

Why invest in China now?

The path to success in the fast growing market



In the last decade, China has become an essential player in the world’s economic landscape and has been the favored investment target for countless companies located in the mature markets. Although China has been a driver of economic success for most of these companies, in the last few years the world economy has changed fundamentally and has been drastically reshaped by several crises. In its recent study, Arthur D. Little conducted a survey in order to answer the question “Why invest in China now?” and identified and analyzed the key trends and success factors in terms of investments in China.

Introduction

Since China implemented reforms and opened to the outside world 34 years ago, foreign direct investments of western companies have played a pivotal role in China’s phenomenal economic growth.

However most of them still face enormous challenges in their home markets as a result of the latest crisis.

Arthur D. Little’s survey was aimed at answering the following questions:

- Will Greater China still be an investment priority for foreign companies in the next years?
- If yes, what are the conditions for successfully investing in Greater China?
- Why has innovation become critical for the market in China?

Investment in China – Trends & Drivers

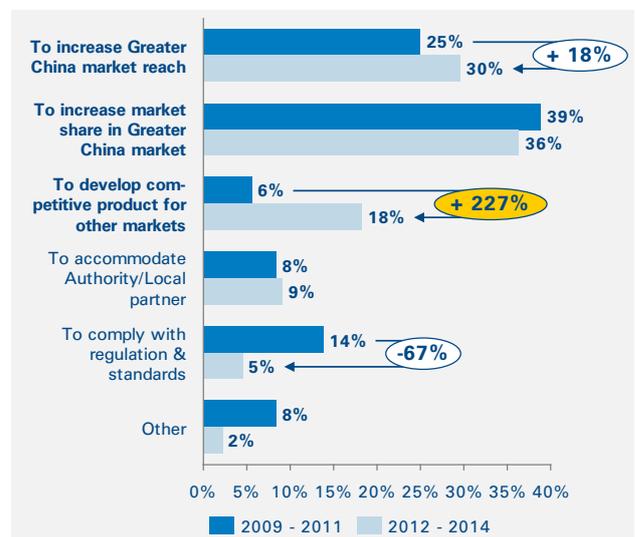
Attracted by its large market, exploding demand and cheap labor, China has been a more than attractive location for western companies looking to expand their business.

But in recent years the attentive reader will have noticed more and more news about the diminishing growth of the Chinese economy, rising labor costs and the emergence of new markets which may threaten China’s role as the world’s most competitive manufacturing location.

Nevertheless 9 out of 10 of the survey participants stated that they plan to increase their investments in China and it also does not take a lot of efforts to find numerous world-leading corporations and medium-sized companies that are still planning major investments in China.

This may at first glance appear counter intuitive. But in spite of the changed circumstances and challenges, companies are still confident about China’s future and the continuation of its positive development – changes do not inevitably mean a threat,

Figure 1: Driver of investment



but on the contrary can be the starting point for new business opportunities and enhanced future perspectives.

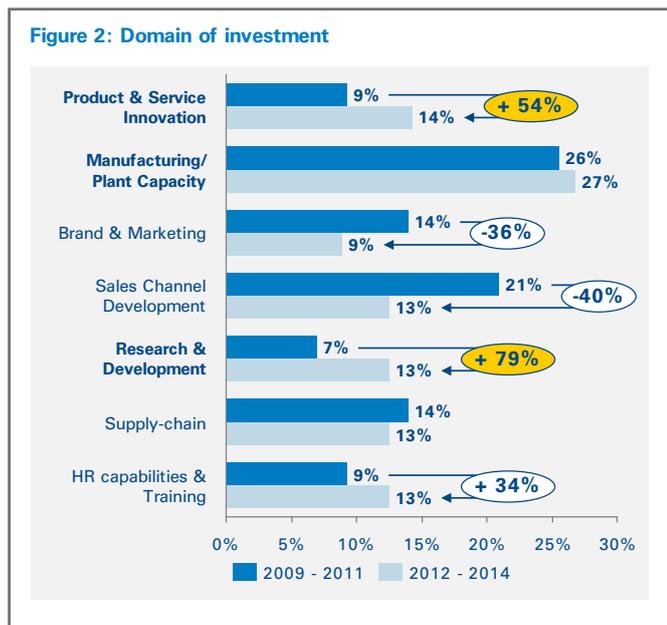
In accordance with the future trend of continued and increased investments, Arthur D. Little observes fundamental changes in companies' investment strategies.

