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A pocket guide to doing business in China

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McKinsey director Gordon Orr goes behind the trends shaping the world's second-largest economy to explain what companies must do to operate effectively.

China, a \$10 trillion economy growing at 7 percent annually, is a never-before-seen force reshaping our global economy. Over the past 30 years, the Chinese government has at times opened the door wide for foreign companies to participate in its domestic economic growth. At other times, it has kept the door firmly closed. While some global leaders, such as automotive original-equipment manufacturers, have turned China into their single largest source of profits, others, especially in the service sectors, have been challenged to capture a meaningful share of revenue or profits.

This article summarizes some of the trends shaping the next phase of China's economic growth, which industries might benefit the most, and what could potentially go wrong. It also lays out what I believe it takes to build a successful, large-scale, and profitable business in China today as a foreign company.

Trends shaping growth and creating new opportunities in China

As the contribution of net exports and real estate to economic growth diminishes, the focus on infrastructure and domestic consumption—as traditional and new sources of growth for the economy, respectively—rises. Whether or not the current growth of the Chinese economy is sustainable depends on the evolution of several trends.

Government policy continues to be the critical shaping force. As the ministimulus delivered in the second quarter of 2014 demonstrates, the government still possesses levers to push GDP growth rates up and down quite rapidly. In other ongoing government initiatives, the “marketization” of prices for electricity, water, land, and capital is having a major impact on the behavior of business, leading to a new focus on productivity, even within state-owned enterprises. Progress in bringing more private capital into state-owned enterprises is slow at the national level, with few scale

examples, such as the \$30 billion partial privatization of Sinopec's gas stations under way. At the city level, much more momentum is building, with local governments selling out of noncore activities such as hotels and many manufacturing businesses. The anticorruption campaign continues aggressively throughout state-owned enterprises, and government has itself become a material brake on growth. Officials and executives are simply unwilling to make decisions that could possibly be held against them later. President Xi has pursued anticorruption as a theme for more than a decade; he is not going to back off.

The Chinese middle class—the people who are buying new homes, who today are buying 18 million cars a year (delivering a third of the global auto industry's profits), and who are starting to spend more on services—are critical. Only if they remain confident in their personal economic future will they continue to increase their spending and become a larger driver of economic growth. By 2022, more than 50 percent of urban households should be in the middle class (in current US dollars, that means an annual household income of \$20,000 to \$40,000), an increase of more than 100 million households over the coming decade.

China is now more than 50 percent urban, but 10 million to 15 million people a year will still be moving to cities from the countryside. Rural migrants already in the cities need to be better integrated. City governments need to make their cities more livable, more efficient, and better able to integrate their migrants. "Smart cities" is a clichéd term, but China's cities need everything from more efficient mass transit to better water usage. Investment to deliver this will be massive, indicating how the construction of China's infrastructure is not yet complete.

Many businesses are coming under a new level of cost and margin pressure. Margins of industrial state-owned enterprises have fallen by a third over the past four years. Often the industries they compete in, from steel production to telecom-network equipment, are simply growing much more slowly. By the standards of China over the past 30 years, state-owned enterprises have become mature industries. This leads to three outcomes: initiatives on productivity, diversification, and globalization. The latter two are more often conducted on the basis that prior success in one industry in China will automatically lead to success in the next industry and country.

Multinationals selling to Chinese consumers often continue to perform extremely well, using their skills in consumer insights, branding, and pricing to differentiate from local companies that, while large, are still developing world-class functional capabilities. Multinationals selling to government, at the other end of the spectrum, find market access much more challenging.

China is home to some of the world's largest, most successful, and innovative Internet-based companies. The pace at which Chinese consumers are embracing the Internet is at the cusp of causing major disruptions to many sectors in China. Perhaps because consumers are still new to our traditional ways of shopping or banking (only having had modern shopping malls for a decade in many cities), consumers are very willing to switch to buying online. When the experience of going into a Chinese bank branch is so poor, it's not surprising that consumers would rather transact online.

Almost no consumer-facing business in China can succeed without an online and offline strategy today. Mall owners are struggling to find a new economic model. Retailers are trying to bring order to their nationwide distribution chains to exert control over the price at which their products are sold online. Online wealth-management products have been able to gather \$100 billion dollars in less than 100 days, forcing traditional banks to increase rates on much of their deposit base. The impact on employment is just starting to appear, but many millions of sought-after white-collar jobs will be eliminated in the next few years.

The risks

This growth is not risk free. Perhaps most critically, Chinese consumers remain relatively unsophisticated. A loss of confidence as a result of a default in a wealth-management product, or a decline in housing prices in a specific city, could easily become a nationwide contagion creating a vicious cycle of consumers who withdraw from spending, thereby worsening market conditions. One has to be over 40 to remember a recession in China.

