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ENTERPRISE CHINA

ADOPTING A COMPETITIVE STRATEGY FOR
BUSINESS SUCCESS

ALLEN J. MORRISON / J. STEWART BLACK

WILEY

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CHINA**

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PREFACE

As senior professors of leadership and strategy, our research and writing go back more than 30 years. Over that time, collectively, we have traveled to China (including Hong Kong) more than 120 times. We have written more than a dozen business case studies on Western companies in China and Chinese companies expanding abroad. We have served as visiting professors at leading Chinese business schools and have taught scores of executives and senior Chinese government officials. As well, we have run workshops for more than 3,000 Western executives about doing business in China or working with Chinese companies. In addition, we have interviewed dozens of Chinese executives and government officials, including mayors and members of Chinese state regulatory agencies and planning offices in China, as well as equal numbers of US and European officers in trade associations and business roundtables and Western executives with significant experience in China. We have served on governance and advisory boards of publicly listed Chinese companies and distinguished Chinese universities.

Our interest in China has only grown throughout the years. The country's growth and prosperity have surpassed everyone's expectations, including our own. We each traveled to China for the first time in the summer of 1989—one to Beijing and the other to Shenzhen. The impact of the protests in Tiananmen Square had a profound impact on the country and each of us. One of our first joint research trips to China took us to Shanghai in the early 1990s. The airport was not the shiny, sprawling edifice that people see today. In fact, part of the concourse was being repaired with only a dirt floor to walk on. We had to walk from the international terminal to the domestic terminal through the town streets. Flash-forward a few decades, and we recall a recent trip on one of the country's high-speed trains from Nanjing to Beijing. The journey of about 640 miles is not much different than the distance between Nashville, Tennessee, and Orlando, Florida, which by car would normally take between 10 and 12 hours. The trip took just over 3.5 hours. The train and the ride was as nice as any in Japan or Switzerland. Today the country's airports, seaports, subways, roads, and bridges are among the best in the world. We have been equally impressed by the level of digitization and advances in the cloud and online services, as well as by the staggering number of Swiss watch shops, glitzy high-rises, and German luxury cars on the roads. More recently, we were surprised to find panhandlers flashing QR codes instead of presenting tin cups at passersby.

These modern sights, sounds, and impressions have been experienced by virtually anyone and everyone who has traveled to China in the last decade. Those with long experience in China are astounded at the degree and pace of change. Those who have only visited China for the first time in the last few years are often shocked by what they see and experience. As one tourist we ran into before the COVID-19 pandemic stated, “I didn’t expect rickshaws and people in Mao suits, but I also didn’t expect this. The level of modernization hits you smack in the face.” We agree.

As impressive as is the “what” of China’s modernization, our fascination and research has always focused on the “how,” especially over the last two decades. How China got to where it is today is amazing. If this were a history book, that would be our primary focus. However, this is a business book, written for business executives. Consequently, we focus on *where* China and its commercial enterprises are going and *how* they plan to compete and win along the way—their competitive strategy.

We say “their,” but we really mean “its,” and the change from plural to singular pronoun goes to the heart of one of the most common misperceptions foreign executives have about commercial China. Most Western executives, as they are trained to do, analyze the competitive strategy of suppliers, strategic partners, or commercial rivals with the individual company as the unit of analysis. Sadly, this approach has a fatal flaw because where a Western executive is trained to see an independent, multibillion-dollar enterprise, it is only the nose of a multitrillion-dollar beast. That monolith we label “Enterprise China.” It consists not just of the company in focus but an entire ecosystem of companies tied together by the largest entity on the planet by employment and the second largest by revenues—the Chinese state, which includes the central, provincial, and municipal governments. But contrary to what most foreign executives imagine, the Chinese state is not working behind closed doors in smoke-filled rooms whispering its desires to commercial entities hoping that they will listen. No, because the state outright owns entities that account for 30 to 40% of the economy, it operates in the open. It is public about its intent of ensuring that no daylight comes between the vision, ambition, and strategy of the state and key commercial enterprises. However, Enterprise China extends far beyond this core cluster of state-owned enterprises (SOEs) and includes virtually all privately owned enterprises (POEs) of any significant size or importance. How, and the extent to which, this happens is a core part of the first third of the book.

