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DECODING THE SECRETS OF SUCCESS OF CHINESE PRIVATE COMPANIES

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Chinese privately owned enterprises (POEs) have played a major role in the rapid economic development of the nation. According to China's National Bureau of Statistics, POEs' contribution to the country's GDP rose from 40% in 2000 to 50% by the end of 2005. Their contribution to tax revenue, export and import volumes, and urban employment had surpassed three-quarters of the respective national totals. More recent statistics show that POEs have also outperformed state-owned enterprises (SOEs) in terms of profitability.[1] More than 90% of POEs are small enterprises. Considering that 30 years ago POEs were virtually non-existent, their rapid ascent in the Chinese economy is impressive. Most POEs, unlike their state-owned counterparts, have relatively humble beginnings with limited resources and compete in low-margin businesses. As they grow, they are increasingly becoming the engines of the local economy and posing tough competition for multinational companies (MNCs) in the China market.

In 1993 Deng Xiaoping gave a series of talks – referred to subsequently as the Southern China Speeches – which were widely credited with reaffirming China's resolve to continue reforming and opening up the country. It was no coincidence that the Chinese economy experienced accelerated growth from that point on. In the meantime, the legitimacy of POEs in China's nominally socialist market economy was gradually established. In our book *Made in China: Secrets of China's Dynamic Entrepreneurs,* we analyze the growth trajectories of 20 such firms. Out of the 20 entrepreneurs we interviewed, 14 had an average of 15 years of industrial experience in their respective businesses. The starting point of these entrepreneurs' business careers pretty much coincided with the takeoff of China's explosive economic growth. As we learned about the success stories of these native-born Chinese businessmen, several common themes emerged which help explain the phenomenal success of POEs over the last two decades.

Starting at the low end of the market

Initially, many POEs targeted the low-end markets. Typically, this was not a conscious strategic choice. Rather, it resulted from a lack of financing and the necessary know-how to reach beyond these segments. Most POE funding would be borrowed from relatives and friends. At least at the beginning, the staff often consisted solely of spouses, children and other relatives. However, even in such modest circumstances, one thing worked to their advantage: The entrepreneurs had intimate knowledge of their target market. They had an intuitive understanding of China's huge potential as its citizens began to move towards a more material world. These customers are extremely price conscious, so grabbing a share of this segment of the market requires an

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appreciation of their needs without losing sight of the limitation of their wallet size.

From the countryside to the cities

Many Chinese entrepreneurs, well versed in Mao's writings, espoused his strategy of "starting from the countryside and encircling the cities" – outlined in his 1940 treatise "The War of Resistance against Japan" – and applied it to their business planning. This strategy was closely related to the fact that China's rural areas, where people generally have limited income opportunities, account for the great majority of China's low-end mass market. In their early stages, POEs usually make and/or sell products targeting low-end markets, expanding market share and building their brand through distribution networks covering the extensive rural areas. Once they have built up enough strength, they try to break into urban areas and move to the mid-tier or high-end markets, where they might pose a challenge to the dominance of MNCs.

The competition between Nice Group – China's leading detergent manufacturer – and P&G is a pertinent example. Nice's precursor was a rural workshop located in a remote village that no one had heard of. It made its name with two laundry soaps under the Eagle brand that targeted the rural market. As washing machines became more common in Chinese households, Nice expanded into the mid-tier urban market by moving into the laundry detergent business in 1999. Having established the Eagle brand name with its laundry soaps, Nice in its advertising campaign emphasized the message "Choose what is right, not what is high price." Helped by its lower pricing relative to similar products made by MNCs, in just one year Nice quickly captured by far the largest share of the market. A year later, in 2001, its sales volume was five times the total of all MNC competitors in China. Later, Nice introduced two new products – natural soap powder, designed to be the next-generation laundry detergent, and nutrition toothpaste – both targeting the mid- and high-end markets. At the end of 2003, when it began to reconsider the importance of its "mid-tier market strategy," P&G announced its Eagle Shooting Campaign – a clear indication that it considered Nice a strong and serious rival.

Benefiting from gaps in the market

With many POEs starting in low-end markets, and with MNCs entering the Chinese market by focusing on high-end markets in urban areas, this often leaves a void – the mid-tier markets, which supposedly demand products of sufficient quality at a reasonable price. Some POE entrepreneurs have had the insight to spot this market opportunity and act quickly. Having achieved success in the mid-tier markets, they can attempt to penetrate the high-end markets, posing a direct threat to the MNCs. Opple Lighting, established in 1996 and now the leading lighting manufacturer, is a case in point.

Wang Yaohai, one of the co-founders of Opple Lighting, entered the lighting industry in 1994 by selling lamps for his brother-in-law. Like many other entrepreneurs in China who have started from scratch, Wang and his wife gained first-hand knowledge of what sells and what does not in a highly fragmented market, with over 10,000 small local manufacturers engaged at the low end. Global industry leaders such as Philips, GE and Osram, mainly targeting the high end, accounted for less than 10% of the whole market.

