



Chazen International Study Tour Report

When in China: How American-Owned Companies Are Doing Business in the Middle Kingdom

Jordan Bliss MBA '06

Christopher Louie MBA '06

Marcelo Ortiz MBA '06

Ricardo Mendez-Acevedo MBA '06

Sponsored by The Heinz Dürr International Communications Fund

A Note from the Authors

The authors are MBA students at Columbia Business School. From March 5 to 12, 2005, they participated in a study tour to China that was organized in concert with the School's Jerome A. Chazen Institute of International Business. The information about the companies discussed in this paper is primarily drawn from the authors' interactions during this trip with the following company representatives:

Shuching Regina Chang, CFO of PepsiCo International: Greater China Snacks Business Unit

Jack Perkowski, Chairman and CEO of Asimco Technologies

James Rhee, Senior Director, Client Products, in China, Hong Kong and Korea for Dell

Hugo Shong, Senior Vice President of IDG Inc., President of IDG—Asia and Vice Chairman of IDG Technology Venture Investment

Joe Zhu, Associate Trade Marketing Director of PepsiCo International: Greater China Snacks Business Unit

Chazen International Study Tours

Designed to enhance the classroom curriculum, Chazen International Study Tours offer students and their faculty adviser an intense, firsthand experience of the business culture of their chosen country or region. Study tours are initiated by students and organized with the help of the Jerome A. Chazen Institute of International Business. During study tours students meet with leading executives and government officials while visiting businesses, factories and cultural sites. Recent destinations include China, France, India, Japan, Russia and Scandinavia.

Browse any business periodical at your local newsstand, and you are bound to find at least one article about an American firm's efforts in China. The promise of China—with its 1.3 billion people, annual GDP growth of approximately 9 percent for two decades¹ and burgeoning middle class—is not lost on anyone. For senior executives of American companies, the question no longer is *whether* they should be operating in China; rather, today American executives need to know *how* they can operate in China. In a market characterized by a primitive regulatory infrastructure and a rapidly changing competitive environment—in which the rules of the game are being written and rewritten seemingly overnight—American companies are searching for a game plan that they can trust and to which they can stick.

On a trip to Beijing and Shanghai in March 2005, we met with representatives of four American-owned businesses that have made inroads in China. We asked them about their strategies, their current operations and their future plans in the Middle Kingdom. While such a small sample set clearly cannot give us an exhaustive view of American business efforts in China, we were able to select a diverse set of companies: Dell, International Data Group (IDG), PepsiCo's Frito-Lay division and Asimco. Though these companies vary greatly in terms of industry, size and footing in China, their philosophies on operating in China are strikingly similar in many ways. By analyzing the quartet's Chinese operations, we have identified common themes that give us a sense of the approach American companies have taken when entering the Chinese market and the tactics they employ to handle the complications of operating in a developing, perpetually changing market.

Before exploring what it takes for an American company to find success in China, it is important to identify why the company is in China in the first place. Generally, we can group companies into two broad categories: those producing products and services in China for export and those that are targeting the Chinese market itself—those in China for China. Of course, there is some overlap, as in Dell's case. As the constructs of offshoring and low-cost production in China are both well-established and well-covered territory, we will limit the scope of this paper to the efforts of American companies trying to target the Chinese market.

On the surface, one would be hard-pressed to find commonalities among the world's largest computer manufacturer, a prominent technology magazine publisher, a leading purveyor of potato chips and snacks and an upstart automotive parts manufacturer. However, in assessing their approaches to the Chinese market, the following themes were consistent across all four companies:

¹ Barry Bosworth, "Valuing the Renminbi," presentation, Tokyo Club Research Meeting, Washington, D.C., February 9–10, 2004, http://www.brookings.edu/dybdocroot/views/papers/bosworth/20040209_bosworth.pdf.

