



# Cluster companies in China's Zhejiang Province – part II

How they operate

By Professor Jean-Pierre Jeannet - July 2009

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**In the second of three articles on industry clusters in China's Zhejiang Province, Professor Jean-Pierre Jeannot explores how Chinese firms operate within a cluster - a concept that may be alien to the western observer, but a linchpin in Chinese enterprise...**

To recap, industry clusters in China are on a different scale to their equivalents in other parts of the world. Here they can represent several thousand enterprises, from small to large, in a limited geographic area and all engaged in the same sector. From silk ties to socks to auto accessories – each industry has its cluster in China.

As part of my research into this subject, I wanted to find out how Chinese firms in Zhejiang operate within this structure and what constraints they face.

Each cluster has firms that I call “cluster captains”. These firms tend to be larger than the rest, are active internationally, and represent the best technology. In addition, cluster captains are often the industry association leaders, or their CEO/Chairman is also the Chairman of the industry association.

While in the western economies we differentiate ourselves from others, cluster captains are happy to exploit opportunities to, for example, purchase at low cost and save capital. There is also an increasing focus on brand building within the clusters.

This means that cluster captains gain a large part of their competitiveness from the cluster as a whole. Since clusters are very local and closely located, it is difficult for other companies who operate outside the reach of the cluster to tap into them.

You might expect cut-throat competition between cluster members. In fact, they are eager to collaborate with many sourcing raw materials jointly and setting up websites for the export of finished products. But with room for only a few cluster captains, the majority of firms will need to find their place as “crew members” working for the cluster in the role of industry organizer, or as sub-suppliers of cluster captains.

It all sounds quite straightforward, but inevitably cluster companies face problems. The main issues are resource constraints inherent in the structure, location, and the Chinese business environment – namely constraints on real estate, human resources, capital and technology.

## Scarcity of land

One issue that came up time and time again was the scarcity of land to expand. Most clusters are very densely populated with land often belonging to local farmers who are willing to lease but not sell it. But leasing rather than owning land restricts credit or mortgage options for companies. They get just 25% financing on equipment, and could do much better if factories were built on their own land.

Some firms want to update their processing methods by installing machine-operated production lines, but they have been forced to put expansion plans on hold pending a resolution of the land issue.

In some cases, companies have moved away from the original clusters to cities such as Shanghai where land issues are less restrictive. When they do, they risk cost disadvantages due to transportation and logistics issues.

## The talent pool

Many firms expressed concern about the lack of sufficient talent to embark on their expansion plans. In particular, R&D and marketing professionals are hard to come by – partly due to the location of clusters and partly the distribution of residence permits.

University graduates expect to live in and obtain residence permits for major cities. Most of the PhD students in my research seminar admitted they would not choose to move to some of these cluster cities. Furthermore, Chinese residents cannot move to a new place without a permit. If they do, they won't have access to social services from the municipality.

Most cluster captains like to retain all activities, including innovation, research, marketing and branding, in the same location, whereas firms in Europe and the US are used to splitting these functions if it serves the recruiting of talent. Basing high value-added functions in major cities would increase the talent pool, but the local government and the cluster associations might not want to see this happen.

## Capital

The world financial crisis has had an impact on cluster captains. Those who could still manage an IPO prior to the big stock market decline have an advantage, some holding still substantial cash reserves. Others, who would now be ready for expansion and would raise capital through an IPO, find themselves restricted.

Zotye Auto is a typical example. The company has made its name as an auto parts suppliers to Chinese OEMs and began to develop and market its own car brands. Managing five platforms yielding 13 models, the company is under producing against its potential in China. The company needs to invest about \$30 million into capacity expansion but does not think an IPO will be possible before 2011. The company believes it could sell 10,000 additional cars (current capacity set at 80,000 units) annually if it could get access to additional capital.

Other industry clusters require less capital to operate than the automotive industry. Governments at all levels are willing to extend grants for research projects and some companies will be eager to move some capital-intensive steps into the cluster and concentrate their own financial resources on marketing or development.

## Technology troubles

Upgrading both production and design technology is a big issue for cluster captains. As technology moves on a pace, cluster companies have already ordered, or are about to order upgraded equipment - much of this from overseas companies.

Additional R&D resources will be needed to move from a to-order manufacturing base to create their own models. And several companies admitted that they would need to substantially increase their R&D expenditures as a percentage of sales, which will be a drag on initial profits.

For many of these Chinese firms, this is the first downturn that they have experienced. It will be interesting to see what actions and strategies they will use to see them through – and that's exactly what I'll be covering in my final article on industry clusters in the Zhejiang Province.

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