Because most Western executives focus on individual enterprises, they also center their attention on the competitive strategy of that entity. However, just as there is an overarching Enterprise China monolith, there is an overarching vision and strategy that supersedes any individual Chinese business. Focusing on specific entity strategies is like looking at individual pieces but not seeing the picture of the overall puzzle. The good news is that the strategy for Enterprise China is not a state secret. It is not locked away in a vault. It has been laid out in

public documents for all to see, but about which most foreign executives have only a passing awareness. In this sense Enterprise China's competitive strategy has been hiding in plain sight for nearly two decades. Consequently, the middle portion of the book is devoted to laying out Enterprise China's competitive strategy and the associated tactics.

Because this is a book written for executives, the final section focuses on the business implications of Enterprise China and its competitive strategy. Specifically, we ask and answer the question: What strategic options and actions can Western business executives take in competing *in* and *with* Enterprise China?

While there is no debating the impressive progress that China and its commercial enterprises have made, as all safe harbor statements stress, past performance is no guarantee of future success. Consequently, China's past may be prologue, but it is not prophesy, nor is it destiny. In 2019, we published a *Harvard Business Review* article that outlined many of the key factors that could derail Enterprise China. At the end of this book, we dive deeper into this topic.

We are neither in the camp that predicts that China will take over the world nor aligned with those that predict the coming collapse of the country. Rather, we take a pragmatic approach. Our perspective is that foreign executives ought to understand the nature of Enterprise China, should appreciate the elegance of its strategy, and acknowledge the focus and discipline of the Chinese. They would be wise to plan their own strategies accordingly and ought to take up a mantra of Navy Seals—assess and adapt. To best facilitate this, we lay out those factors that foreign executives should monitor as Enterprise China moves forward. We explain how those factors could help or hurt Enterprise China's strategy so that executives can adjust their own strategies as needed.

When we decided to write this book, it was in the middle of the COVID-19 pandemic, and the political tensions between China and the United States were high. Decoupling between the two was the talk of the time and persists in many circles. We are not ignorant of the importance of political relationships in the course of commerce, but we wanted to approach the topic of Enterprise China and its competitive strategy largely free of politics. We leave it to others to measure out blame or policy disagreements when it comes to ongoing or future tensions between China and the United States or any other country for that matter. Our goal is simple: Help executives make more informed and wise strategic choices for their companies relative to China. We hope our insights and recommendations will be relevant to executives regardless of whether they lead small, medium, or large companies or whether they have large investments and operations in China or none at all. We believe they are.

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We are grateful to many people who helped guide our thinking in preparing this book. These include those who participated in our research and who shared with us their rich experiences and challenged our thinking. We specifically recognize the guidance and input of Bob and Jenny Theleen, David Young, Doug Guthrie, Brian Hu, Dave Ulrich, John Nossiff, and Ali Jawad. We are also grateful to our editor, Daryl James, for his thoughtful comments. And finally, we express our deep gratitude to our families, who have put up with us over the many months we dedicated to composing this book. Their decades of support have been pivotal in shaping our worldviews and in allowing us to indulge in our fascination with China.

Chapter 1

A NEW TYPE OF COMPETITOR

China has the world's attention. Most Western executives, whether their firms operate in China or not, can easily list key Chinese competitors. Many of these rival companies did not exist 30 years ago, but today they command respect—even if foreigners struggle to pronounce their names or simply refer to them by their initials, such as SAIC (Shanghai Automotive Industrial Company), ICBC (Industrial and Commercial Bank of China), or CNOOC (China National Offshore Oil Company). Unfortunately, the formidable Chinese foes that Western executives see do not capture the full picture of the challenges they face. Where a foreign executive sees an independent, individual multibillion-dollar Chinese company, it is merely the nose of a larger, multitrillion-dollar monolith. The real rival includes not just the individual companies on which Western executives typically focus their competitive analysis but an array of interconnected firms in a much larger ecosystem. More importantly, this monolith includes the largest entity on the planet by number of employees (386 million¹) and the second largest by revenue (\$1.3 trillion²). We're talking about the Chinese state, which includes national, regional, and municipal governments. We refer to this commercial totality as "Enterprise China."

Without taking this full picture into account, foreign executives can easily misunderstand their opportunities and challenges and miscalculate their responses. Consequently, we have two main objectives with this book. First, we provide a comprehensive review of Enterprise China with a focus on the competitive realities that Western companies face. Second, we lay out the strategies that Western firms might take as they compete *in* and *with* Enterprise China. To appreciate the challenges involved, foreign executives first must consider the distinction between Chinese enterprises and Enterprise China.