Maintain patience and perseverance. These characteristics would seem to be wise for any business development effort, but they are especially appropriate for initiatives in China. Of the four companies whose executives we spoke with, three (PepsiCo/Frito-Lay, IDG and Asimco) have had a physical presence in China for more than a decade, and all four conducted extensive due diligence before entering the market. Additionally, although each of the companies now has a foothold in China, the ride has not always been a smooth one. In the wake of the Asian financial crisis, Asimco nearly folded. PepsiCo/Frito-Lay's China division recently underwent a major restructuring, which coincided with a dramatic shift in strategy. Even Dell China has had difficulty in its attempts to take the lead in the consumer PC market. Despite these struggles, each of these companies has remained committed to China, and that has been a key factor in achieving success.

Establish relationships, especially with the government. Part of what makes launching a business in China a lengthy process is the need to establish strong relationships in order to effectively do business. This emphasis on relationships is attributable to both cultural and structural aspects of the Chinese business environment. Under the Chinese concept of *guanxi*, which means "connections," business is conducted not only as a series of transactions but also as the product of long-standing and well-established relationships. Furthermore, given that the Chinese government, both on a national and a regional basis, still maintains control of crucial elements of the business world, relationships with government entities and agents are not only recommended, they're a must. IDG, for example, clearly acknowledges the need to build relationships, having hosted 625 banquets for government officials—and counting. And Asimco founder and CEO Jack Perkowski jokes about the barrels of mao tai, a clear white liquor common at formal meals in China, that he has consumed at the countless business dinners and banquets he has hosted.

Hire managers with strong local knowledge and Western experience. When asked about the greatest challenge facing his company going forward, Asimco's Perkowski did not hesitate to highlight the difficulty of finding competent managers who knew the Chinese market. It is crucial to have senior people on your management team who know how to operate in China and have the connections and knowledge of the market to make your business a success. However, many Chinese managers suffer from a legacy of state ownership that has trained some people to be adept at managing in a bureaucratic fashion. On the other hand, since China enacted reform policies in 1978 it has experienced rapid change, leading to some aggressive managers with unbridled entrepreneurialism. These extremes are in contrast to the blend of these management styles that is found in developed economies.

Asimco is addressing the lack of competent Chinese managers by spending resources developing managers to fill this gap. The firm has been able to recruit top talent in China, as the auto industry is seen as high growth. The firm has targeted experienced managers at General Motors and Delphi who are looking to join a smaller firm to create something new. Similarly, Dell, IDG and PepsiCo/Frito-Lay all have managers in key decision-making positions with local ties and Western experience, both academic and professional.

Stay true to your business model, but adapt to the local market. Hugo Shong, president of IDG—Asia, maintains that American companies often make a fatal error when trying to enter China. Some companies assume that the Chinese market is exactly the same as the American market and develop a rigid approach. Others think that China is completely different and abandon their existing principles and procedures. The majority of the time, Shong feels that both approaches are doomed to failure.

The companies whose executives we spoke with seem to adhere to a philosophy of keeping to their core business while still adapting to local market requirements. For example, PepsiCo/Frito-Lay leverages its competencies in production and distribution, and its product in China is the same as in other markets—essentially, snack chips. However, it has modified its product to fit local tastes, creating fish and pork-flavored Lays potato chip lines and exploring the launch of a line of traditional Chinese snacks. Similarly, IDG has launched the same magazines in China as it has in other markets, but local content is starting to make up a high percentage of their pages. Dell is at somewhat of a crossroads: it has successfully transplanted its model of profitably serving corporate customers to China, but it may need to abandon its vaunted direct model if it hopes to gain leadership of the consumer market.

In the remainder of this paper, we profile the efforts of the four companies with whose executives we met during our trip. Through their stories, we can see the strategies that each has employed in approaching the Chinese market, in terms of both the themes we cited above and the unique decisions they made that led to small victories or setbacks along the way.

Dell²

Dell is a premier provider of products and services required by customers worldwide to build their information-technology and Internet infrastructures. Company revenue for the past year totaled \$43.5 billion. Dell, through its direct business model, designs, manufactures and customizes products and services to customer requirements and offers an extensive selection of software and peripherals. It segments its business by customer

² Dell Inc. China, *Dell Annual Report 10-K*; Tim Clissold, *Mr. China: A Memoir* (New York: Harper Business, 2004).

type: Home & Home Office; Small Business; Medium and Large Business; and Government, Education and Healthcare.