(1) Drivers for investment

Besides the increase of Greater China market reach and market share which remain essential drivers for investments in China, the development of competitive products for other markets is becoming a stronger focal point compared to previous years (Figure 1 overleaf).

(2) Domains of investment

Consistent with the latter development Figure 2 shows that in addition to the traditional domains of investment (e.g. Manufacturing/Plant capacity) companies are also planning to increase investments in Product & Service Innovation and R&D.



Later we will also see that in line with this trend, innovation within China has to be increasingly in the focus of the companies to be able to participate in future trends.

(3) Regional focus of investments

Companies' plans to increase their Greater China market reach primarily stem from the fact that lower-tier cities and the western part of China are becoming more attractive from an economic perspective. Thus new investment possibilities and necessities for companies are emerging. The future regional focus of investments is shifting to 2nd, 3rd and lower tier cities.

This trend is driven by several factors like the increase in available income and demand in these cities, higher future GDP growth rates (compared to the higher developed cities), lower

labor costs and the strategic benefit of being support by several governmental programs initiated in the last five-year plan.

Key Success Factors for Investments in China

Although China remains attractive for future investments, there are several key success factors companies need to address in order to continue benefiting from the ongoing success story of China.

(1) Challenges and risks

When investing in China, companies should be highly aware of the fact that in the strict sense China is not one single market. Indeed it is that huge and diverse, that it cannot only be segmented geographically, but also socio-economically and culturally. Due to the enormous economic and demographic differences across the country and the fast pace of growth, companies have to take account of different stages of consumer development and quickly changing consumer profiles – a business model successful in one region might fail in another or be obsolete in no time.

Figure 3 shows major challenges and risks companies face while investing in China.



Whereas cultural differences are (relatively) no longer considered a serious problem, companies for the first time fear a drop in demand and rising labor costs and difficulties in hiring / retaining talents remain challenging fields.

The labor costs in China have increased drastically and there is an intensifying competition for talent.

Rising wages as the industry matures is a common development we could also observe in formerly developing

Japan or Korea. Though there are strong differences within China; whereas the developed coastal cities push this trend, China inland and less developed cities are lagging behind by 10 years.

Another reason for rising labor costs is rooted in the improving information flows among employees and the fact that employees are generally better informed due to the easier access to information sources like the internet. As a consequence employees are increasingly aware of the rising value of labor in China, a development that progressively results in higher salary expectations and ultimately also supports the increasing number of labor disputes.

Furthermore turnover rates remain high and job hopping is common across most of the industries due to a lack of loyalty towards employers.

Both developments show that companies urgently need to rethink their HR concepts and processes to improve their relationship with the employees in order to retain valuable talents, and to become more attractive to potential highly qualified employees. Since we can observe an increasing gap between labor supply and demand, especially considering the supply of qualified workforce, companies will have to cope with a severe shortage of management talent in the coming years.

The second big issue is the intellectual property (IP) of companies. IP rights infringements have been and are still a major concern for companies in China. Main problems in the context of IPR infringements are that, above all, local courts stay biased and favor local firms over outsiders (not only MNCs, but also Chinese companies), damage awards are usually too meager compared to the cost of litigation and the legal processes are not sufficiently structured and transparent. But first signs of improvement are visible as China begins to realize that failing to enforce IP rights will hurt the country in the long term. The number of patent filings and IP lawsuits, also between Chinese companies (e.g. Shanghai Sanlian vs. Suzhou Wu Liang Cai, 2007), are both rising.