THE RISE OF CHINESE ENTERPRISES

As professors, we each took our first trips to China in June 1989. One of us traveled south to Shenzhen, and the other headed north to Beijing. Most readers will remember the momentous events of that month and year in China, when troops moved against protesters at Tiananmen Square. We certainly do. In the three decades that followed, our research, case study writing, and consulting on China have primarily focused on how Western firms compete in and with China. In the process, we also have directed and taught hundreds of executive development programs involving over 3,000 executives in which “Competing *in and with China*” was a central theme.

Competitive analysis was almost always a core topic in these programs. Typically, assessing Chinese competitors was a central element of that analysis. In starting these sessions, we regularly asked a simple question: “Who are your Chinese competitors?” Back in the 1990s, we invariably got one of three responses:

- I’m not sure.
- We don’t really have any Chinese competitors.
- I can name a few, but we are not really worried about them. They aren’t serious competition for us.

The story is different today. When we ask Western executives to name names, they typically have no problem identifying their key Chinese competitors, as well as those competitors’ tier 1 customers and suppliers.

Domestic Strength: Growth as a Source and Market

What explains this change in response? The answer is as straightforward as it is profound: China has exploded as a supply source and as a market over the last 30 years. Because most readers are no doubt familiar with the story of China’s growth, we will summarize it with just two charts.

The first shows China’s fivefold increase as a supply source over the last 20 years (see Exhibit 1.1); China rocketed from No. 4 to No. 1 in the world. Today, it is at the top of the chart by a wide margin, with the United States a distant second.

Because China so strongly dominates global manufacturing, it is often referred to as the “world’s factory.” In some areas China is not just the top producer globally, its production is greater than all other countries combined. For example, in terms of steel production over the last 20 years, China has gone from producing about 16% of the global supply to 53%, or slightly more steel than the rest of the entire world combined. Likewise, China is not only the No. 1 producer of refrigerators in the world, but as with steel, it produces more than all other countries put together. In mobile phones, it is not even a close race. China produces roughly 65% of all the smartphones made on the planet. In terms of

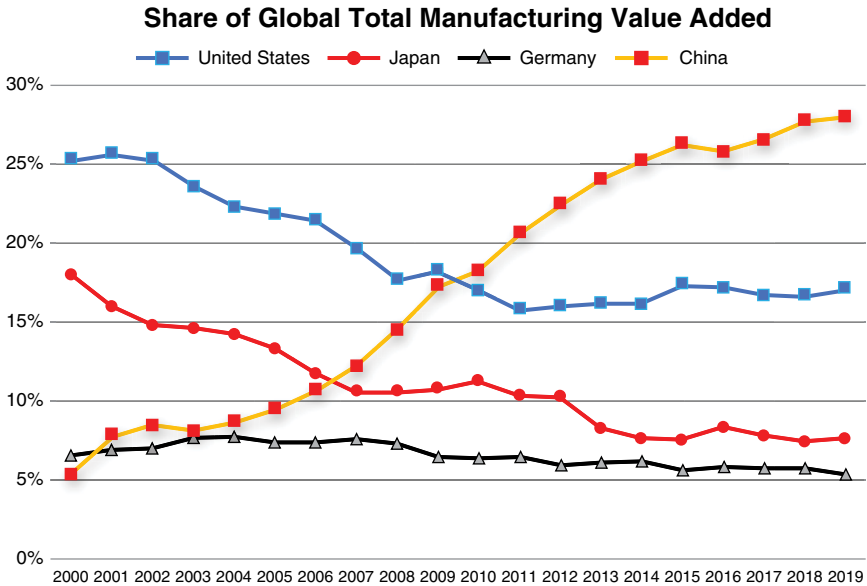


Exhibit 1.1 China's Rise as a Source

Source: World Bank.

televisions, more than 70% of all the televisions produced in the world are made in China. The same is true for air conditioners. And the list goes on. With this large and strong position in supply and manufacturing, it is little wonder that Western executives can name key Chinese companies, especially those in their upstream value chain.

The second chart illustrates how far China has come as a market (see Exhibit 1.2). The country has soared from No. 11 to No. 2 in the world as measured by its share of global GDP. Although the slope of the line representing China's rise as a market may not look steep, it represents a 900% increase over the past 30 years.