Dell's famed direct model for supply chain management seems uncomplicated, so why is it not replicated more easily? The answer is that Dell's incomparable ability to execute is the direct result of its unique culture and processes—its DNA, if you will. The Dell culture is based upon the following principles: no excuses, set tough goals, leave your ego at the door, save on costs, short inventories.

A key element of Dell's supply chain is that it does not manufacture any product unless there is an order for it. Therefore, there is essentially no inventory; the firm has efficient cash conversion; orders to suppliers are placed only for six hours of production; there is no bricks and mortar retailing; and there is an efficient flow of information. The following illustrates the impact of this model. On average, a computer producer pays suppliers 20 to 60 days before it receives payment from customers. In contrast, Dell collects cash from customers 37 days before it has to pay its suppliers. Dell is able to price below the competition in a value play because its operational advantages allow it to have lower costs. This generates profitable growth and increases market share. Here is a staggering statistic: globally, Dell has 18 percent of industry revenue share but 30 percent of industry profit share.

DELL in China

Without a doubt, China is becoming a precious gem for Dell. Dell's strongest geographic segment during fiscal 2004, in terms of the rate of revenue growth, was Asia Pacific-Japan at 26 percent. This was led by strong growth and expansion in China. During fiscal 2004, Dell's net unit growth was 38 percent in a market that increased by only 8 percent (excluding Dell), which produced a combined net revenue growth of 26 percent for Dell's efforts in Japan and China.

Dell started operations in China in August of 1998, with its headquarters in Xiamen and sales offices in Shanghai; after opening a design center in 2004 and a technical and customer support center in Shanghai, the workforce numbers 3,000 people. Dell currently ranks as the No. 3 computer producer in the Asian market. By product category, the company is No. 3 in number of PC units, No. 3 in desktops, No. 6 in notebooks and No. 3 in servers.

In China, Dell's sales have grown much faster than in any other country and are extremely concentrated in big cities. Dell's current market penetration is 3 percent, and it is expected to grow to 20 percent within the next 20 years. However, the fastest-growing segment for Dell is the low-priced, low-margin product segment. Some competitors, such as Tong Fang, are well positioned in this segment despite sustaining losses. In contrast,

some companies experiencing losses have chosen to exit the market, the most recent and publicized example being IBM, which sold its PC division to Lenovo, a Chinese company.

Though Dell's business model in Asia is generally the same as the one it employs in the United States and in the rest of the world, it has had to make some changes to adapt to the Chinese market. There is very low credit card penetration in China, which initially presented a hurdle for Dell's model. In order to continue to sell directly, Dell China guarantees four-day delivery and collects cash payments in person. Additionally, Dell believes that the key executives must be local people instead of people from outside of China, recognizing the necessity of building a relationship with the local government and following local regulations. Therefore, we can say that Dell China is, in essence, a Chinese company that has established strong bonds with the government.

The immediate goals of Dell China are to become No. 1 in market share, revenue and profit share. Moreover, Dell is interested in pushing other business lines, such as printers and projection screen televisions that will contribute to growth in the region.

Although China has been a success for Dell in terms of growth and sales, the company still faces tremendous challenges. First, there is intense competition for human capital. China's economic growth has translated into thousands of new companies opening operations every year. However, the country has failed to generate specialized human resources at the same pace, which has generated fierce competition for talented human capital in the country.

The education level of customers is another issue to consider. While some technologies have caught on in other regions, the Chinese market has not accepted all the available technologies in the personal computer market. The Chinese are reluctant to adopt new products. For example, Dell has had difficulty marketing Intel's Celeron processors, a less-expensive processor than Intel's Pentium processors. Chinese consumers perceive the Celeron technology as inferior because of its lower cost.

Dell's direct model is not as popular in China as in other countries. Although corporate customers do not constitute a problem, the final consumer does. There is a strong retail channel system in China, and customers are skeptical about purchasing from developing channels. Low credit card penetration in China requires Dell to accept cash payment, hurting Dell's cash conversion cycle.

Finally, as mentioned earlier, no company is making money in the low-price, low-margin segment. The biggest challenge for Dell is to continue to adapt its strategy and find a way to grow in this niche and still be profitable.

