Moving up the value chain

By Andrew Sleigh and Hans von Lewinski

China is attempting to maintain a vast manufacturing base, develop a market of 1.3 billion consumers and create the capacity to provide the world with high-value goods and services—all at the same time. Companies that want to succeed in that country will need strategies that enable them to respond accordingly.


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China's role in the global economy is no longer defined by a simple export-driven model. Although the low wages that enable China to be the world's manufacturing supplier still exist, they are rising relentlessly.

More important, the Chinese government, in its pursuit of sustainable growth, wants to reduce the country's dependence on foreign investment and demand. Therefore, the development of technology-led sectors and high-value capabilities has become a key policy focus. The government's recent five-year program, ratified in March 2006, focuses on the creation of a knowledge-led, innovation-oriented economy supported by greater domestic consumption. This new economic model has broad implications that go well beyond the technology sector and will significantly affect companies in every industry.

Its massive scale and keen embrace of change make China's situation unique. Its economy combines the size of the US market with the variety and complexity of the European market. China's goals are no different from those of other countries that aspire to move up the value chain. But it is the first country trying to concurrently maintain a vast manufacturing base, develop a market of 1.3 billion consumers and build on its ability to provide the world with high-value goods and services.

China's new, multidimensional role in the global value chain is causing unprecedented shifts in the world's business landscape. Companies that aspire to be high performers must make sure that their corporate strategies enable them to respond accordingly in the face of China's unique characteristics—not least of which is that, while other economies took centuries to evolve, China is attempting to achieve its economic transformation in a fraction of the time.

China's comprehensive approach to the value chain is also unlike the approach taken by any other country, and its evolution will be carried out very much on its own terms. Accenture research suggests that China's holistic strategy for economic development has three basic dimensions that, in turn, are best understood through a number of distinct characteristics.

1. Markets

The sophistication of the domestic consumer market

Retail sales in China surpassed $827 billion in 2005—a nearly 13 percent increase from 2004 and the country's biggest year-on-year growth since 1997. One estimate predicts that retail sales, underpinned by government policies that focus on further raising private incomes and encouraging domestic spending, will continue to increase and will top $1.2 trillion by 2010.

This burgeoning market is no longer dominated by low-cost, low-quality products. With an increasingly tech-savvy, image-conscious middle class (estimated by the Chinese Academy of Social Sciences to be nearly 250 million people), the opportunities to sell high-end products and services in China are growing. Consider, for example, China's consumer electronics market, which has soared by an average of 15 percent per year since 2000 and reached $55 billion in 2005, or its luxury goods market, which generates sales of more than $2 billion a year. For technology firms, China's 410 million mobile phone users (the largest market in the world) and more than 100 million Internet users are an extremely attractive proposition.

In 2005, the Chinese auto industry saw sales top 5.7 million vehicles; that number is expected to reach at least 8 million by 2010. What's more, the growth in China's domestic auto market accounted for a little over 23 percent of the industry's total global growth. As long as China's economy continues its strong performance, many expect to see the demand for cars continue to grow at 10 percent to 20 percent annually for several years to come. In another nascent industry, insurance, the market has seen total premiums triple during the past five years. Total life insurance premiums reached about $36 billion in 2004.

Still, companies aspiring to high performance understand that China's market offers more than spectacular sales potential. The country's remarkable combination of mass, youth and capital provides an additional opportunity to use it as a test market for new products and technologies. Nokia, for example, recently unveiled three new handsets in China, including one that could retail for as little as $54.

If a company's new product is successful in China's highly competitive market—where sophisticated consumers demand quality and value—it is seen as an indicator of the product's chances for success in other markets around the world. And as more products and services are developed and introduced in China first, successful companies realize that Chinese consumers will have a growing influence on global tastes and trends in the years to come.

Investment in indigenous technology standards and emerging sectors

As the sophistication and influence of the Chinese consumer increases, so does the country's confidence. This can be seen in the development of indigenous standards as part of China's efforts to cultivate its own technology industries and reduce its reliance on foreign technology.

The government has been instrumental in pushing through the research and development that have produced China's own standards in various areas, from audio/video coding to Wi-Fi networks. The most notable of these is the creation of the country's own third-generation digital wireless standard, TD-SCDMA, a collaborative effort between Datang Telecom, a Chinese state-owned enterprise, and the Ministry of Information Industry, with support from multinational telecom and mobile phone companies.

