

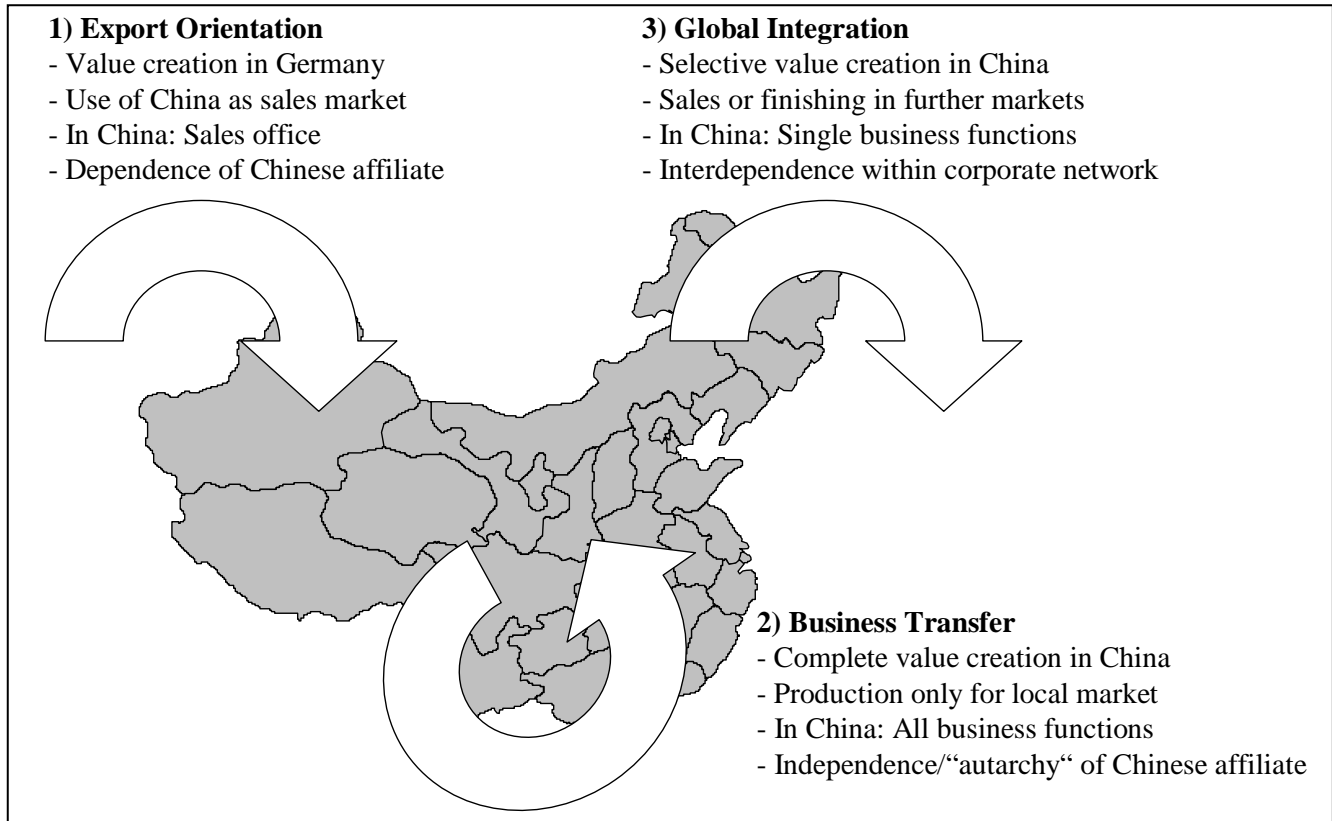
Executive Summary

We conducted a series of 50 interviews with top managers in China to find out what *strategic orientation* German companies apply towards China and which measures of *operational adaptation* they take in order to adjust their businesses to the peculiarities of the Chinese business environment.

With respect to their *strategic orientation* we discovered that the majority of German companies is still following a mix of Business Transfer and Export Orientation and that the strategy of Global Integration will most gain in importance in the future.