While China as an overall market is second only to the United States, it is No. 1 in several areas. For example, China is now the largest retail market in the world. Within retail, China is the largest e-commerce market in the world both in terms of total revenue and number of customers who purchase online. China is also the largest car market in the world. And it is the world's largest market for luxury goods such as designer handbags and Swiss watches. Again, the list goes on.

China's explosive growth as both a supply source and market have given birth to and nurtured a host of new, large, and strong Chinese companies. Again, most readers either know or can intuitively understand this dynamic, and consequently it needs little further explanation. However, a single chart provides a useful summary (see Exhibit 1.3). This chart shows the number of Chinese firms on

ENTERPRISE CHINA

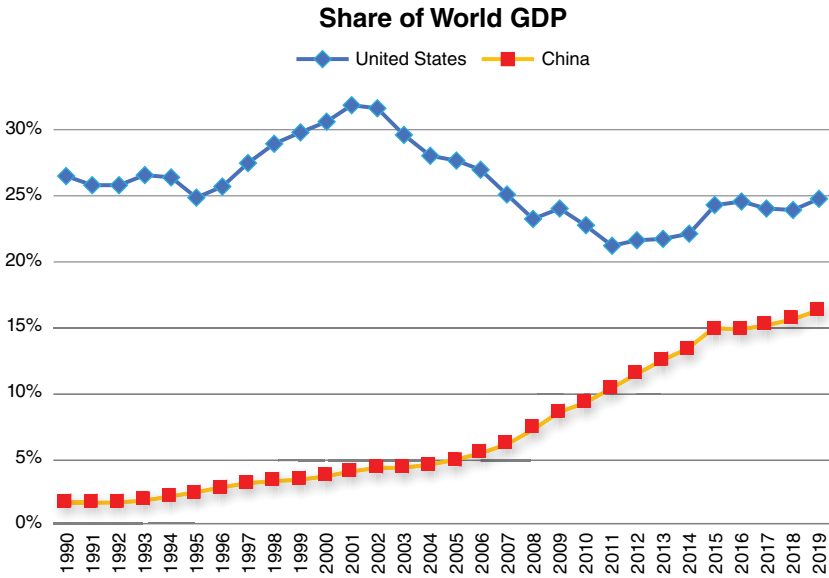


Exhibit 1.2 China's Rise as a Market

Source: World Bank.

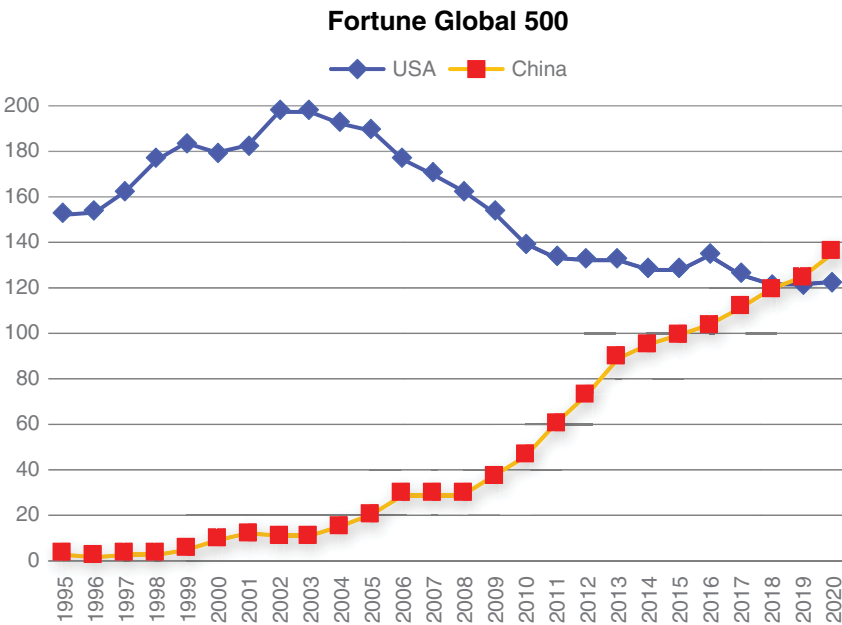


Exhibit 1.3 The Rise of Chinese Firms

Source: Fortune Global 500.

Fortune's list of Global 500 firms from 1995 through 2021, representing the largest 500 firms on the planet by revenue.

