

## What Chinese Companies Must Do to Secure Globally Competitive Reputations By Vincent Leung, Jonathan Low and Professor Yang Zhang

### Introduction

To be globally competitive, Chinese companies must adopt internationally recognized benchmarks for corporate performance. Doing so will improve their reputation for quality and design, encourage global acceptance, increase market share and boost sales and profits. If they refuse to embrace these types of changes, they risk facing doubts about their financial and operational soundness.

History teaches us that companies can only compete on price for a limited period of time. China is already finding that companies in Vietnam, Sri Lanka, Morocco and Peru can deliver the same results for even lower costs. Price competition does not lead to sustainable profitability. Only performance on a broader set of metrics will deliver longer term results. Market share and financial support both depend on trust and strategy execution in globally recognized terms. A company's desire to enter new markets or initiate an IPO in New York, Hong Kong or London may depend on meeting these standards.

### **Professionalism versus family**

China's size gives its policy makers a propensity to think in terms of scale. Whether in government policy or business creation, bigness makes sense in a country as vast and populous as China. However, since Chinese economic reform took place in the early 80s, large numbers of family-run businesses have sprung up. Some of them have grown but many have remained smaller. This is due in part to a second aspect of Chinese culture; despite the size of the country – or perhaps because of it – the family unit remains very important in business creation and management.

While there are many benefits to family operations—trust, familiarity, and operational cohesion, for example—family-run businesses tend to undervalue professionalism as it is perceived to be a weaker metric for generating revenue or solving problems than *Guanxi* (connections).

In the Pearl River Delta, China's premier manufacturing hub, factory managers found that workers born in the 90s were less obedient than those born in the 70s and early 80s. Region of origin had less to do with this than a growing awareness that their skills and experience were worth more than some employers were willing to pay. Armed with knowledge gleaned from the internet via computer and cell phone, workers cast traditional notions of loyalty aside and began to realize their true value in the global marketplace. As more information about what their employers were charging foreign customers for products and services became available, workers were better able to gauge their own value.



As a result, labor disputes and turnover have grown and new recruits are less and less willing to work for factories that are reluctant to change their traditional management practices. Some business owners think that increasing salary alone will solve these problems, but trends in employee availability suggest it cannot.

Such issues are not confined to family-owned businesses, though they are most prevalent in operations where executives may benefit from family ties rather than management training. Even in large global corporations, fast growth often results in the promotion of skilled workers with little formal education. Whether a company is family-owned or not, management must think longer term to improve governance and increase margins, focusing on which practices provide the company with its most productive opportunities.

The practices prevalent in family-owned management styles are the greatest threat to the reputation and financial stability of Chinese companies. This is exemplified by the accounting scandals that have plagued newly listed firms with spurious financials. The perception is that Chinese managers encourage lax accounting practices to lower their tax liabilities, bilk Western investors and keep government regulators uninformed. These scandals have affected Western perceptions of all Chinese companies – large and small, public and private – so that as of this writing in the early autumn of 2011, even the largest multinational banks and oil companies are now viewed with suspicion.

The lesson is that listed companies, along with those with the intention to be listed, must raise the level of their operational integrity and keep it consistent before, during and after the IPO process. Formalizing board meetings, monitoring compliance, promoting integrity and empowering internal audits are major activities which could raise the professional level of companies in China.

The accounting irregularities and business mishaps of some New York listed Chinese firms have led to lower trust and decreased interest of foreign investors toward Chinese enterprises, both those listed overseas and those either private or listed domestically. Practices such as keeping more than one set of books and manipulating numbers are no longer as easy to hide as they were a decade ago. Chinese companies should focus on the strength of their products or differentiated services as their primary selling point. The values of human capital, structure capital, network capital and social capital are increasingly recognized worldwide. Intangibles are becoming competitive advantage, catching the attention of intelligent investors and gaining their trust.

### Transparency and financial reporting

In a global economy, distance and culture can be bridged by technology, but only if the information being shared is trusted. Business owners and executives are frequently opposed to disclosing too much information. They usually cite as reasons the fear of revealing competitive secrets or inviting additional regulatory and tax authority scrutiny.



However, global business requires greater disclosure because shared assumptions – from language to metrics – are often misleading. Sharing information gives companies a strategic advantage because it enables the company to shape perceptions of its prospects rather than conjecture and the competition.

A Chinese company that has benefitted from this approach is ICBC (Industrial and Commercial Bank of China). To prepare for its IPO in 2006, the company and the government of China initiated a series of asset transfers, capital injections and non-performing loan transfers. Rather than conceal the problems, the company informed investors and analysts of the actions. As a result, the bank floated the largest IPO in history up to that time. It later became the second Chinese bank permitted to open a branch in New York City. And in 2011, it was named China's most valuable brand.