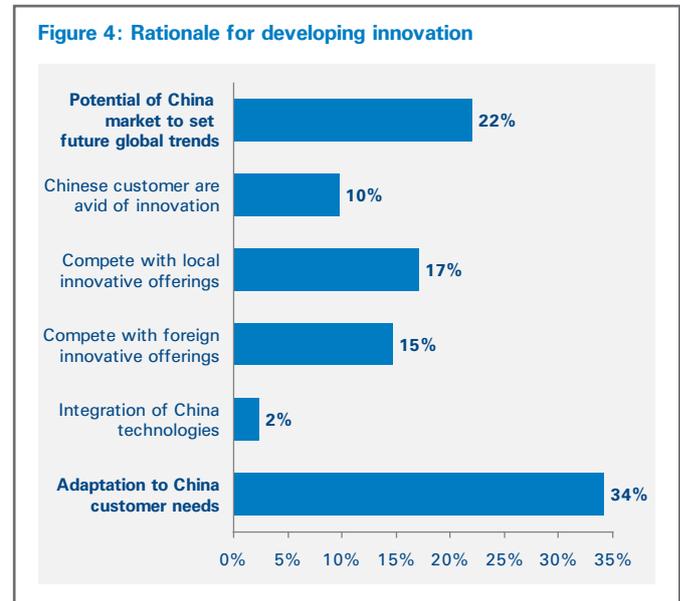
China's government and business leaders are seriously worried that the country will remain unable to develop truly innovative products and put more efforts into moving China beyond the manufacturing phase – not least because of increasing wages. Strengthening IP rights might increase the competition in this area breeding innovation.

(2) Innovation as a key to future success

Not only are China's elite re-defining China's role in the global community, but western companies are also changing their perception of China.

A high majority of the companies are about to introduce innovations specifically for the Greater China market. This trend

is mainly driven by the necessity of adapting to local demands, but companies also see the potential for China to set future trends (Figure 4).



In most industries China has become a major player in terms of sales and production volume and consequently fulfills the requirements to serve as a starting point for future trends. It seems that it is no longer the privilege of western economies to be the innovative pioneers of our times – in the future new products will be increasingly introduced in China and then spread across the globe.

There are numerous examples in China and/or for Chinese customers developed products which innovated their industry or set future trends. For instance Huawei developed the world's slimmest smartphone, Chinese electric two-wheeler vehicles - which excel in their price-performance relation - are a bestseller in Africa and TP Link, a Chinese manufacturer of networking products, recently introduced the world's smallest WLAN router.

China, as well as other emerging markets, is thereby reshaping the term innovation and breaking new ground by re-innovating existing products which also offer benefits to western consumers.

In this context experts talk about "micro innovation" or "frugal innovation".

The former describes the process of adapting or modifying an existing invention by generally improving one or several of its features in order to increase the value proposition to customers. Micro innovation is thereby iterative and usually follows a breakthrough innovation.

In contrast, frugal innovation, also called reverse or constraint-based innovation, describes the process of redesigning a

product and/or its production process in order to adapt it to the special needs and/or limited budget of a new target group (generally for low-budget consumers in emerging/developing markets). This usually refers to removing nonessential features, increasing the durability or the use of cheaper materials and uncommon distribution channels (even whole business models might be redesigned).

TP Link, as mentioned before, not only managed to reduce the price of its WLAN router considerably, but also kept the most essential functions. Retaining its high quality while reducing its size drastically made it more eligible as a portable device and also highly attractive to western consumers.

To take part in this new trend more and more companies are deciding to develop innovations locally despite the threats of IPR infringements. But the advantages are obvious: Lower development cost and the proximity to the manufacturing base, suppliers, the market and the consumers.

A striking example is the automotive industry. Aligned with their globalization strategy, many leading automotive brands are establishing R&D centers in China (e.g. Toyota, GM, PSA and Audi). The reasons are the same: better adaptability to local demand, lower labor costs and preferential policies (e.g. exempt from customs duties and import added value tax, deduction of taxable income up to 50% etc.).

All these developments are indicators that China is continuing its emerging development from the former workbench of the world to a progressively innovative location.

Conclusion

Although the environment beyond any doubt is challenging, China and particularly direct investments will continue to play an essential role for foreign companies in the future.

Despite all the challenges, the advantages of an investment in China by far outweigh the risks companies face in the market.

As long as companies react to the changing circumstances, adapt their strategies and foresee the new trends, they will be able to participate in the ongoing success story of China.

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Arthur D. Little

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