International Data Group

While recent years have seen one Fortune 500 company after another make grand declarations about spinning its own China story, International Data Group (IDG) has actually been making history in China for 25 years. On the heels of Deng Xiaoping's "open door" policy, IDG founder and CEO Pat McGovern flew to China in 1980 and established the first joint venture between a U.S. media company and the Chinese government. Within six months, the newly minted IDG China was operational, publishing the weekly technology magazine *Computerworld*.

Today, IDG China is one of the largest publishing enterprises in the Middle Kingdom and has been profitable for more than a decade. Further, excess profits from publishing were used by IDG to establish arguably the premier venture capital fund in China, with a 42 percent internal rate of return since 1992. IDG's success demonstrates how an American company can thrive in China by investing in critical relationships, adapting to the environment while staying true to its core business strategy and acting decisively in shaping a developing market.

Boston-based IDG is no stranger to operating internationally, as its 300 magazines and newspapers reach more than 100 million people in 85 countries. However, the company's investment in China is notable, and not merely in terms of the \$20 million in capital IDG has invested in its Chinese operations. McGovern has publicly stated that he envisions China growing into "our largest single-country market," and the resources that IDG has committed to the country reflect that.

Specifically, throughout its time in China, IDG has focused on developing business relationships. McGovern himself has visited China more than 90 times. In that span of time, his staff has held 625 banquets with government officials. Explaining this dedication to personal relationships earlier this year in an interview with *Business Week*, McGovern remarked, "You have to keep these relationships strong. It will always be important to have [face-to-face] contact." Not establishing relationships, he believes, is "a mistake Western companies make."³

IDG has adapted to the eccentricities and complexities of the Chinese market while still adhering to the strategies that have brought it success in its existing markets. IDG's core publications in other markets are largely technology focused, and IDG used the same fare to take advantage of a nascent technology wave and establish a foothold in China. In 1998, IDG established a joint venture with Hearst Magazines to publish *Cosmopolitan* magazine. While this venture was a deviation from the strategy of owning and distributing

³ Spencer E. Ante and Dexter Roberts, "What IDG Saw in China," *Business Week*, January 24, 2005, http://www.businessweek.com/magazine/content/05_04/b3917120_mz063.htm.

its own content, in addition to leveraging the knowledge base and distribution network IDG has built in China, it kept with the tenet of staying away from core news.

Staying away from core news is crucial to maintaining journalistic independence in a market in which the government has a strong hand in regulating the media and general news is disseminated by the government-controlled Xinhua News Agency. McGovern's visits and the hundreds of banquets have paid off in the form of strong relationships between IDG China and government entities. In order to launch *Computerworld* in 1980, IDG signed agreements with both the Ministry of Computers & Electronics and the Ministry of Information. Hugo Shong, president of IDG—Asia, says that IDG publications work closely with government regulators and largely censor themselves. Since the government restricts the number of licenses given to publications, these relationships will be crucial as IDG China looks to increase the number of publications beyond the 37 magazines it currently has in the market.

IDG faces a number of challenges ahead, after having reaped the benefits of first-mover advantage and of maintaining an informed, persistent and methodical approach to the market. Both multinational and local competitors have sprung up in recent years, attracted by the promise of a \$5.5 billion print advertising market that is growing 37 percent per annum. This competition is pushing IDG China to further develop its distribution network outside the major cities and increase the amount of local content in its publications, which largely had contained articles translated from those in other countries' editions. Additionally, IDG is vulnerable to the war for managerial talent in China. While IDG was able to hire local managers with exposure to American business tactics to lead its businesses—like Shong and Quan Zhou, the head of IDG's venture capital fund in China—as the firm grows in China, IDG will increasingly need to compete for talent. Lastly, as Chinese society continues to change as a result of foreign influence, IDG China will need to manage any public or regulatory reaction.

PepsiCo/Frito-Lay

In 1994, Frito-Lay decided to enter China, aspiring to gain a strong position in this fast-growing market. Soon after, this goal would encounter its first challenges. Initially, the company could not launch its potato chips line because of government regulation of potato imports. Therefore, Frito-Lay would have to start from the ground up by starting farms to supply the raw material. Once the company could secure a steady supply of potatoes, potato chips were introduced to the market in 1997.