China is also keen to increase its influence in emerging industry sectors at the top of the value chain as a means of laying the foundation for a dominant market position in the future. Just as the US government invested in semiconductors for a number of years before the sector began to produce returns, Beijing is doing the same in such fields as biotechnology, nanotechnology and renewable energy. In nanotechnology, for example, the government's quiet but steady patent-seeding has produced dramatic results: China holds 12 percent of the world's nanotechnology patents.

Expansion into markets abroad

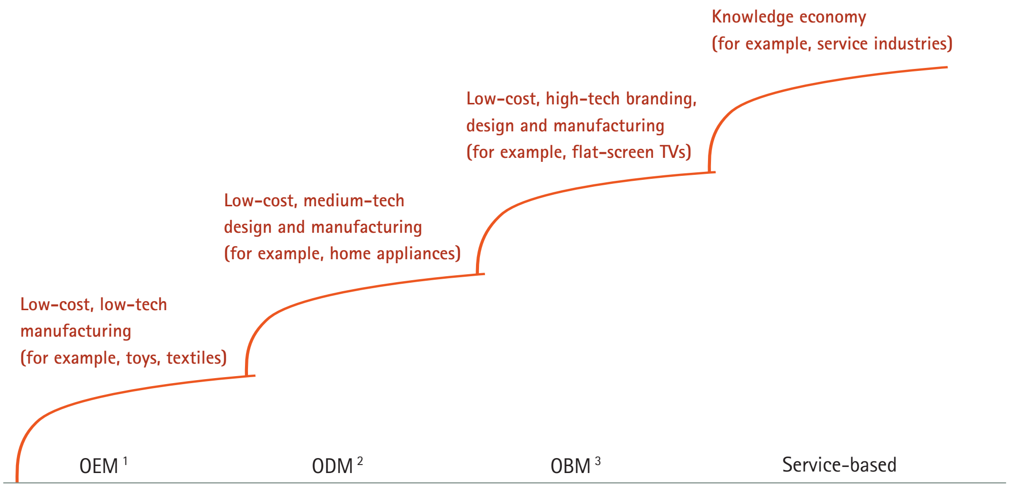
The country's new confidence is being felt beyond its borders, as Chinese companies venture abroad, looking to access new markets and acquire the soft capabilities domestic businesses often lack, especially in areas like marketing and branding, advanced technological innovation and management. Lenovo's purchase of IBM's personal computer business is just one example of a growing number of Chinese companies that are expanding their global presence to build brand recognition and to counter increasing competition at home.

This "go global" strategy is increasing China's influence in overseas economies. Given the lessons they have learned from operating in their own emerging economy, many Chinese companies are placing a particular focus on developing countries in Africa and Latin America. There they are able to outmaneuver their larger Western competitors by leveraging their price advantage, their deeper understanding of emerging markets and the fact that they are often more welcome to operate in such places.

In October 2005, for example, ZTE Corporation, a large Chinese telecommunications equipment exporter,

Closing the gap

The United States lead over China as their economies have evolved through the value chain has narrowed dramatically in recent years.



	OEM [1]	ODM [2]	OBM [3]	Service-based
China's progress:	1980s	1990s	2000s	2005+
US comparison:	1900s	1950s	1980s	1990s

Source: Oded Shankar, *The Chinese Century* (Wharton School Publishing, 2004); Accenture analysis
1 Original equipment manufacturer
2 Original design manufacturer
3 Original branded manufacturer

outbid four other global providers to win a contract to supply Angola with a WiMAX network—a wireless digital communications system that enables wide-ranging broadband access. This was the first-ever commercial WiMAX network contract for ZTE, which already serves telecom providers in Brazil, the Philippines, Pakistan, Russia, Norway and Malaysia, and aims to have its overseas markets account for up to half of its total revenues by 2008.

Chinese companies have been particularly active in developing countries, especially when it comes to energy and resource investment. For example, Chinese companies recently won licenses to explore four oil blocks in Nigeria, promising, in exchange for the drilling rights, to invest $2 billion in the country's northern Kaduna refinery. A third of China's imported oil now comes from Africa, where, besides drilling projects, Chinese businesses are heavily involved in infrastructure development and construction.

Chinese companies have been active in Western countries, too, forming strategic partnerships with overseas businesses in an attempt to gain a stronger foothold in and a greater understanding of these markets. Earlier this year, another prominent Chinese telecommunications manufacturer, Huawei Technologies Company, signed a five-year deal with Vodafone to provide third-generation handsets, marking its entry into the European market in this field. The company has also been forming joint ventures and partnerships with network operators and telecom vendors, including 3Com Corporation, Siemens and NEC Corporation, increasing its options for cooperation and collaboration.