Other risks to growth include geopolitics, especially China's relationship with Japan, where the government's credibility depends on being seen to do the right thing by the Internet classes. A final and rising risk is the underemployment of graduates. Of the seven million graduates each year, maybe only three million find jobs that require a degree. The remainder discovers that their aspiration of joining the middle class and owning a home and a car is possibly out of reach permanently. They are a large, dissatisfied, and growing segment of society.

Industries with potential for faster growth in the next decade

Many of the industries with the highest growth potential in China over the next decade are in the services sector, but not all. For example, energy and agriculture will have segments with very rapid growth. Below is a very brief snapshot of where we see opportunities.

E-tailing. The online share of retail in China, at 8 percent in 2014, is higher than it is in the United States and is not close to reaching saturation. Increasingly, this is conducted through mobile devices. The payments system is in place, logistics are improving, and online providers are

trusted. Many retailers will adapt, often with far fewer physical locations. Malls will have to become destinations for services beyond retail.

Logistics. Modernization of supply chains is a key enabler of increasing productivity in many sectors in China today. Until recently, most goods were carried by individual truck owner-operators. As express parcels become a \$100 billion industry on the back of e-tailing, e-commerce companies themselves are investing billions in modern warehouses and trucks. Alibaba alone is committed to spending billions of dollars on its own logistics. Third-party carriers such as SF Express are rapidly becoming regional leaders on the back of growth in China. Even in agriculture, massive investment is under way in cold storage and cold carriage to reduce waste and provide higher-quality food products to China's middle class.

Education. Nearly two-thirds of registered kindergartens in China are privately owned. Private universities are expanding. Traditional and online vocational learning schools are publicly listed multibillion-dollar businesses. Niche businesses, such as preparing children to apply to US, UK, and Australian high schools and universities, are also flourishing. The amount the Chinese are willing to spend on tutoring and support for their children is almost unlimited. As the middle class becomes wealthier, the increased ability to spend will drive market growth.

Healthcare. More than 1,500 new private hospitals opened in China in 2013, a number of which are 100 percent foreign owned. The shortcomings of the mainstream public healthcare system in China are not likely to be overcome quickly. Patients are looking for solutions where both cost and quality are more certain, and private and foreign companies are being encouraged to deliver. There is a related boom in supplying equipment to these new facilities.

Tourism. Available hotel rooms in China have tripled over the last decade. Four million mainland Chinese visited South Korea in 2013; four million visited Thailand. China's middle class expects to take three to four weeks of vacation each year and no longer accepts visiting the overcrowded, overexploited traditional domestic destinations. Disneyland's opening in Shanghai in 2015 could trigger a new wave of investment to create higher-caliber resorts.

Wealth management. China represents more than 50 percent of Asia ex-Japan growth, with high-net-worth assets expected to reach \$16 trillion by 2016. The more than one million high-net-worth individuals in China remain generally unsophisticated as investors, seeking advice on how to broaden their investment portfolio both onshore and offshore.

Entertainment. China is the second-largest movie box office market in the world, despite the fact that tickets cost upward of \$10 and DVDs are still available for \$1. In 2013, more than 1,000 new theaters opened, yet admissions per capita are less than one-fifth of South Korea's.

IT Services. Finding the chief information officer in a Chinese company is often hard, especially in a state-owned enterprise. Historically regarded as simply a support role for the business, CIOs were pushed three to four levels down in the organization and attracted little talent (which instead went to Internet start-ups). A typical Chinese company spends only 2 percent of revenue on IT versus international benchmarks of around 4 percent. As these companies struggle to bring technology into the core of their operations, they need massive amounts of help to do so. The cost of good IT talent is already soaring. Most Chinese companies will be unable to solve their technology challenges for themselves.

Clean energy. China already produces 60 percent of solar panels and wind turbines. Increasingly, it is consuming this output domestically. For example, 11 gigawatts was installed in large-scale solar farms in 2013, and this will grow an additional 30 percent in 2014. China is also investing heavily to exploit its shale-gas assets and develop cleaner coal technologies.

Agriculture. China does not feed itself today—certainly not with the kind of quality and value-added products that the middle class seeks—but it will be challenged to do so in the future. Continual food-safety crises illustrate the challenge. For many successful technology investors, such as Legend Holdings, agriculture is the new Internet. Chinese companies are investing in agriculture outside of China at scale, from Chile to the Ukraine, for China. They also invest in China, especially in value-added products—such as fruit and the production of frozen ready meals.