The Chinese people adopted Western cars, clothes and other goods with relative ease. Yet Frito-Lay would come to learn that eating habits are much more difficult to change in China. Frito-Lay had the challenge not only of entering a new market but also of creating

demand for so-called Western snacks in a country where seasoned seaweed and dried fruit have been favorites for generations. At first, Frito-Lay struggled as it tried to sell the same Lay's and Cheetos brand products that it sold in its established markets. Chinese consumers rejected these products, believing that they were unhealthy, especially for the core consumers: children and teens.

Frito-Lay eventually tried to adapt to local tastes. It introduced Lay's potato chips with such local flavors as "cool cucumber" and "five-flavored fish." Acceptance of the new products raised the company's prospects in China.

Now Frito-Lay has turned an eye toward the large and attractive segment of the market served by traditional Chinese snacks. It has introduced the Poca brand, under which it markets corn snacks with even more localized flavors, such as seafood and spices. Using a new brand helps the company distance the new product from the Western association that the Lay's brand carries.

This astute marketing strategy has helped the company strengthen its position in China's major urban centers. A key challenge Frito-Lay now faces is penetrating midsize cities, small towns and rural areas, where half of its target market is located. Developing viable distribution systems to supply its products to such locales is one of the biggest challenges facing Frito-Lay.

Asimco Technologies

Asimco Technologies is one of the largest automobile components manufacturers in China. The company was founded in 1994 by experienced Western executives. It now has more than \$400 million in sales, with 70 percent of its sales in China and 30 percent exported out of China.

In contrast to the situation in the United States and Western Europe, the automobile industry represents a significant growth opportunity in China. China entered the World Trade Organization in 2002, which resulted in a significant increase in production, trade and income. Since China entered the WTO, the automobile market has exploded, with growth in vehicle unit sales of 36 percent in 2002 and 36 percent in 2003.⁴ The growth of the industry began in the early 1990s but softened in the mid- to late 1990s as China faced slower economic growth.

Jack Perkowski, the founder and CEO of Asimco, and his partner spent nearly two years doing research in the early 1990s before entering the auto components business. It was clear at that time, as it is now, that Chinese economic growth was going to a major trend for the 21st century. China has half of the world's population, and the population has an average age in the mid-20s. Asimco's founders realized that as the Chinese economy

⁴ *China Auto Industry Yearbook 2004* (China Association of Auto Manufacturers), s.v. "Asimco Technologies."

grew, the demand for transportation would increase, as these geographically distant areas would need to be tied together. In addition to the transportation needs of industry, the growth in GDP per capita would also lead to demand for consumer automobiles. This same pattern of transportation growth took place in many developed nations during their early economic expansion and led to the creation of a massive automobile industry in the United States, Japan and Western Europe that is approximately 10 percent of global GDP.

In the early 1990s, Volkswagen and a number of other car manufacturers began to invest in car manufacturing facilities in China. These manufacturers were having difficulty sourcing components for production. Western component manufacturers were charging exorbitant prices due to shipping costs, while the Chinese manufacturers were unreliable, small manufacturing plants owned by local governments. Perkowski saw that there was an opportunity to bring in the “capital, management and technology” of developed economies to service these automobile manufacturers in China.

Government regulation prevented Asimco from building or purchasing automobile component manufacturing capacity. At that time, and in many cases still today, foreign-owned entities were unable to do business in China on their own. These firms were required to form joint ventures with state-owned enterprises, while Chinese citizens were free to start new businesses. Asimco had to develop joint ventures with state-owned entities to secure the capacity needed to be in the components business. As the former head of investment banking at Paine Webber, Perkowski had strong contacts in the capital markets. He utilized these contacts to raise a \$150 million investment fund from institutional investors. Perkowski and his partner then used the fund like a venture capital fund to create a number of subsidiary companies.