As Chinese companies expand abroad, they need to adapt their management styles, cultures and priorities, and conform to international standards, systems and processes. In these areas, many top Chinese firms are displaying an impressive flexibility and readiness to learn and are skillfully exploiting their significant advantages in low-cost labor.

2. Innovation

Government support for domestic R&D investment

In addition to acquiring capabilities and know-how from overseas markets, encouraging innovation in China continues to be a key government focus. Developing research and development capabilities is an important part of this agenda. Beijing aims to increase R&D spending as a percentage of GDP from 1.3 percent in 2005 to 2 percent by 2010. In 2005, the European Commission predicted that within five years, China will be investing a higher proportion of its GDP in R&D than the European Union in purchasing power parity terms.

Many domestic Chinese companies still lag behind their Western counterparts in this area; one study suggests that only a fifth of China's top 500 companies actually invest more than 2 percent of their sales in the research and development of new technology and products. China's best companies, however, are catching up. Huawei, which has R&D centers in India, Sweden, the United States and Russia, already spends at least 10 percent of its sales on this critical activity.

Multinational company R&D partnerships with China

Multinational companies have been quick to grasp the opportunities that China's economic evolution provides. The number of R&D centers in China funded by foreign companies rose from one in the early 1990s to more than 750 by 2005.

Most of these centers began life as cheaply staffed, simplified offshoots of the R&D activities at headquarters and focused primarily on adapting products for local markets. However, encouraged by government incentives and Beijing's policies to stimulate domestic demand, and attracted by the increasing sophistication of China's consumer market, a growing number of multinationals are setting up globally oriented R&D centers in the country. For example, Cisco Systems and Intel Corporation have been establishing venture capital funds that are investing between $200 and $500 million in Chinese companies that are developing innovative technology, and Royal Philips Electronics recently set up a global research facility in Shanghai to focus on developing manufacturing system solutions to produce low-cost mobile phones.

Nokia recently announced that it is setting up a Nokia China Campus in the Beijing Economic-Technological Development Area. This campus will bring Nokia's China headquarters, R&D centers and mobile phone manufacturing facility together in

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Multinationals in China: Navigating the new reality

Clearly, China's changing role in the global value chain has profound implications for any company with genuinely global aspirations, as it does for those intent on achieving high performance (see story). What follows are several strategic responses to this new reality.

1. Assess your global operations strategy

As China's domestic market develops, companies should evaluate their operations strategies with the aim of optimizing the balance between their supply-side and demand-side opportunities. For example, China's low-cost manufacturing advantages might be offset by the time-to-market implications of extended supply chains in overseas markets. Companies that aspire to high performance may consider what the ramifications are of relocating some of their production to even lower-cost countries in the region, such as Vietnam and the Philippines, or moving it away from the coastal regions and tier-one cities to lower-cost regions in the west and north of China.

Indeed, the fact that top Chinese companies are now expanding their manufacturing presence overseas suggests that the right global operations strategy is driven by a number of considerations—not cost alone. For example, Haier, a Chinese whitegoods manufacturer, which already has a factory in the United States, is looking to set up a second and also has its sights set on the Middle East and South Asia. By 2010, it expects to have at least 20 factories in foreign locations, up from its current 13.

Beyond reassessing their operations, companies will recognize the emerging symbiotic relationship between production and consumption in China. As Chinese consumers become more sophisticated, so does the production that occurs locally to satisfy this demand. Astute companies have been quick to adapt and to capture these opportunities, often moving more decision-making functions to China and encouraging greater flexibility in their operations.

By taking advantage of China's developing capabilities, many leading companies are already introducing the Chinese influenced, designed and invented products overseas to other markets. Motorola's Chinese R&D center, for example, developed the technology that allows a caller to use a finger rather than a stylus to write on a mobile phone screen; several Motorola phone models that use this technology are now available in the United States and Europe.

2. Maintain a balanced strategy toward the competition

Understanding the nuances and complexities of operating in China is vital. Multinational companies must acknowledge some of the distinct advantages enjoyed by local Chinese companies. In this market of intense competition, low customer loyalty and short product lifecycles, coupled with huge variations in geography, language, culture and income, local knowledge matters most.

