Emerging Dragons: The Rise of the Chinese Multinational

Professor Dean Xu
University of Melbourne

12 November 2013
The dragons are coming
In around 2005-2006, the Chinese government initiated a “going out” strategy.

Chinese outward foreign direct investment (OFDI) has been rising rapidly since then

- $5.5b in 2004,
- $87.8b in 2012,
- $150b in 2015 (est).
Some Major Destinations of Chinese Investments (2004-2010)

- Australia
- South Africa
- Singapore
- United States
- Canada
- Russia
- Myanmar
Notable Acquisitions

- CNOOC – Nexen (2013, $15.1b)
- China Investment Corporation – Morgan Stanley (2007, $5.6b, 9.9%)
- Shuanghui – Smithfield Foods (2013, $4.72b)
- Wanda – AMC Entertainment (2012, $2.6b)
- Geely – Volvo (2010, $1.8b)
- Lenovo – IBM PC (2004, $1.75b)
- Sany – Putzmeister (2012, €0.5b)
Who made the dragons?
• At the beginning of the economic reform and “open door” policy, modern corporations did not exist in China.

• Inward FDI brought technological and managerial knowhow, just as the FDI spillovers literature (Caves, 1974; Spencer, 2008) had predicted,
  – through the “demonstration effect”;
  – through labor turnover;
  – by forming buyer-supplier relationships with local firms.
FDI to China

Total Actual FDI in 100M USD

Source: NBS China
Recent Controversies

- Charges against FDI and multinational firms: *Selling China* (Huang, 2002)
  - China’s obsession with inward FDI has adversely affected the growth of the private sector, while SOEs are less affected.
My Empirical Studies

- Used data from annual census of industrial enterprises conducted by National Bureau of Statistics (NBS) China.
- From 1998 onward, the database covered hundreds of thousands of firms in China including
  - State-owned enterprises (SOEs),
  - Collectively owned enterprises (COEs),
  - Privately owned enterprises (POEs),
  - Incorporated firms (SHEs and LLEs),
  - Foreign Invested Enterprises (FIEs).
Comparison of Profitability
(Xu, Pan, Wu, & Yim, 2006)

<table>
<thead>
<tr>
<th></th>
<th>ROA 1998</th>
<th>COE</th>
<th>SHE</th>
<th>LLE</th>
<th>POE</th>
<th>FIE</th>
</tr>
</thead>
<tbody>
<tr>
<td>SOE</td>
<td>-0.024</td>
<td>0.103</td>
<td>0.050</td>
<td>0.019</td>
<td>0.103</td>
<td>0.023</td>
</tr>
<tr>
<td>COE</td>
<td>0.103</td>
<td>0.054</td>
<td>0.038</td>
<td>0.083</td>
<td>0.047</td>
<td></td>
</tr>
<tr>
<td>SHE</td>
<td>0.050</td>
<td>0.038</td>
<td>0.083</td>
<td>0.047</td>
<td></td>
<td></td>
</tr>
<tr>
<td>LLE</td>
<td>0.019</td>
<td>0.083</td>
<td>0.047</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>POE</td>
<td>0.103</td>
<td>0.047</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FIE</td>
<td>0.023</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The table above shows the comparison of profitability for different years and categories, with ROA 1998 and ROA 2002 presented separately.
• All types of Chinese firms have benefited from FDI spillovers.

• Yes, private firms have exhibited a higher failure rate than SOEs in the presence of FDI.

• However, private firms are also the main force to crowd out foreign entrants.
Winners and Losers

# of firms 165K 162K 181K 279K 301K 412K

Source: NBS China
Lessons learned by multinationals in China
Lesson #1: Entry Strategy

- Joint venture may not be the optimal mode of entry.
  - Multinationals favored JVs because they thought they could rely on the local partners to secure the China market.
  - Yet they found that the local Chinese partners were often unable to achieve that objective due to the existence of separated regional markets and Chinese “federalism”.
• Just because you are the first-mover doesn’t mean success is secured, because once in China it is no longer business as usual.

• The biggest mistake multinational firms can make is “corporate imperialism” (Prahalad & Lieberthal, 2008)
  – assuming the same product life cycle;
  – assuming the same rules of the game;
  – assuming the same competitive dynamics.
Global Product Life Cycle

- Demand
- Time
- Emerging Markets
- Developed Markets
- Domestic Market
Kodak’s China Strategy

Population

First Level:
27 leading cities with 83m population
Higher: disposable income, brand sophistication, camera penetration and burn rate
Per capita income: $1,050

Second Level:
246 Cities with 132m population
Lower: disposable income, brand sophistication, camera penetration and burn rate
Per capita income: $750

Third Level:
393 Tertiary cities and all rural areas with 1,033m population
Low: disposable income, brand sophistication, camera penetration and burn rate
Per capita income: $330

Camera Ownership

56% 38% 7%
• Despite the prevalence of *guanxi* in China, excessive relationship building may not be cost-effective for multinationals.
  
  – The more embedded they are politically, the higher the degree of cost-inefficiency when the markets are increasingly liberalized (Sun, Mellahi, & Thun, 2010).
Lesson #4: Learning

• While early foreign entrants had to rely on their local partners for gaining local knowledge, newcomers can learn from these early entrants.

• If you lack China experience, stick with your peers and learn from them (Kim, Delios, & Xu, 2010).
Waiting for the dragons—
Some quick analyses of Chinese firms
State-Owned Enterprises

• SOEs from China are not your major contenders, and probably will never be.
  – They are more likely to be acquirers of energy and natural resources.
  – Linkage to the government is their advantage, as well as their constraint.
  – They are at risk in China’s economic transition.
Private Firms

- Private firms from China may become a force to be reckoned with.
  - They have been treated unequally in the domestic market (Xu, Zhou, & Phan, 2010).
  - They have the absorptive capacity to learn and imitate.
  - In overseas markets, their lack of high-end brands can be made up for by a large home market, which helps drive costs down (Xu & Meyer, 2013).
Many Chinese firms still have a weak governance structure that limits their potential.

- Managers of the largest companies in China are often government officials.
- Board chairmen are often the Secretaries of the Chinese Communist Party.
- Owners of many private firms are Party members, or even Party Secretaries.
- Regardless of their ownership form, their fate is often affected by political events and processes.
Conclusions

• For the most part, FDI has benefited local firms in the host country.

• Such benefits are differentially distributed, favoring firms that have the willingness and capacity to learn.

• Some Chinese firms have learned from you fast enough and may be coming to your home country.

• This doesn’t mean Western firms have failed in China; it’s a win-win situation.

• In the worst scenario, if one day you find yourself in a competitive disadvantage against Chinese firms, learn from them.
Questions?