Chinese companies at a crossroads

By
Jean Estin
Chairman, Estin & Co

Chinese leading companies are at a crossroads. According to a five-year plan formulated by SASAC[1], the country's 120 largest companies should significantly increase the proportion of sales they generate abroad by 2015. The competitiveness of these companies and their strong financial position are naturally prompting them to pursue this route. *But is it in their interests to do so?* Should they be seeking to expand internationally now, as the large Japanese companies did in the 1970s and 1980s? Or should they first focus on strengthening their position in their domestic market, mirroring what the large US firms did over a number of decades before subsequently emerging as world leaders?

1 – The Middle Kingdom

Statistics show that over the last few years Chinese investors have been making an increasing number of acquisitions in the West. However, with a few notable exceptions, Chinese leading firms still do not have a substantial international presence (see Table 1). For example, if we take the 50 largest Chinese companies[2], only 18% of their sales come from outside China. China is the world's factory and exports 30% of its production, *but 50% of these exports are manufactured by foreign companies operating in China.*

Moreover, the large, characteristically Chinese companies operating in steel (Baosteel), car manufacturing (SAIC), construction (China State Construction Engineering) and construction machinery (Sany Group) still generate 85% to 95% of their sales in China. (This percentage rises to 100% if we look at companies operating in sectors that are traditionally state-owned, such as energy, banking, insurance and telecommunications).

The very few companies that are pursuing international strategies operate in global sectors, in which either the main markets or the resources on which they depend are generally outside China. Examples of these sectors include oil, shipyards, electrical appliances, telecommunications equipment, computing and consumer electronics.

The small group of dragons that are emerging – Petrochina, COSCO, Midea, Huawei, Lenovo and TCL – are on their way to becoming global leaders within their industries (see Table 2).

- Table 2 -

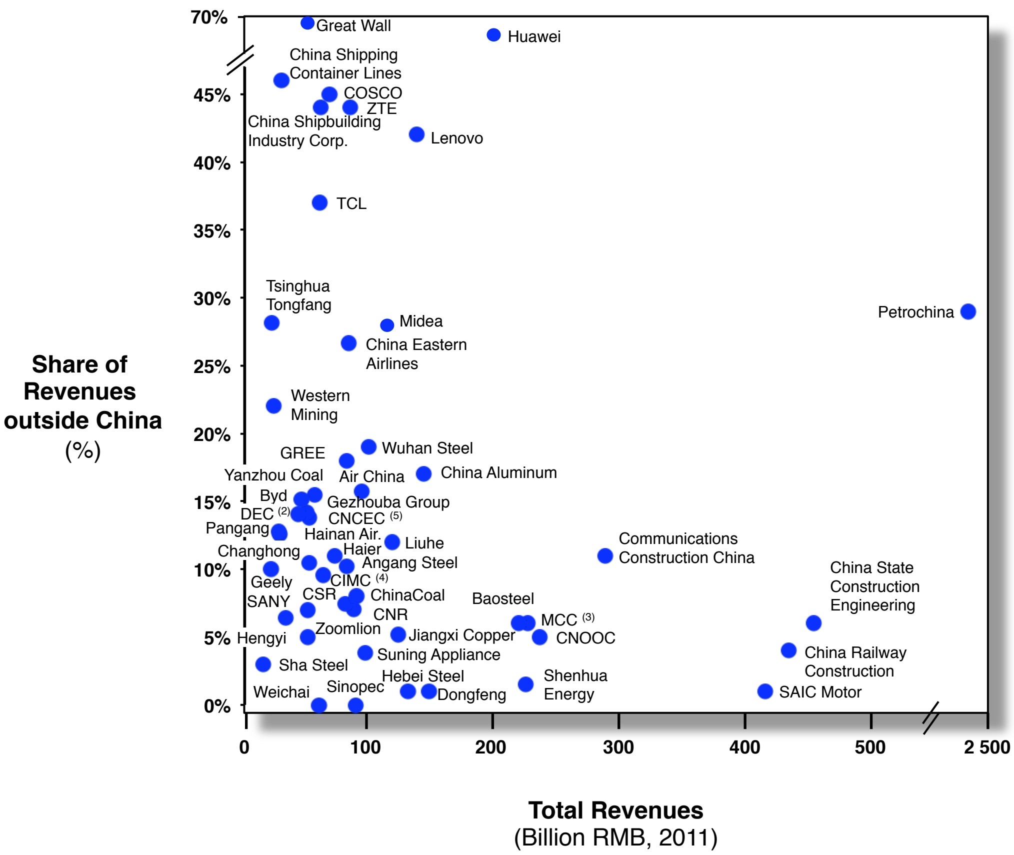
	Sector	2011 turnover (RMB billions)	2011 global market share[3]	Position in world ranking[4]
Petrochina	Oil exploration and production	2,004	10%	# 5
Huawei	Telecoms equipment and infrastructure	204	22%	# 2
Lenovo	Personal computing	140	13%	# 2
Midea	Consumer electronics and domestic appliances	109	6%	# 3
COSCO	Shipping	69	4%	# 4
TCL	LCD	61	6%	# 5

Source: Annual reports and presentations, Oanda, Bloomberg, World Energy, Estin & Co analyses and estimates

[1] SASAC: State-Owned Assets Supervision and Administration Commission.
[2] Excluding financial services firms, electricity suppliers and telecommunications operators.
[3] Global market share in relation to relevant sector.
[4] World ranking for relevant sector.