Some local companies have become successful by taking advantage of their knowledge of the Chinese consumer. Focus Media, for example, which is headquartered in Shanghai, realized that putting advertising on LCD displays in elevator lobbies in China would be acceptable—and profitable—because the Chinese don't mind intrusions or noise, unlike their US and European counterparts. Such cultural subtleties are often missed by Westerners operating in China.

On a broader scale, multinational firms need to take stock of their companies' strategies when it comes to Chinese companies. Competition from these players is going to intensify further in multiple markets (not just in China), and a proactive approach to engagement will serve companies better than a wait-and-see approach. Multinationals should consider three options in this realm.

- Look for opportunities to engage and cooperate with local Chinese players—complementary research, for example, or marketing, funding and commercialization opportunities.
- Collaborate with Chinese partners in other emerging markets. Chinese firms are often more experienced in these environments and, in some cases, more accepted.
- Consider the extent to which market activities in China can be used defensively to limit Chinese competitors' involvement in home markets. Some domestic e-commerce companies, online gaming and portals are being acquired by foreign companies before they have the critical mass to compete internationally.

3. Embed the business in the local fabric

Working alongside local governments, industry associations and relevant universities enables firms to be more closely involved in strategic government priorities like developing technology standards. In China's rapidly evolving business environment, such investments help foreign firms to become shapers rather than responders.

Multinational companies, for example, realizing the importance of the TD-SCDMA indigenous digital wireless standard to their success in China, have quickly aligned their strategies accordingly. Both Siemens and Nokia have invested well over $100 million to help develop the standard, while other companies, including Alcatel, Ericsson and Motorola, remain fully involved in China's mobile phone market.

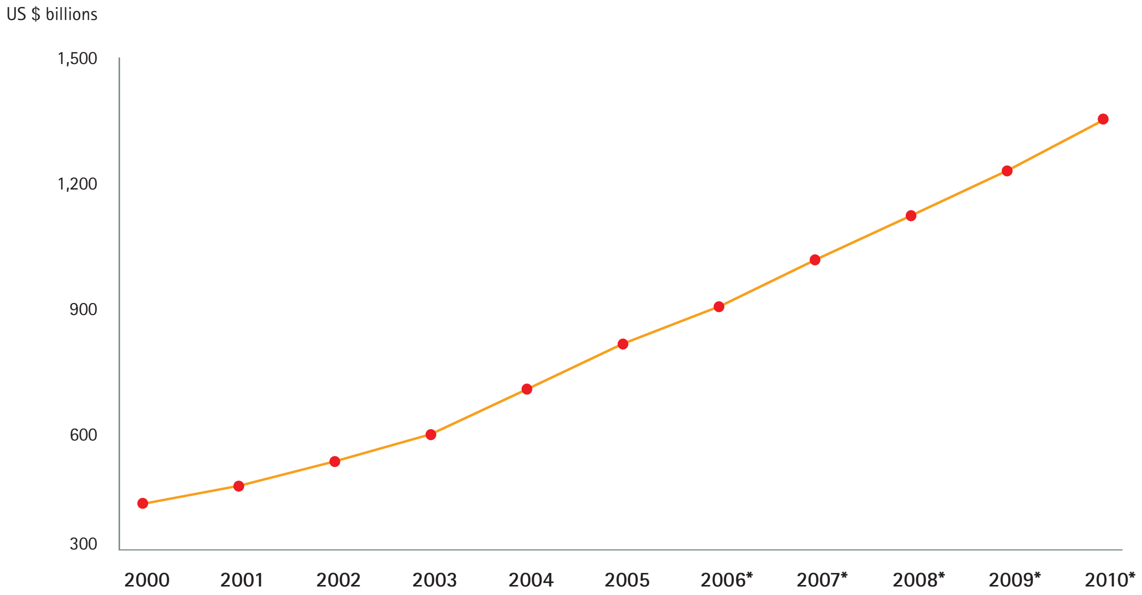
China's determination to overcome current technology barriers and gain the first-mover advantage in emerging technologies means that multinationals should keep a tab on government initiatives by building appropriate relationships and, where necessary, collaborating on standards development. Given the size, growth and influence of the Chinese market, technology vendors can ill afford to underestimate the impact of China's standards revolution.

