**EMERGING DRAGONS: THE RISE OF THE CHINESE MULTINATIONAL**

*Western companies can perhaps learn from their once students.*

**BY DEAN XU**

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**The dragons are coming**

Unlike most of my colleagues at the University of Melbourne I started my academic career in a Chinese university, and spent the next 12 years in China, so I had the opportunity to observe Chinese companies rather closely. One thing that struck me was the enormous progress made by Chinese companies, both domestically and internationally. In 2001, when I finished my PhD and went to China, the country was at the eve of its World Trade Organisation (WTO) accession. At the time there was much discussion about the potentially negative consequences of WTO access on Chinese firms. Newspapers were full of headings such as ‘the wolf is coming’. Yet, such fears quickly dissipated. By 2006, the Chinese government was confident enough to launch a policy initiative commonly referred to as ‘the going-out strategy’ which called upon Chinese companies to focus internationally and invest directly in foreign countries.

Since then, Chinese outward foreign direct investment (OFDI) has increased substantially. In 2004, China’s total OFDI was roughly $US 5.5 billion. It reached $US 87.8 billion in 2012, and is predicted to be $US 150 billion by 2015. Much of this OFDI takes the form of international mergers and acquisitions (M&As). Examples of notable M&As are provided in Table 1. Further, a significant part of this OFDI came to Australia. If we exclude the three tax havens of Hong Kong, Cayman Islands and Virgin Islands, then Australia received the largest share of China’s OFDI during 2004–2010, among all countries.

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**Table 1: Examples of Notable Acquisitions by Chinese Firms**

<table>
<thead>
<tr>
<th>Acquirer</th>
<th>Target Firm</th>
<th>Amount</th>
<th>Industry</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>CNOOC*</td>
<td>Nexen</td>
<td>$US 15.1 billion</td>
<td>Energy</td>
<td>2013</td>
</tr>
<tr>
<td>CIC**</td>
<td>Morgan Stanley</td>
<td>$US 5.6 billion (9.9% equity)</td>
<td>Financial services</td>
<td>2007</td>
</tr>
<tr>
<td>Shuanghui</td>
<td>Smithfield</td>
<td>$US 4.72 billion</td>
<td>Food</td>
<td>2013</td>
</tr>
<tr>
<td>Wanda</td>
<td>AMC</td>
<td>$US 2.6 billion</td>
<td>Entertainment</td>
<td>2012</td>
</tr>
<tr>
<td>Geely</td>
<td>Volvo</td>
<td>$US 1.8 billion</td>
<td>Automobile</td>
<td>2010</td>
</tr>
<tr>
<td>Lenovo</td>
<td>IBM PC</td>
<td>$US 1.75 billion</td>
<td>Personal computing</td>
<td>2004</td>
</tr>
<tr>
<td>Sany</td>
<td>Putzmeister</td>
<td>€0.5 billion</td>
<td>Construction equipment</td>
<td>2012</td>
</tr>
</tbody>
</table>

*China National Offshore Oil Corporation
**China Investment Corporation

Source: NBS China
Who made the dragons?

So who made the Chinese dragons? Why were they able to make such rapid progress in a short period of time? The answer is at least partly found in a stream of research in economics and international business commonly referred to as the ‘FDI spillovers’ literature. The spillovers research examines the impact of FDI on local industries and firms in host countries. It posits that the benefits of FDI will spillover to local firms mainly through three channels: the demonstration effect, buyer-supplier relations, and employee turnovers (Caves, 1974; Spencer, 2008). In China’s case, all these mechanisms worked.

When the Chinese government first adopted the ‘open door’ policy in the late 1970s, modern corporations did not exist in China. All China had were bankrupt state-owned enterprises (SOEs). As FDI came into the country, four Special Economic Zones were created in coastal Southeastern China, where multinational firms established joint ventures (JVs) with local firms and, later, wholly-owned subsidiaries. These foreign firms served as showrooms for technology and managerial principles which were quickly adopted or imitated by local Chinese firms. Meanwhile, as multinationals entered the Chinese market, many of them (e.g. Volkswagen in Shanghai and Tianjin) created their local supplier-networks. In order to be part of those networks, Chinese firms had to improve their product quality and managerial processes and comply with the standards of multinational firms. More importantly, there was knowledge spillover from the multinationals to local Chinese firms through labour turnover. Initially, it was the foreign firms that lured skilled labour away from local firms. In later years as the salary gap between foreign and local firms reduced, many experienced local managers and workers left their multinational employers to join Chinese firms.

Through these mechanisms, Chinese firms had made steady improvements by the time China entered the WTO at the end of 2001. Consequently, the WTO accession did not bring devastating consequences for Chinese firms. On the contrary, it simply fastened the spillover process, and facilitated learning by Chinese firms. As FDI continued to rise in subsequent years (see Figure 1), the effect of knowledge spillover also accumulated.

Of course, not everyone assesses the impact of FDI in China positively. Some believe that rather than bringing anticipated technology spillovers, FDI has had a negative impact on local industries by depressing their technological advancement. One vocal critic is Professor Yasheng Huang of MIT in the US, whose book Selling China aroused strong emotions among many Chinese people. He suggests that the Chinese government’s obsession with inward FDI has adversely affected the growth of the Chinese private sector, whereas SOEs are less affected (Huang, 2003).

