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WILL CHINA'S GLOBAL CHALLENGERS BE THE NEXT GLOBAL LEADERS?

By Carol Liao, Christoph Nettesheim, and David Lee

Ever since Chinese companies began going global in force a couple of decades ago, their impact on worldwide business has been hard to overstate. By combining low cost with massive scale, and by taking full advantage of a huge domestic market, companies based in China have disrupted and transformed industries from telecommunications equipment to solar panels. Twenty-nine Chinese companies are represented in The Boston Consulting Group's most recent list of 100 global challengers. (See *2014 BCG Global Challengers: Redefining Global Competitive Dynamics,* BCG report, September 2014.) *Fortune* magazine's Global 500 list for 2014 includes 91 companies based in mainland China, which is now second in number only to the U.S.

But a close analysis of the Chinese corporate landscape reveals new sets of challenges driven by dramatic changes in the business environments both at home and abroad. For Chinese companies in many industries, the era of easy, rapid growth is winding down. Achieving profits is more problematic. Old competitive advantages, such as low labor costs, are beginning to erode. Innovation, marketing acumen, an intimate understanding of global consumers, and an ability to manage global, multicultural talent are becoming critical differentiators of success. Competition from companies in other emerging markets is intensifying, while established multinationals in Asia, Europe, and the U.S. are devising new strategies to defend their turf.

The new BCG list of global challengers—fast-growing, internationally minded companies with roots in emerging markets—illustrates the shifting landscape. The number of Chinese challengers has declined steadily over the years, from 44 in 2006 to 36 in 2009 to 29 today. In fact, more than half of the Chinese companies that appeared on the 2009 list have dropped off the 2014 list.

This suggests that global challengers from other rapidly developing economies are catching up with Chinese companies. But it could also mean that some of the Chinese companies on our list have shifted their focus back to the strongly growing domestic market: the list includes only companies that have at least $500 million in overseas revenue or derive at least 10 percent of their total revenues overseas.

What Shifts in Global Rankings Reveal

The changing composition of Chinese companies in global-business rankings also highlights some interesting trends. For example, only a few big Chinese industrial-goods, resources, and commodities companies appear to be making significant headway in becoming true global leaders. Most of the handful of Chinese companies currently on our list that produce steel, automobiles, or natural resources are state-owned giants that have benefitted from advantageous positions and a large market at home. Indeed, the number of Chinese industrial-goods and resources companies has declined from 23 on the 2006 list to 20 in 2014.

In another trend, only one Chinese consumer-durable-goods company, Haier, now ranks among the top 100 global challengers. In 2009, there were seven. Though Lenovo graduated from being a global challenger to an industry leader, the global standing of most of the other dropouts—also makers of appliances or electronic products—decreased. This could mean that the strategy of being a low-cost follower—coming out with products similar to those of market leaders but at lower price points—has not proved effective over the long term.

What's more, no Chinese manufacturer of fast-moving consumer packaged goods, such as soft drinks and toiletries, performed well enough outside China to be considered a BCG global challenger. The message appears to be that few Chinese consumer-goods companies have developed the strong brands, marketing capabilities, and insights into consumer tastes in different regions needed to compete globally.

Several Chinese Internet companies are successfully meeting domestic consumer needs and are now starting to translate that success abroad. Alibaba Group and Tencent Holdings are accelerating their expansions and have made big moves in the international market.

The rising importance of private Chinese companies is yet another trend. In 2009, 67 percent of Chinese global challengers were owned or controlled by the state. By 2014, that share had dropped slightly, to 62 percent. Most Chinese companies on the *Fortune* Global 500 list are also state owned, but the number of private companies has increased, from three in 2010 to eight in 2014. They include financial-services companies, such as Ping An Insurance and China Minsheng Bank, and industrial conglomerates, such as Shandong Weiqiao Pioneering Group. In addition to scale, these private companies typically have the ambition required to become potential global leaders.

The Need for New Competitive Strengths

Until now, Chinese global challengers have enjoyed a number of competitive advantages that have enabled them to emerge as international players. Chief among them have been China's enormous domestic market and low costs—especially for manufacturing labor.

The nation's rapidly expanding middle class has been a powerful source of solid, top-line growth and has provided Chinese companies with the large talent pool needed to compete globally. Access to low-cost capital, tax benefits, and government policies that encourage Chinese companies to go global and compete with foreign companies have also been beneficial.

Many Chinese challengers have also excelled at developing innovative low-cost business models, often driven by process innovation. Instead of achieving technological breakthroughs, they have seized market share and disrupted industries by delivering value for money. That has given them a huge edge in the fast-growing global market for products that are both affordable and of sufficient quality to meet customers' needs. These companies then created the capabilities to go global, confront international incumbents in more sophisticated product segments, and even acquire leading foreign brands—as Geely did with Volvo and Lenovo did with IBM's ThinkPad business.

But because of years of rapid wage increases, labor costs no longer constitute a sustainable competitive advantage for Chinese companies. As a result of cost pressures, foreign manufacturers of products such as car tires and computers intended for sale in North America are shifting some production back to the U.S. to be closer to end consumers. Other companies are shutting down Chinese garment and footwear factories and moving the work to lower-cost Asian nations, such as Indonesia and Vietnam, where foreign direct investment has tripled over the past five years.

