these three entrepreneurs had in common were tough beginnings, hard work, fearless persistence and great long-term vision. All of them were trailblazers. They were focused on success, although not necessarily exports (at first) and all of them interacted with the west. They became very real role models for Chinese entrepreneurs, harbingers of the China Dream.

C. SWOT Analysis of Chinese Suppliers

The 3 success stories outlined above are examples of what can happen when Chinese entrepreneurs overcome the odds and do well. But the large majority of enterprises focused on exports are small companies that cannot be compared to those three.

To understand them in general terms, it is useful to do a hypothetical and general SWOT analysis to evaluate strengths, weaknesses, opportunities and threats that most of these companies must confront in developing their business. Using this method, we note that most Chinese suppliers as a group have traits in common as per the graphic below.

Without going into detail, importers will note that street smarts is a big asset, and this often means that they have unconventional ways to reduce labor costs and avoid taxes, among other things. This enables them to manage and compete with

razor thin margins, but it also makes them vulnerable.

At the same time, their rapid growth means that many of them have had no time to develop good brands or even marketing skills: they make what importers want them to make. Most of the owners of these businesses do not speak the language of their clients (i.e. English) and thus find it difficult to closely interact with them and to understand the key drivers of the market.

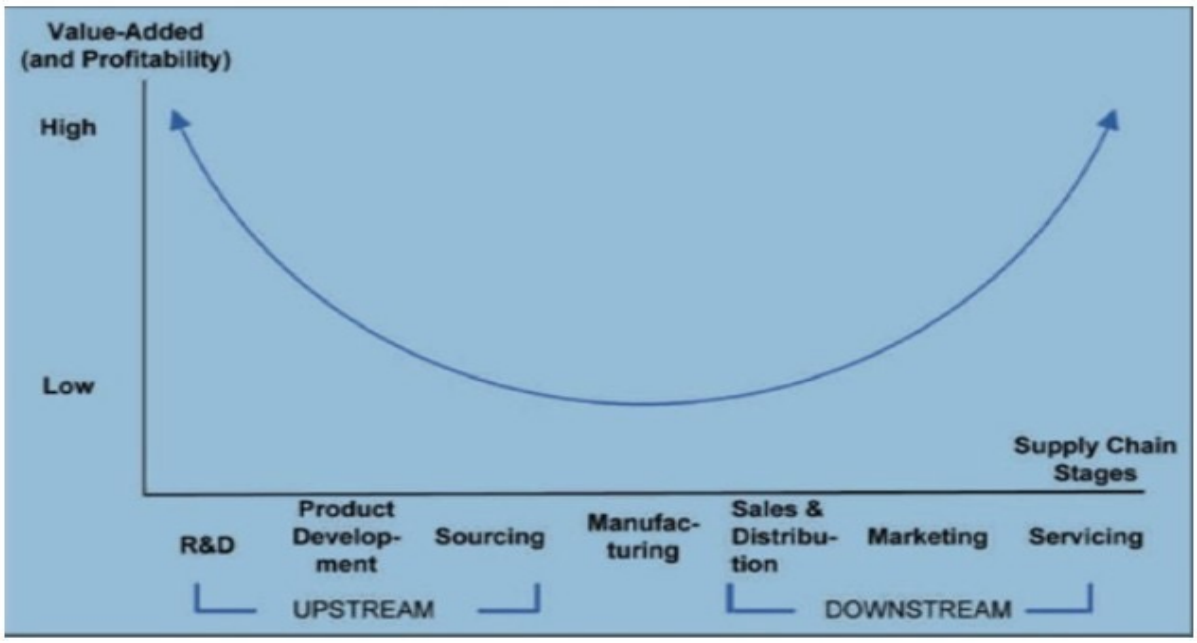
These export companies do have access to the internet and use it both to find new customers and to understand the price structure of the products they are selling. Through this process they learn about retail pricing and become aware of the margins that importers make. Many of them want to move up the supply chain, but intense competition with their peers often distracts them. They suffer when subjected to the vagaries of international economies and the fluctuation of currencies, which obviously they cannot control. They yearn for more stability and more profits and constantly think about ways to achieve that.

D. Chinese Manufacturing and Supply Chains

In order to understand the conditions in which Chinese suppliers have emerged, it's also important to examine China's supply chain and its evolution in stages of profitability. Besides manufacturing, there are six other elements in this process, 3 are **upstream** (actions taken before manufacturing) and 3 are **downstream** (post manufacturing).

The upstream process starts with R&D (Research and development where new products are imagined), product development (where they're refined as concepts) and the sourcing (i.e. Identify suppliers and raw materials). The downstream process includes sales and distribution, marketing, and servicing clients.

As illustrated by the "smiling" graph below, generally speaking, the least profitable element of the supply is manufacturing, and, initially, this was the only part of the sourcing process that China was providing. But soon, Chinese manufacturers were looking to improve on that position.



In the late 1970's to the 1990's, when China had just started exporting consumer goods, the infrastructure was not in place and Chinese suppliers could only claim the manufacturing segment. Already then, they were looking to improve their profitability by addressing upstream and downstream elements of the supply chain. During the mid-to-late 1990's, some of these companies secured part of product development, sourcing of materials, and sales/ distribution. By the early 2000's, some suppliers became effective in R&D as well. In the process, some business owners chose to abandon the ultra-competitive export market and focused on the Chinese market exclusively. The most difficult aspect of the export supply chain to conquer has been the downstream: sales, marketing, and servicing of the clients overseas, but at present time, all stages-both upstream and downstream-of the supply chain are addressed by at least some of the Chinese suppliers. As a group, they have become truly competent and highly effective. By 2006, exports had grown to 35% of the Chinese economy, nearly twice the percentage of 10 years before. By 2008, China had 2.8 million factories and industrial enterprises, accounting for more than 47% of its economic output.