Wang and his wife witnessed the maturing of the household lighting market and the evolving buying habits of their customers. In 1996, seeing the market opportunities for energy-saving lamps, they founded Opple Lighting and set up a factory. In terms of technology and market research, their company was not in the same league as international powerhouses like GE, Philips and Panasonic. Although international companies saw opportunities in China when the government promoted its "Green Lighting Project" and encouraged energy-saving fixtures, energy-saving lamps costing €20 were simply too expensive for the majority of the Chinese population. For the price of €1, Wang offered a product of acceptable quality which appealed to many customers. Furthermore, he worked on improving the quality of this lamp. As a consequence, Opple stood out among the domestic low-price competitors.

In 1998, when a growing number of competitive products reduced the profits on energy-saving lamps, Wang refused to join the price war by compromising on quality. Instead, he began producing lighting fixtures and lamps aimed at the middle segment under the Opple brand. Opple's products were of better quality than local products and cost less than the international brands. This enabled the company to avoid both the price war among local manufacturers and the head-on competition from MNCs. By 2000 sales had reached €30 million and they were up at €180 million by 2001.

As Chinese customers' buying power grew, Wang devoted more efforts to building up the brand, improving product quality, and increasing marketing efforts. By 2006, Opple was a domestic industry leader with revenues of over RMB 1 billion. The mid-tier strategy had paid off!

Moving up the value chain

Most of the 20 POEs we interviewed followed the typical three-stage growth path: From trader to manufacturer to technology developer. In the trading stage, POEs gain know-how about the market, products, sales and management, as well as building up their distribution networks and accumulating funds. As they master manufacturing techniques and gain production management expertise, they enter the second stage of scale production (as contract manufacturers in many cases). Eventually, in the third stage, some go on to invest in R&D to establish their own brands.

The time taken for this evolution varies according to the industry. For Nice Group it was relatively rapid compared with Liu Qiongying's transformation. She started her business in 1986, at the age of 16, when she had to leave school to help her father make ends meet. Using family savings of RMB 600, she managed to rent a nine-square-meter room to sell shoes. By the following year, she had saved enough money to double the size of her store. When she realized that wholesale margins were much more generous than those in retail, she moved into the wholesale business as well.

In the fifth year, the accumulated profit reached RMB 1 million, laying the financial foundations for her first shoe-manufacturing plant. In the late 1990s, faced with a surplus of stock that she could not sell, and on hearing that Russians "might need shoes," she filled two suitcases and set off for that country – even though she was unable to speak a word of Russian or English. She started selling shoes from door to door, and was soon a successful exporter, extending her reach to other eastern European markets. By then about 70% of her business was OEM and some 30% was self-owned brands. With the importance of creating her own brand now high on the agenda, she invested in R&D by building a design team and also outsourced R&D projects to Italian and Spanish design companies. Finally her own brand came to be known in parts of China.

Summary

Entrepreneurs in Chinese POEs are typically endowed with an intimate knowledge of the local market, a vast network of *guanxi*, fine business acumen and a readiness to respond rapidly to market changes. More often than not, their industriousness and resourcefulness more than compensate for the lack of systematic corporate governance, limited access to capital markets, and an often unsophisticated approach to organization and management.

In *The Art of War,* his classic work on war strategies written more than two millennia ago, Sun Tzu famously stated that "if you know your enemies and know yourself, you will not be imperiled in a hundred battles." It is our view that MNCs are generally good at knowing themselves. Yet, their knowledge about local competitors is typically quite limited, possibly because they don't consider them as *real*

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challengers and therefore don't think they are worth watching too closely. However, we suggest that MNCs can learn from the POEs' approach to business and their agility and flexibility, which can be surprising to outsiders.

Obviously it is more difficult for a giant corporation to make fast moves, but many large companies tend to over-analyze, make centralized decisions from headquarters for the local market, and by the time they get round to acting it is too late. Perhaps it is worth thinking about quicker decisions, with more tolerance for failure and readiness to adapt if things are not working. Likewise, perhaps MNCs need to think more about their target markets and what their local customers want because Chinese customer needs and the market environment may be fundamentally different from those in developed countries. As in the Opple example, a €20 light bulb is just too expensive for the majority of the population if there is a good enough one for €1. In our opinion, MNCs would do well to consider the POEs as serious competitors, not only in the Chinese market but also globally, instead of operating under the misapprehension that the most challenging competition they face in China comes from other MNCs.

1 Zhang Weijiong, Zhang Hua, Zhu Honghui. "On Top of Their Game: China's Top 100 Listed Private Companies." *The Link*, Fall 2007.

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