To appreciate the growth of large Chinese companies, consider that in 1995 when *Fortune* launched its first list of the top 500 global companies, China had only three firms on the entire list; 19 other countries had more. In 2021, China had three firms just in the top 10. With 135 Chinese firms on the total list, no other country had more, including the United States (122 firms), the second year in a row that China was No.1 and the United States was No.2.

As a consequence of China's size and scope as a source of supply and as a market, most large foreign multinational firms have at least some operations in China. Those operations may be primarily upstream or downstream, but many firms have operations in China across the entire value chain. For firms without much or any presence in China, they nevertheless have likely encountered Chinese competitors exporting products into their home markets or setting up shop next door.

Foreign Strength: Growth as an Exporter and Investor

The proposition that indigenous Chinese firms would have an inside track when it comes to competing on their home turf is easy to understand. How they have achieved that domestic strength and how they plan to elevate it will be the focus of an important part of this book.

However, as we will explain and examine, Chinese firms are not content with dominating domestically. Through exports and foreign direct investment (FDI) abroad, they plan not only to compete overseas but to lead globally. This is why firms with no presence in China, whether they are small, medium, or large, which are completely content to stay home and not engage in battles with Chinese firms, will nonetheless find themselves in a fight going forward—if they are not already struggling today. The next five charts help to illustrate the development of this competitive battlefield.

Export Strength

Most firms with no presence in China first encounter Chinese competitors via exports from China (see Exhibit 1.4). Given the significant rise in Chinese exports over the last 20 years, many firms already have felt the pain of losing market share because of Chinese exports appearing on their shores. For example, US firms have seen imports from China explode from \$103 billion in 2000 to just over \$500 billion in 2021. China's successful expansion via exports has enabled it to overtake historical export leaders such as Japan, Germany, and the United States. Today, China is the world's largest exporter.

Because international trade also has grown over the last 50 years, a better way to appreciate the success of Chinese exports is to view them from a relative perspective—that is, their share of total global exports (see Exhibit 1.5). Here the results are visually even more stunning. China's global share of exports has soared

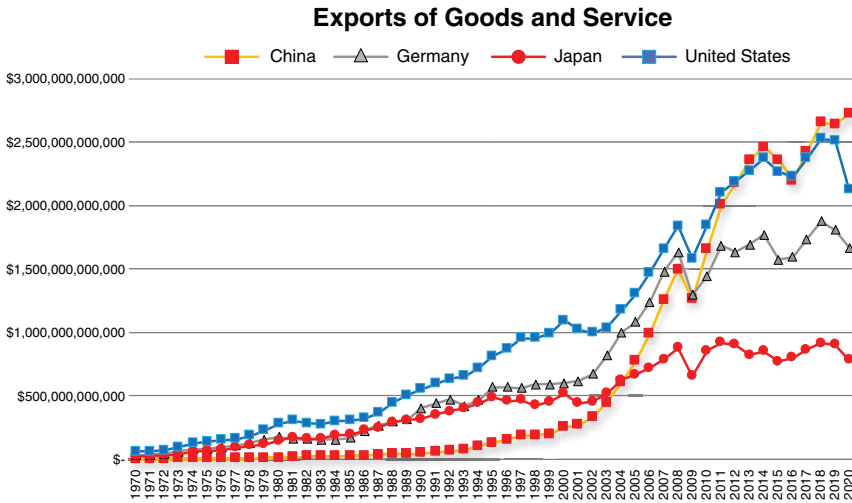


Exhibit 1.4 Goods and Services Export Value (\$US)

Source: World Bank.