Microsoft, for example, recently signed a series of agreements with China's Ministry of Information Industry, committing millions of dollars to help develop China's information industry and to alleviate the digital divide between urban and rural areas. Microsoft will work with the MII to build five pilot information centers, which will help farmers gain access to agricultural and market information. The company will train more than 70,000 software engineers; provide training and consulting for a number of Chinese software companies; and, in collaboration with the MII, set up several R&D centers in rural areas to develop new software technology and applications.

Understanding and monitoring China's aspirations to export indigenous technology standards overseas will also pay dividends. This is particularly true in those emerging markets where China is nurturing its economic and political influence.

Consumer boom

Retail sales in China are forecast to increase by about two-thirds within the next four years.



Source: EIU
* Estimate

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one place. Nokia, which expects to have about 2,000 employees working at the location, hopes the move will improve communication across the board and provide unique opportunities to exchange information and ideas.

A key aspect of this dynamic R&D environment is greater collaboration and knowledge transfer between local and foreign firms, whether it's about basic research, product design or understanding the complexity of the Chinese market. This is especially true in the high-technology clusters, such as the one being developed in Xi'an in Shaanxi province in the northern central part of the country. This high-tech industrial zone, which is expected to eventually almost triple in size to cover 90 square kilometers, already houses more than 7,000 companies.

Savvy players are also taking advantage of the government's drive to encourage more academic–business collaborations. For example, Tsinghua University in Beijing, the so-called MIT of China, has signed research deals with General Electric Company, Alcatel, Lucent Technologies and Procter & Gamble.

GE has also reached an agreement to spend up to $50 million in China over the next five years on new technology development. Its joint effort with China's National Development and Reform Commission is expected to focus on experimental technology in energy–related fields and water technology. As part of the agreement, GE will also provide training for up to 2,500 Chinese managers and government officials during that time.

3. People

Emphasis on science and technology

Critical to China's development at the top end of the value chain are government policies that focus on providing the talent to fuel that development. China already has the second largest share of science and engineering researchers in the world, and between 2005 and 2010, the country will graduate some 3 million engineers, nearly nine times the number that will graduate in the United States.

Beijing's various efforts to increase enrollment in higher education include encouraging Chinese students abroad to return to work in China. These returnees (known locally as "sea turtles") are being targeted with attractive incentives, including generous research grants and opportunities to run their own R&D projects. Many come home carrying the knowledge of Western markets and management practices that is so highly valued by local firms.

Closing the talent and education gap

While the supply of human capital in the scientific sector appears plentiful, there is also a well-publicized shortage of people with the relevant softer management, creative and leadership skills. Most new graduates, for example, have little practical experience working on projects and teams. So although the raw talent is clearly there, going forward the educational system needs to evolve in line with China's ambitions.

How quickly the government can solve this particular problem is open to debate. The fact that China spends about half of what the average OECD member country does on education and health suggests that there is a lot of catching up to do. A commitment in the recent five-year plan to double spending on education from about 2.8 percent of GDP to 4 percent is a step in the right direction.

4. Focus on talent

The intensifying competition from both multinational and domestic firms for the limited number of Chinese graduates with the appropriate soft skills means that a war for talent is raging in the country today. In 1999, the entire graduating class of the Shanghai-based China Europe International Business School MBA program went to work for multinational companies. Today, 25 percent of these graduates are pursuing careers with domestic firms, which many Chinese believe offer greater responsibilities, challenges and career opportunities.

Faced with this competition, multinationals need to view talent management as an integral part of their company's overall Chinese strategy. Local employees must be treated from a global perspective, not only by ensuring that they are given the headroom they need to grow and develop within the company, but also that they receive the same opportunities as their colleagues in other geographies to travel overseas and rotate through different parts of the organization. As tempting as it may be to deploy local employees solely in the China market to use their local knowledge, a longer-term view of talent management will pay much bigger dividends.

Companies seeking to profit from the new opportunities being created by China's evolving role in the global value chain will need to respond to these developments proactively and efficiently. Clearly, the days of passively viewing China simply as a base for low-cost manufacturing are long gone.

By continuously assessing and altering their global operations, businesses aspiring to high performance will maximize the value received from their China-based functions. They will tap into new sources of innovation that are emerging in the Chinese market, which can then be applied on a global basis. However, success will depend on understanding the complexities of operating in China.

By taking the right approach toward local competition, by recognizing the importance of local knowledge and by establishing relationships with relevant local organizations, companies can begin to navigate their way through this new reality. Those that nurture and retain a pool of talent to help them on this journey will be the winners.

About the authors

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