An investor who bought shares in the Chinese 68 companies that have gone public in the US since 2008 would have suffered an average loss of 24%. Had that investor bought shares in the non-Chinese companies that went public during the same period, she would have realized an average gain of 25%. The New York Stock Exchange and NASDAQ have halted trading in 21 Chinese small and midcap stocks in 2011.

The primary reason for all of this is that financial scandals based on fraudulent accounting have raised suspicions about the integrity of Chinese accounting. The 'quality of earnings' is a constant topic of discussion among securities analysts. Chinese companies that used firms willing to change numbers to make the company look better may have benefitted in the short term, but their long term viability is unsustainable. Companies like Sino Forest, Long Top Financial and Duoyuan Global Water have become synonymous with dishonest reporting, angry investors and legal investigations.

These scandals, and others like them, have negatively affected the reputations of all Chinese companies, limiting their ability to go public or seek outside investors. The impact of transparency on market penetration can be seen in the cases of Haier and Lenovo. Not only did they work to win the respect and continued business of global consumers, they communicated how they were doing so – even though it was not required. In 2009 Haier was named number one in global market share among major appliance manufacturers. Lenovo has announced that its goal is to become number two in global personal computer market share by the end of 2011.

### Improving Marketing, Brand and Reputation

Foreign products with the "Made in China" label have become commonplace. Even so, there were no Chinese brands included on the list of 2011 Best Global Brands published by the international brand consultancy Interbrand. Despite its sheer economic might, China hasn't been able to create a world-class brand of its own.



The advantages which Chinese companies possessed prior to the 2008 financial crisis have gradually disappeared. Being confronted with competition from efficient and low-cost manufactures in Vietnam, Indonesia, and other countries and regions, as well as the threat of trade protectionism from overseas markets, Chinese companies are finding that they have to modify their low-cost strategy and find a new growth engine.

Traditionally, Chinese companies have not had strong motivations to market or brand their products and services for global acceptance. China's huge domestic market potential has provided great opportunities for any entrepreneur able to start their own business and grow it. But now Chinese companies are seeking to enter markets abroad where margins are higher. At the same time, foreign companies are entering the Chinese market because its size is now complemented by a rising living standard, producing a middle class consumer segment which has the financial means to buy higher quality and higher margin products.

The advantage of a global brand is that, once established, it enables broader marketing opportunities both in current markets and new ones. It also provides a pricing umbrella to protect margins. This enables further product development while creating a barrier to entry for potential competitors. Due to customer brand familiarity and favorability as well as cost hurdles, newer entrants have to swallow high advertising expenditures to achieve recognition and scale.

To build a global brand, Chinese companies can cultivate their own brands such as Galanz (a microwave manufacture which has made inroads in the West) and Kangnai, a leather shoe maker and the first Chinese shoe manufacturer to enter the global market. Another approach is to purchase instant global recognition through acquisitions, for which Lenovo's purchase of IBM's PC division in 2004 and Chinese automaker Geely's purchase of Volvo are the best examples.

Whatever the brand strategy might be, Chinese companies may encounter perception issues. Though many Chinese companies have mastered advanced production technology and can manufacture high quality products, in most of foreign consumers' minds, 'Made in China' still denotes cheapness. The reputations of brands new to a market are colored by consumer perceptions of other products, even if the related industry is not notorious for faulty products.

In the course of building a global brand, Chinese companies must also learn how to create and manage a positive reputation both for its product and corporate brands. Reputation is the overall perception various stakeholders have about a business, product or service, both cognitive and emotional. A good reputation not only increases customers' confidence in a company's products, services, and advertisements, it enables companies to achieve price premiums and win the war for talented employees. It can help companies to reinforce their competitiveness and cannot be easily imitated by rivals.



A good reputation can help protect companies from negative news and unfair competition. It can deflect the longer term impact of crises like oil spills, deficient construction materials and unsafe food products or toys. Reputation reflects the perceptions of multiple stakeholders. Chinese, like most other consumers, enjoy new products from outside their home market, but there is a perception that such products are more expensive than those produced domestically. There is also an inherent bias in favor of Chinese products, which reflects both national pride and cultural familiarity. When companies enter new markets, they must be aware of how local culture and local consumers' perceptions will affect their reputation.

Effective management of the relationship between brand and customers is a challenge that extends beyond just products and services. Chinese companies are learning that as they expand globally they have a greater stake in respecting and protecting intellectual property rights. They are now subject to the same threats that foreign companies face entering the Chinese market. Chinese companies must learn how to protect themselves by taking advantage of the tougher IP protections available outside China. Research has demonstrated that returns to transparency outweigh returns to secrecy. To quickly adapt to foreign business environments, Chinese companies should learn how to effectively use business partnerships and alliances.

### Conclusion

In sum, as Chinese companies expand internationally and as more Western companies expand into China, Chinese managers are finding that the assumptions on which they have built their businesses since the late 1970s are changing. As they become more familiar with the impact of intangibles like management credibility, strategy execution, brand, reputation, communications, innovation and human capital, acting on this knowledge will enhance their competitive strength.