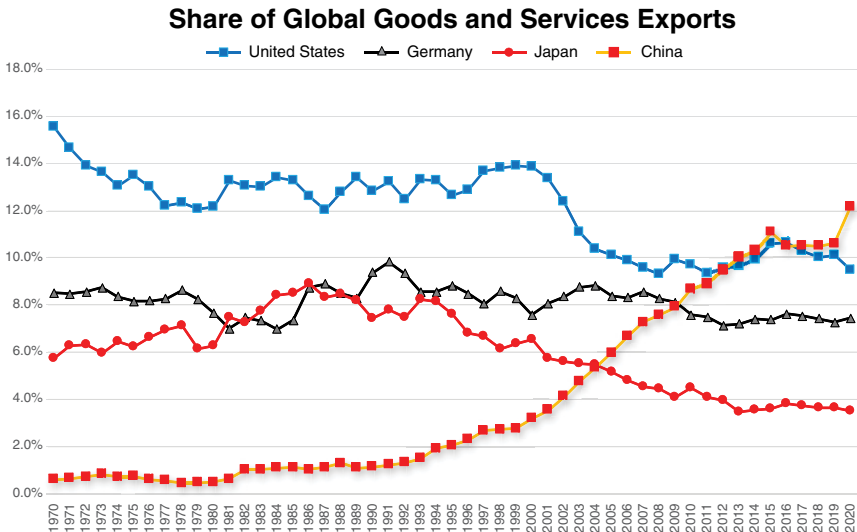


Exhibit 1.5 Share of Goods and Services Export Value

Source: World Bank.

1,665%, while those from Germany, Japan, and the United States have declined 12.5%, 39.0%, and 39.2% respectively. To put it bluntly, China’s export gains have been the previous export champions’ losses.

Books have been dedicated to explaining the dramatic rise of Chinese exports, so there is no need for us to do much more than hit on two highlights. The first driver of Chinese export success has been the country's abundant and cheap labor. All experienced executives understand this factor, though the key behind it and the strains on that source are typically less well understood, so we will take some space to highlight them here. The second driver of China's export success, improved infrastructure, is one that is often underappreciated by many outside the country. Consequently, we will devote a bit more space to this factor and illustrate it with some impressive numbers and charts.

Abundant and Cheap Labor. Few would debate that China's abundant and cheap labor has been a critical component of its export success. However, there is an element to this part of the story that typically goes underreported—internal migration. Many foreign executives underappreciate how vital internal migration has been in China, as the country has scrambled to staff its urban factories. In fact, during China's historic economic explosion, over 200 million Chinese migrated from low-paying, unproductive, rural farms to much higher-paying, productive urban factories. The potential of this cheap labor, which was larger than that of Japan, Germany, France, the United Kingdom, and Italy combined, would have gone uncaptured without this population shift. Had these 200 million workers stayed on their farms and not moved to urban factories, China's massive explosion of exports could not have happened.

Impressive Infrastructure. This migration could efficiently and effectively produce products for export only if the infrastructure required to (a) move raw materials and components into the country, (b) transport them from one subassembly location to another and ultimately to final assembly, and then (c) transfer finished products to ports for export was superior. Cheap and abundant labor with poor physical infrastructure would not have produced a winning combination. Any experienced executive understands this. What many Western executives might not realize is how much China has invested in infrastructure. To upgrade its physical infrastructure, the country has spent more on building and improving its roads, rails, and airports than the United States and Europe combined (see Exhibit 1.6).

This investment pattern continues unabated. Li Xiaopeng, China's minister of transport, announced in 2019 that during the previous year the country had invested the equivalent of US \$460 billion in transportation fixed assets.³ This included the development of an additional 8,000 kilometers of railway lines and 330,000 kilometers of roads, as well as five new civil transport airports. Morgan Stanley estimates that China on average will spend around \$180 billion each year for the next 11 years—or \$1.98 trillion in total.⁴ That annual figure is almost double the past three-year average in China. In contrast, US public investment on infrastructure fell by nearly 11% from 2003 to 2017 when adjusted for inflation and the cost of infrastructure inputs. Today, China continues to invest more in physical infrastructure than the United States and Europe combined, even with the US's infrastructure bill passed in 2021.