- Table 1 -

Large Chinese groups generate today a small share of their revenues from abroad
(50 main largest Chinese groups (1), 2011)



(1) Excluding banks, insurance groups, telecoms and utilities companies; (2) Dongfang Electric Corporation ; (3) Metallurgical Corporation of China ; (4) China International Marine Containers ; (5) China National Chemical Engineering
Sources: Bloomberg, annual reports, Estin & Co analyses et estimates

For example, Huawei, which is currently number two in the world for telecommunications equipment and infrastructure, has increased its sales tenfold since 2000. The proportion of these sales coming from outside China has risen from 5% to 68% in the space of ten years. Today, Huawei's main market is the US. It is number one in the world for internet mobile access equipment, mobile television and data management, amongst other things. 30% of its production is made outside China, mainly in South-East Asia and India. 40% of its R&D workforce is based outside China, mainly in the US and Europe (the UK, Germany, France and Scandinavia).

Contrary to common belief, the large Chinese companies that decide to expand internationally are capable of becoming world-leading firms in a short space of time, even in technological industries. *But is this the right strategy?*

2 – Chinese companies at a crossroads

It is tempting here to draw a parallel between Chinese companies and the large Japanese companies that mounted a challenge to western firms in the 1970s and 1980s, and later in the 1990s, becoming global leaders in the main rapidly developing industries of the time (e.g. cars, electronics). Toyota, for example, went from selling 5% of its cars outside Japan in 1960 to 40% in 1970. Today, this percentage stands at 80%. However, to draw such a parallel would be to forget that Japan was a small market in the world and that it was impossible for Japanese firms in the 1970s and 1980s to build up industrial scale and develop competitive cost positions without winning global market shares.

Chinese companies today are actually in the same situation as the large US companies of the 1950s (see Table 3). They have a vast, uniform, and rapidly developing domestic market to focus on, which has the potential to create economies of scale for companies that succeed in carving out a leading position for themselves. Chinese firms are predominantly multi-activity conglomerates that are only marginally profitable. They will need to overhaul their portfolios in order to channel their resources into becoming leaders in a small number of sectors. They need to invest heavily in order to transform their business model from one based on industrial economies of scale and mass production to one focusing on state-of-the-art technology and differentiated approaches to end clients.

Given this context, is it worth wasting resources on breaking into markets in extremely competitive, small western countries with no growth, paying out much higher costs to do so and at the same time risking losing market share in what will ultimately turn out to be the world's largest market?

All things being equal, 15 years from now China will account for 20% of the world economy, and the size of its markets will be on average equal to or 10% to 20% greater than that of comparable US markets, as well as 9 to 10 times greater than that of comparable French markets. A clear leader in the Chinese market would automatically be a market leader or co-leader worldwide.