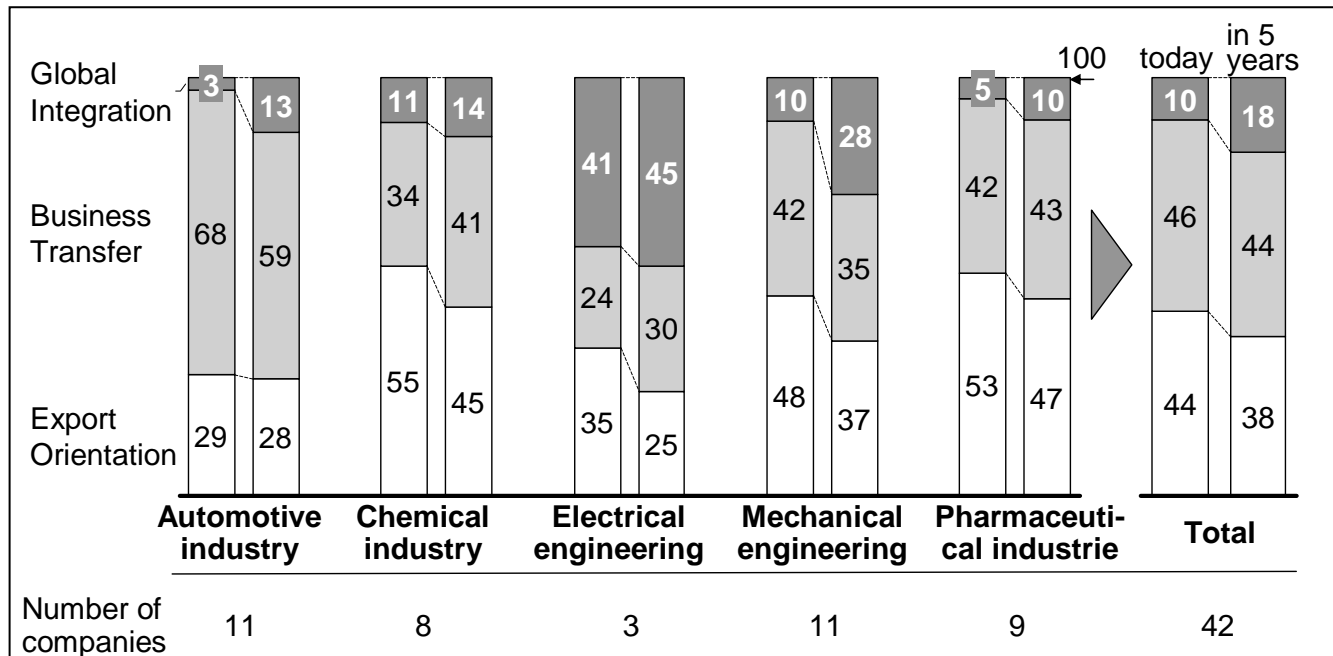
- The strategy of *Export Orientation* is widely used for upstream business functions, such as sourcing and R&D. In this case, established German functions will be applied in China. For example, in the case of a product that was developed in Germany but will now be produced in China, German development competencies are "exported" to China.
- The main initiative of the *Business Transfer* strategy is to replicate business systems in China in order to address the local market and to exploit firm-specific core-competencies against weaker local competitors. In the purest form of Business Transfer, the Chinese daughter company is totally autonomous, addresses only the local market, and contains all business functions from R&D to marketing & sales. We did not encounter this pure form in the course of our research, yet most companies we interviewed have localized some downstream business functions, such as marketing & sales or some parts of production.
- In the future, the strategy of *Global Integration* will gain in importance. In this strategy, selected parts of the value chain are transferred to China and outputs are then sold or further processed elsewhere in the world. One driver behind this development is the gradual decrease of trade and investment barriers in China that makes it lucrative for companies to relocate more process steps of their value chains to China and that favors the increasing integration of Chinese affiliates into the global corporate networks. On the other hand, the overheating competition on the Chinese sales market will trigger this strategic reorientation, at least in some industry sectors.

Up until now, it appeared unthinkable for most Chinese affiliates to supply third markets as well. The build-up of production capacity in China could hardly keep pace with the quickly evolving demand, especially not in the light of the country's extensive need to play catch-up. Yet in recent years, a considerable number of production over-capacities have emerged as the result of this gold rush type build-up within a relatively obscure market environment. In response, investors increasingly shift their focus away from the turnover fantasies of high growth markets with little competition to the more sustainable exploitation of economies of location. China offers the promise of a geographical advantage that German companies can exploit: It is becoming an increasingly sensible production location for Asian and worldwide markets with its combination of low factor costs and high economies of scale. Our study shows that German companies plan to double their exports from China within the next five years, so that already one third of the value creation of their affiliates in China will then be destined for third markets. After the investment hype we saw in recent years, this is the next logical step to integrate China into the corporate networks of international companies.



Many international companies still regard China merely as a fast-growing consumer market, even today. In the future, however, we will see that China will become host to a multitude of business functions for manufacturing companies. Businesses that pursue a Global Integration strategy are ultimately choosing an efficiency-seeking strategy, combining China’s location-specific advantages with their firm-specific advantages to bolster efficiency.

Each industry has been left with a distinct imprint. With competition heating up, German automotive OEMs and suppliers are already facing overcapacities of roughly 40 percent, and this in the world’s fastest growing market. Chemical companies are strategically investing in large integrated production sites to satisfy the excess demand that has been created by a strong growth in downstream industries. Some electronic firms keenly use China as a production location and already export 40 percent to third markets. The machinery industry is about to catch up in this respect and is planning to nearly triple its export share from China within the next five years. Pharmaceutical companies still perform most of their value creation back home and only hesitantly invest in China, deterred by the heavy violations of intellectual property rights.



The *operational adaptation* of a given business system to the location specific peculiarities of the Chinese business environment is – besides strategy formulation – crucial for success. The three most important success factors we identified in the course of our interviews are the following:

- *Human resource management*: In order to recruit, retain, and motivate local talent, successful companies cooperate with academic and educational institutions, provide professional development opportunities including global employee exchanges, and offer competitive salaries and bonuses.
- *Relationship management*: Good relationships with governmental authorities have to be maintained to ease the burden of China’s infamous red tape. The concept of “Guanxi” can also be employed to establish good relationships with other stakeholders, such as suppliers, customers and local communities. Although corporate citizenship is yet a relatively new concept in China, it can still have a very favorable effect on a company's reputation.
- *Product adaptation*: This concept is not restricted to the translation of instruction leaflets, but is an all-embracing effort to adapt products to local preferences and values. Champions of adaptation understand what Chinese customers demand and what they are willing to pay for.

Companies need to master both aspects to be successful in one of the most competitive nations on earth: They need to formulate a sound expansion strategy and they need to respect the success factors of operational adaptation. These aspects are described in-depth in our management book "China Champions - How German companies can successfully integrate China into their global strategies". It is to appear in June 2005 both in English and German. For ordering information and a more detailed discussion of this book, please visit our website on International Expansion Strategies at www.whu.edu/intman/ies. For further questions please contact dirk.panhans@whu.edu.