Asimco approached local governments that either owned auto component manufacturing plants or had a desire to be in the component manufacturing business. It then offered to purchase a portion of the manufacturing company from the local government or to form a joint venture to build a plant. After building manufacturing capacity with a number of subsidiaries, Asimco then took the manufactured parts and marketed them to automobile manufacturers.

In practice, Asimco split the value chain. The firm put manufacturing in the hands of the most capable managers, the Chinese, while Asimco handled the front-office operations of marketing and sales. Perkowski does not speak Mandarin and had no manufacturing experience, while the local Chinese governments had the manufacturing experience. These local governments are made up of a web of public and private entities. The local governments collect taxes and run state-owned companies to generate revenues to pay for public services. Asimco implemented this strategy across China and built manufacturing capabilities in power trains, chassis and applied materials. Then, Asimco approached the

major automobile manufacturers operating in China to offer its products. The firm has built strong businesses in key products. In China, it has 65 percent of the market share for air brake compressors for trucks and 40 percent of the market share for fuel pumps, injectors and nozzles for trucks. The firm has continued to build its capabilities in this fashion. Perkowski says that the ability to go into local geographies and negotiate with local governments was “less complicated than people think.”

Asimco has faced some critical challenges in building the business. First, the company demanded a majority ownership of all the joint ventures in which it invested, which the founders felt was critical to ensuring strong management of the supply chain. This was something that the Chinese government had not previously allowed in the automobile component industry. Perkowski’s two years of research and relationship building in the early 1990s paid off, as he was able to get the government to allow Asimco to have a majority stake in these joint ventures.

Asimco also faced the challenge of producing parts to the technical specifications desired by carmakers. The local Chinese governments that were already manufacturing auto parts had the capabilities to get Asimco into the business, but Asimco needed to find a way to advance the technology available to compete with global suppliers. The firm decided that the best way to develop this technology was to make strategic acquisitions of U.S. firms to gain technical know-how and then replicate the technology in China. For example, Asimco acquired two firms in the United States, one of which manufactures camshafts, and is now building the largest camshaft plant in China. Asimco intends to continue to follow this model of buying Western technology and then bringing the technical know-how to produce it to China.

Perkowski says that there are three major challenges that will confront the growth of the auto industry in China. First, cost is going to continue to be the major point of competition. There is a huge amount of manufacturing capacity and inexpensive labor in China that will fuel the ability to produce cheap products well into the future. Utilizing technology to launch new products and differentiate Asimco from other suppliers is important to the future success of the firm. Second, the need for fuel efficiency in China and around the world is going to spur major reengineering of automobiles. Oil prices are continuing to rise, and there is no foreseeable end to these price increases. Lastly, the Chinese government is going to have to begin to look at the environmental consequences of its currently lax regulations.

Conclusion

The frenzy to invest in China has been called the gold rush of the 21st century. Like the 19th-century fortune seekers, some companies have found success, while others have come up empty. The four companies profiled in this paper have all faced difficulties in starting businesses in China, but all have achieved a significant level of success. Now these firms are building on that success. Using the knowledge that they have gained, we can make the following recommendations to companies that are pursuing operations in China:

1. **Maintain patience and perseverance.** Starting operations in China is not for the weak of heart. A long-term focus will serve you well while you overcome a host of minor setbacks. The reward for your patience and perseverance will be establishing a foothold in the world's most populous country.
2. **Establish relationships, especially with the government.** Patience is necessary because finding and cultivating these relationships takes time. You will be expected to host banquets and drink plenty of mao tai. However, relationships with business leaders and government officials are the linchpin to success in China.
3. **Hire managers with strong local knowledge and Western experience.** Talented human capital is the scarcest resource in China. Most Chinese managers have been trained to be either government bureaucrats or entrepreneurial wheeler-dealers. Cultivating professional, competent managers is the chief concern of all of the companies with whom we visited, and for good reason.
4. **Stay true to your business model, but adapt to the local market.** You have to stick with what your firm does best, but do not beat your head against a wall if things are not working. PepsiCo/Frito-Lay developed new products, flavors and brands, but it still essentially sells potato chips through a direct store delivery system in urban areas. Do your research and find out how you need to be flexible, and China will open its doors to you.