Doing business effectively in China

Often in China, the fundamental barrier to success is less about identifying the opportunity and more about the inability to execute the plan more effectively than others. One's own management team, the team's relationship with corporate headquarters, the role of and relationship with joint-venture partners—all play a key role. Joint ventures have been part of doing business in China for more than 30 years. In many sectors, they remain the only way to participate, often in a mandatory minority position. But there are a number of clear lessons:

Establish the right strategic positioning.

- If regulations require you to have a joint-venture partner and a minority position today, assume it will be that way forever in the core business activities. From automotive to financial services, the lesson is that it won't change. If that model is not attractive today, do not invest in the hope that it will change.

- Follow the evolution of government policy and align your stated intent with such policy as far as possible. Using the words from government statements in your own statements communicates your commitment to China.
- Be clear if you are in China for the opportunity in China, or if you are in China for the opportunity that China creates for you in the rest of the world. This can lead to a very different presence in China.

Many potential joint-venture partners are highly successful and very large within China, who sees international partners as little more than a temporary accelerator of growth.

- Increasingly, China's mind-set is that there are fewer and fewer things to learn from foreign partners. China doesn't need the capital, it can hire the skills, and it has the customer relationships, insights, and, most critically, the government relationships. Even state-owned enterprises now hold this mind-set.
- Simply stating that "this is how we do it in America/Germany/Japan" will not win friends. What one can do today is make a long-term commitment to help a Chinese joint-venture partner expand internationally. This may well be at a cost to the international partner's existing business and needs to be seen as part of the total China investment.
- Establish from the outset a clear hierarchy of who interacts with whom at the joint-venture partner and with relevant government officials. Chinese partners like the certainty this provides. Ensure that the committed executive shows up for board meetings and the like, and don't delegate.

Place a trusted senior colleague in China with a commitment to have him or her be there for the long term.

He or she is your go-to person when things get volatile in China, someone whose viewpoint the global management team will trust, and someone the head of your joint-venture partner will also learn to trust. Usually, this person will be very strong in people development, with skills almost overlapping with a head of HR. And he or she will need to be 100 percent trusted to enforce compliance and to role model required behaviors. Typically, make this person chairman of your Asia or China operations, as senior a title as possible.

Talent acquisition and development, at all levels, remains highly time consuming and often frustrating for multinationals. Loyalty to an employer is often low on an individual's priority list. Turnover will likely be high and should be planned for.

- Hiring midcareer executives is increasingly common, and in almost all industries the available talent pool is deepening. Both Chinese and global search firms have rapidly growing businesses that serve local and international companies. It is imperative to complete thorough background checks. Getting people to leave quietly in China often involves being silent on the cause of separation.
- At the entry level, many graduates are available. However, many lack workplace-relevant skills, including even those with MBA qualifications, which are more often bought than earned and often come with a lack of self-awareness that can lead to a mentality of entitlement. As a result, many corporations hire and then weed out aggressively during the initial probation period. Once on board, retention of high performers often depends on a highly variable compensation structure and dismissing underperformers.
- While you will likely have to work with “sons and daughters” of government officials as business partners, it does not mean that you have to employ them. Outside of some companies in financial services, few international firms do.

If protecting intellectual property (IP) in China is a concern, consider it very hard if that IP needs to actually come to China. Some companies in the technology sector have been very successful, even while not bringing core IP into China. Secondly, consider if the cost of loss of IP could be contained solely in China. Again, in technology, multinationals have aggressively and successfully sued Chinese companies outside China that have taken IP from multinationals in China and used it outside China. China is evolving fast on IP protection, with more and more Chinese companies suing other Chinese companies. It is becoming increasingly likely that a Chinese partner will recognize the value of IP and be willing to protect IP developed jointly with them. A practical means of making it harder for global IP to leak into China is to establish a stand-alone IT architecture for China that has no access to servers at headquarters.

China is likely to be a more volatile economy. Taking a through-cycle viewpoint rather than a “quarterly performance versus plan” mind-set is key to motivating your China team and to convincing them that you are committed to China for the long term. Indeed, downturns in China have proved to be attractive moments to double down. When partners or governments are under stress, new partnerships and licenses can become available to foreign partners that are willing to step up and invest. Even after 30 years, few multinationals adopt this mind-set.

Don't do anything to compromise your global brand and reputation. If you can't do business the way you want to, then don't do it at all. There may be opportunities to make money in the short and medium term, but shortcuts will eventually be made transparent. The Chinese government will be well aware of how you are operating, and the anticorruption campaign is not going to go away. Don't assume that because your suppliers are international companies that they are automatically operating to the global standards you expect; verify that they are. [□](#)

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