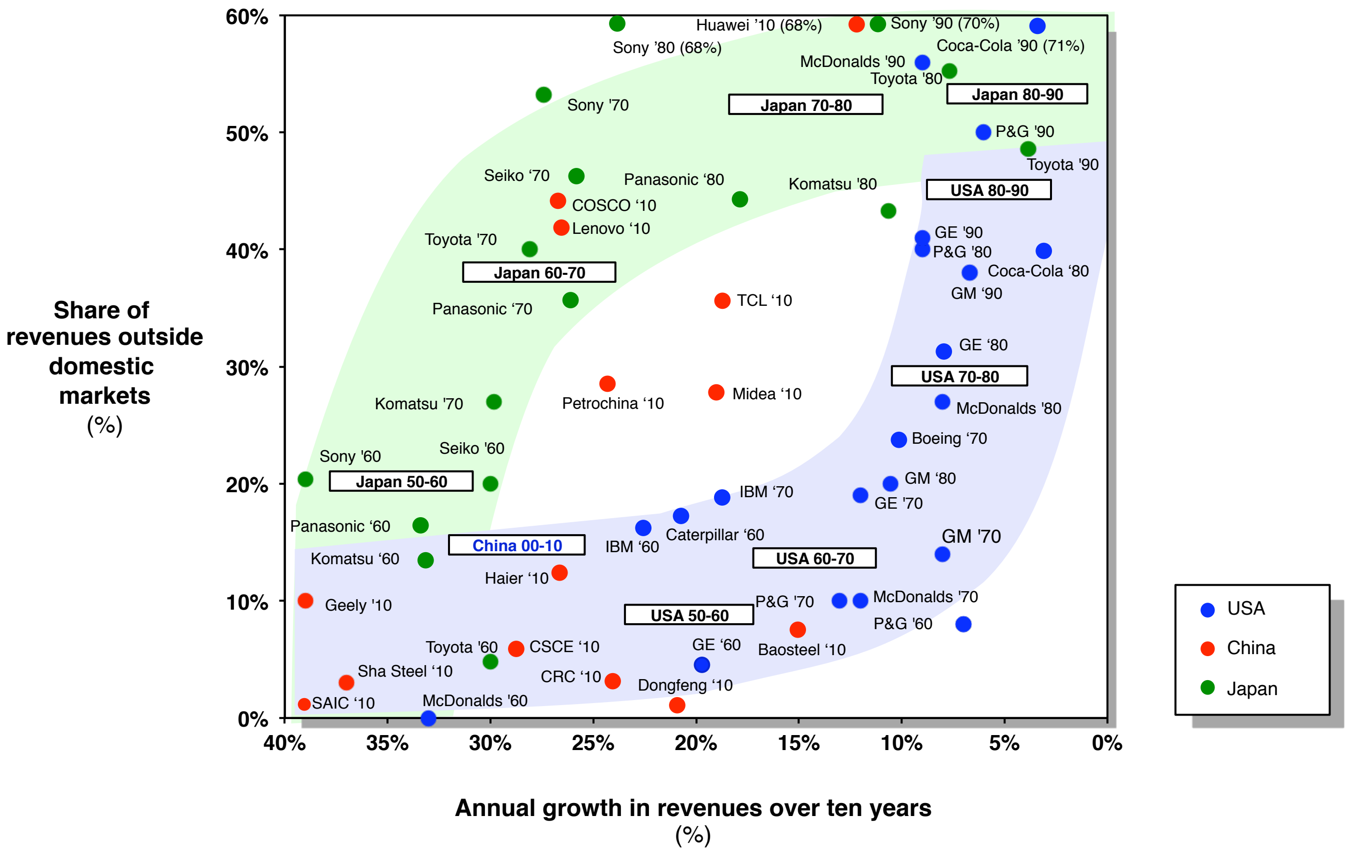
US companies did not start to expand internationally until the 1970s and 1980s, after focusing first on their domestic market. Their move to capture market share abroad was also influenced by three factors: slower growth in the market, an extremely high concentration of market players and powerful antitrust regulators. Supported by a vast domestic market, competitive cost positions, substantial cash flows and proven business models, US firms quickly succeeded in winning foreign market share.

The majority of Chinese large companies would probably do well to pursue this same strategy today: refocus their activities, which are currently too diversified, invest heavily, channeling resources into a small number of major markets within China in order to become established as clear sector leaders, and wait 5 to 10 years before embarking on an international growth strategy, by which time they will be supported by a strong domestic standing.

- Table 3 -

China is today in the same situation as USA in 1950-1960: A very large domestic market with strong growth for the next 10 to 15 years

(Revenues growth and share of revenues outside domestic markets, for a sample of relevant groups 1950-2010)



- **Medium size countries: fast international growth**
- **Large countries: focus on domestic market during its fast growing phase**

Sources: Harvard Business Review, Bloomberg, annual reports, Estin & Co analyses and estimates

3 – Conclusions

Aside from a few exceptions, the large Chinese companies need to predominantly focus on their domestic market over the next 10 years. The winners will emerge as leaders who are naturally destined to win market share around the world. Reversing the order of these two steps would be a strategic error.

The strategy that the large western companies need to pursue is less clear. Only a few of these companies possess the necessary resources to carve out a leading position for themselves in the Chinese market over the next ten years, in doing so securing their status as world-leading firms. Should the other companies target niche positions in the Chinese market? Should they bypass the market? Should they enter into partnerships which they are then able to control? And what is the best way for them to use this interim period so that they are capable of surviving among the wave of Chinese firms that will emerge in ten years' time?

Paradoxically, the best scenario for the leading western companies would be the one they currently, and mistakenly, fear. If Chinese companies were to expand internationally too soon, this would only serve to weaken them, handing more room for maneuver to the large western companies to carve leading positions for themselves in China.

June 2013

Estin & Co is an international strategy consulting firm based in Paris, London, Zürich and Shanghai. The firm assists CEOs and senior executives of European, North American and Asian groups in formulating and implementing growth strategies, and private equity funds in analysing and improving the value of their investments.

ESTIN & CO

PARIS - LONDON - ZURICH - SHANGHAI

Berkeley Square House - Berkeley Square - London W1J 6BD

Phone: +44 20 78 87 63 57 - Email: Estin@estin.com