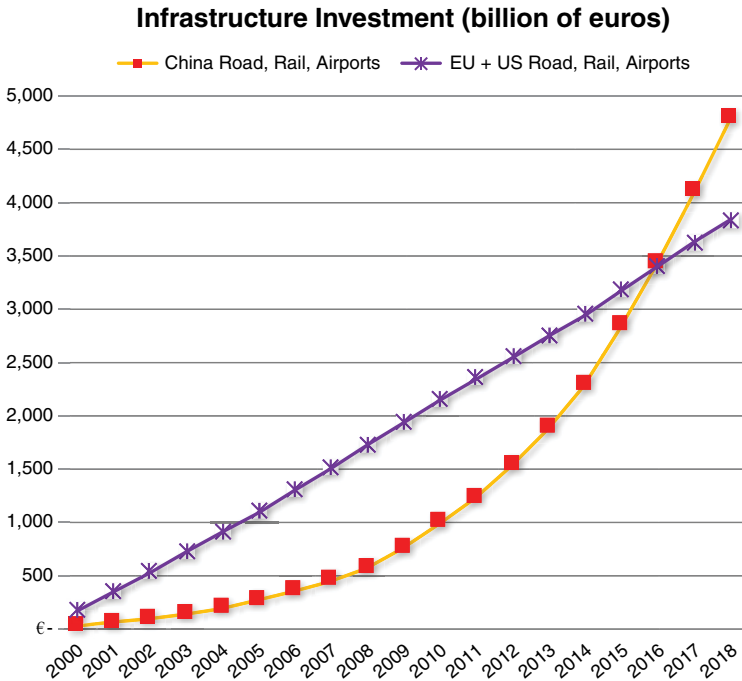


Exhibit 1.6 China's Cumulative Expenditure on Physical Infrastructure
Source: OECD.

Abundant and cheap labor that shifted rural farms to urban factories and aggressive investment in physical infrastructure have been key factors enabling Chinese firms to flood the world with exports. These were not the only factors, but they were pivotal and are often underappreciated. As a consequence of these exports, many wholly domestic firms across the planet that otherwise were content to mind their own business at home have nonetheless found Chinese exports eating away at their market shares and livelihoods.

Foreign Investment Strength

Exports were only the beginning of the disruption for firms that had no presence in China and no desire to compete with Chinese firms. The second major disruption for these “stay-at-home” companies was FDI by Chinese firms. Over the last 20 years, not only did the boom in China spur the formation of an astounding array of indigenous companies with sizable fortresses at home that facilitated exports abroad but also many decided they were big enough and strong enough to invest, expand, and set up overseas outposts. No doubt, the prospect of even greater international revenues drove Chinese firms' outward FDI. Exports make

China Outward FDI Stock as Percentage of GDP

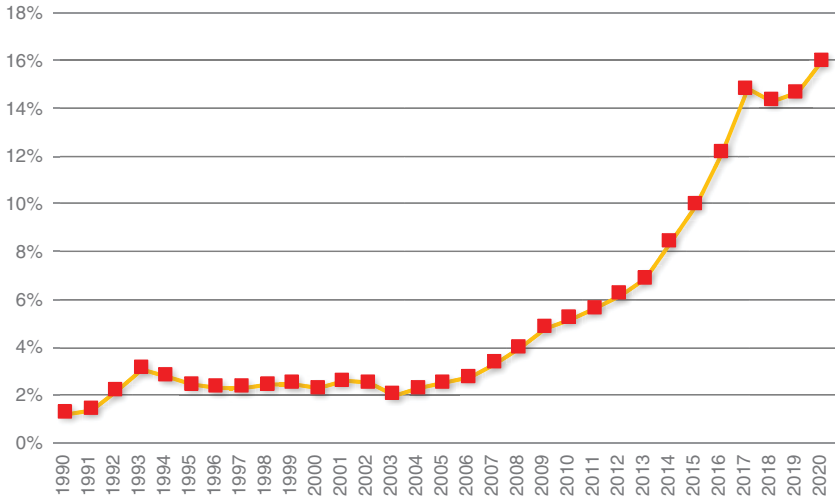


Exhibit 1.7 China's Expansion Overseas

Source: Adapted from UNCTAD World Investment Report 2020.

the most sense (and money) when they can be standardized and made the same regardless of where they are to be sold in the world. Any customization hurts the capture of economies of scale. However, not everyone everywhere wants the same thing. The more exports need customization in order to penetrate a foreign market, the more sense it makes to produce localized versions not in China but in, or close to, that market.

This is often what motivates firms, including Chinese firms, to move from exports to FDI.⁵ Exhibit 1.7 illustrates the dramatic rise in Chinese firms' investments and accumulation of overseas assets (as measured by FDI outward stock). As a consequence of these overseas investments, even executives who thought they were safe from competitive confrontations with Chinese firms have found no reprieve or escape. Though China's increase in foreign assets is absolute and as a percentage of GDP (now 15%) is impressive, as a percentage of GDP it lags far behind Switzerland (230%), Germany (59%), France (66%), Japan (42%), and the United States (39%). Therefore, there is likely even greater outward Chinese FDI flows to come going forward.

EMBRACING THE CHALLENGE

China today is no longer just a source of cheap products or a distant market of 1.4 billion consumers. China has emerged as the world's factory and the world's second-largest market overall and the largest market in many sectors. As