Furthermore, low costs had led many Chinese companies to compete in parts of the industrial value chain that add the least value and generate the lowest profit margins. Many Chinese appliance makers, for example, used to focus on seizing share by developing products that were comparable with others on the market and then selling them at cheaper prices. But when those companies tried to upgrade their product lines, they were left behind. Similarly, Chinese producers of solar panels were able to gain global share with undifferentiated products by relying on massive production scale. But several then ran into severe financial difficulty when global markets became glutted and prices plunged.

In addition, Chinese companies that wish to go global are hindered because they lack adequate knowledge of consumers in target markets and experience in building leading brands. These skills are becoming more important to success in emerging markets. BCG research shows that consumer tastes and expectations in those markets are becoming increasingly sophisticated and demanding—and that consumers place high value on brands. Yet only 2.9 percent of Chinese-made products sold overseas carry the brands of Chinese companies, according to Euromonitor International. What's more, most Chinese companies still spend relatively little on consumer research. Because they usually sell their products through third parties, these companies do not interact directly with their customers. Nor do they have much of an online presence outside of China.

Inward-focused corporate cultures are yet another obstacle. Most Chinese companies beginning to go global are still new to international organizational and governance models. There are no Chinese companies in *Fortune's* ranking of the 25 best global companies to work for. In part, this is because Chinese organizations lack cultural diversity and international management: only a small fraction of China's top 100 private companies include foreign nationals on their boards.

As a result, many Chinese corporate boards lack the international experience needed to achieve their global visions. Many globalization efforts fail because Chinese companies are unable to manage cultural differences, bridge language barriers, or understand local markets. Most Chinese companies also lack global risk-management capabilities that can help them systematically identify and mitigate potential problems, such as macroeconomic shifts, policy changes, and sharp swings in exchange rates.

A number of ambitious Chinese companies have resorted to mergers and acquisitions to go global. While some have succeeded, others have run into stumbling blocks stemming from their lack of international M&A experience and from limited trust of Chinese goods by consumers abroad. Opposition from politicians, civic groups, and competing companies—which have cited concerns ranging from national security to product safety—has scuttled several prominent Chinese acquisitions of companies in the U.S., for example. Some Chinese companies that have completed offshore acquisitions have had trouble assimilating their operations and employees.

Making the Next Leap

Given their current stage of globalization, many Chinese challengers still must improve in several key areas if they are to maintain their competitiveness and emerge as international leaders. We believe that they should concentrate their focus on the following.

Compete on more than cost. To escape the trap of relying on low-value, commodity goods and to prepare for the next phase of global growth, Chinese companies must create strengths in branding, distribution, products, and research and development. They should also pay more attention to product differentiation.

Mindray Medical International has made great progress in such a transition. The world's third-largest maker of patient-monitoring devices, Mindray used to compete primarily at the low end of the market for hospital equipment, typically undercutting rivals' costs by 20 to 30 percent. But in 2008, the company adopted a new approach. It broadened its product offerings, distribution channels, and customer base and developed a series of products tailored to customer needs. It also acquired Datascope, an established brand at major U.S. hospitals. From 2007 through 2013, Mindray achieved 27 percent compound annual sales growth.

Gain better insights into end customers. Rigorous research is required to better understand the wants and needs of consumers at different income levels and in different regions in new markets. Chinese companies should use such insights to develop and enhance brands so that they appeal to target consumers.

Haier is a good example of a Chinese company that knows its customers overseas. The company has carved out a solid niche by selling innovative and high-quality—yet very affordable—home appliances in the U.S. As a result, more than 30 percent of American households own Haier products, according to the brand consulting company Millward Brown.

Chinese companies can also make better use of both digital channels (to provide information) and purchasing channels that meet consumers' needs. Most Chinese companies have experience with digital channels at home. Nearly 800 million Chinese consumers are projected to be Internet users by 2016. And by 2015, according to BCG research, online sales in China are projected to surpass $325 billion per year—more than five times the level in 2010. But because China's Internet ecosystem is fundamentally different from those of other nations, few Chinese companies have successfully translated their domestic digital models into a successful digital presence abroad.

Improve cross-cultural management. Success on the international stage requires an international corporate culture. It is not enough to recruit Chinese nationals who have studied or worked abroad. Chinese challengers must hire and retain top foreign talent from diverse backgrounds—people who know how to operate in key markets and will give the entire company a more global perspective. Companies must learn how to motivate talent from other nations; respect cultural differences; and establish systematic, pragmatic, and down-to-earth training programs to develop multicultural professional teams.

The ability to retain top foreign talent has been critical to Lenovo's success following its acquisition of IBM's personal-computer business. Lenovo has gone so far as to establish headquarters in both China and the U.S. It has also aggressively recruited local talent and launched several cultural-integration initiatives. This has helped the company to achieve a smooth ownership transition and emerge as the world's biggest manufacturer of PCs, according to the market research company International Data.

Strengthen international M&A capabilities. Mergers and acquisitions can be quick ways to develop a strong global presence, but several measures are needed to enhance the chances of success. Companies should improve the transparency of their operations and disclose more and better information. They must also establish strong ties with global stakeholders, including share owners, local communities, schools, labor organizations, and regulatory agencies.

Over the past decade, Chinese companies have made remarkable strides in becoming the big, new disruptive force in global business. Those that make some adjustments to their priorities and develop new capabilities could well make the next leap into positions of global leadership.

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