My own research, however, tells a very different story. Our data are from the Annual Census of Industrial Enterprises conducted by the National Bureau of Statistics (NBS) China, which covers all Chinese industrial enterprises, including SOEs, collectively-owned enterprises (COEs), shareholding enterprises (SHEs), limited-liability enterprises (LLEs), and privately-owned enterprises.
enterprises (POEs), as well as foreign invested firms (FIEs) operating in China. Each year, hundreds of thousands of firms in China, with a minimum sales volume of five million RMB ($AUD800,000), were included in this database, making it the most comprehensive database on Chinese firms.

In the first study (Xu, Pan Yim, and Wu, 2006), we compared profitability, measured by return on assets (ROA), across different types of firms in China. At the time we had data only for 1998 and 2002 (Huang (2003) relied on the same data source, but his data were up to 1995). As can be seen in Figure 2, in both years, foreign firms lagged behind some classes of local Chinese firms, notably the private firms and collectives, in terms of ROA. The only Chinese firms that were clearly performing more poorly were the SOEs. In other words, the conventional perception that foreign firms are powerful predators, and local firms, especially local private firms, are weak victims of foreign predators, is untrue.

In the second study (Chang and Xu, 2008), we looked at the issue more closely, using data from 1998 to 2005. We examined the exit (mortality) rate of various types of firms in China, as dependent on the presence of FDI (namely, the share of foreign firms’ employment in the total employment of an industry or region). There were several major findings from this study. First, all types of Chinese firms have benefited from FDI spillovers. Second, private firms had exhibited a higher exit rate than SOEs in the presence of FDI, which is consistent with Huang’s (2003) study. Third, private firms were also the main force to crowd out foreign entrants. So we can now tell a more complete story: foreign entrants and local private firms are competing fiercely, and this is probably because by now the latter have learned enough from the former to fight back.

If these studies are not straightforward enough, then Figure 3 presents a clearer picture. From 1998 to 2008, SOEs and collectives declined, in terms of percentage in the total population, from close to 70 per cent to about 5 per cent, while private firms increased from less than 10 per cent to about 60 per cent. The percentage of foreign firms remained largely unchanged. It is quite clear that as FDI increased (in terms of number of subsidiaries in China) throughout the years, private firms became the biggest winners in the competitive dynamics.
Learning in the land of dragons

While local firms learned from foreign entrants, foreign firms also learned about operating in China. There is a growing volume of research on this topic, and I draw insights only from the studies that were either conducted by myself or related to my own research. I cover four important aspects: entry mode, business strategy, relationships, and learning.

The first lesson that multinational firms learned in China is that JVs may not be the optimal mode of entry for them. JVs became a popular mode of entry for Western firms because they thought they could rely on the local Chinese partners to secure the China market. That hope quickly dissipated, because China is not ‘a’ market; it consists of many regional markets separated by administrative boundaries. The local partner, often associated with the local government in a particular province or major city, typically is not able to carry business to other regions. Indeed, the local partner may become a hurdle to conducting inter-provincial operations because of the political and economic competition among Chinese regions. Thus, multinationals today are still faced with the difficult task of building national markets in China.

The second aspect is about strategy in China. The lesson is that, just because you are the first-mover doesn’t mean success is guaranteed, because once in China nothing is business as usual. The biggest mistake Western firms can make is ‘corporate imperialism’ (Prahalad and Lieberthal, 2003), that is, assuming the same product life cycles, assuming the same rules of the game, and assuming the same competitive dynamics in China as in other markets. Frequently, they bring outdated products and technologies to China, hoping to extend the life cycles of these products and technologies, and thinking they are good enough for a developing country. Yet China is a very dynamic and competitive market. Such a strategy would not confer any competitive advantage for the multinationals. One example is Kodak China. When I was teaching at Peking University around 2004, a senior executive from the company visited the university and did a

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Figure 4: Kodak’s China Strategy

<table>
<thead>
<tr>
<th>Population</th>
<th>Camera Ownership</th>
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<tbody>
<tr>
<td>1033 M</td>
<td>7%</td>
</tr>
<tr>
<td>393 Tertiary cities and all rural areas with 1,033m population</td>
<td>Low: disposable income, brand sophistication, camera penetration and burn rate</td>
</tr>
<tr>
<td></td>
<td>Per capita income: $330</td>
</tr>
<tr>
<td>132 M</td>
<td>38%</td>
</tr>
<tr>
<td>246 Cities with 132m population</td>
<td>Lower: disposable income, brand sophistication, camera penetration and burn rate</td>
</tr>
<tr>
<td></td>
<td>Per capita income: $750</td>
</tr>
<tr>
<td>132 M</td>
<td>56%</td>
</tr>
<tr>
<td>27 leading cities with 83m population</td>
<td>Higher: disposable income, brand sophistication, camera penetration and burn rate</td>
</tr>
<tr>
<td></td>
<td>Per capita income: $1,050</td>
</tr>
</tbody>
</table>

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Emerging dragons: the rise of the Chinese multinational
presentation on the company’s China business. With a slide depicting China’s three-tier markets (see Figure 4), she told the audience that Kodak was a market leader in the first-tier market (major cities), had a significant presence in the second-tier market (small- and medium-sized cities), and would have ample opportunity to work on the third-tier market (rural areas) for long-term growth. The company probably had developed this three-tier-market strategy in other emerging economies and hoped to replicate their success in China. However, things in China changed quickly with digitalisation, and in just a few years, even in the poorest countryside, nobody would buy traditional Kodak films any more.

Lesson number three concerns guanxi building. Guanxi, the Chinese word for relationships, is extremely important in China. However, despite the prevalence of guanxi in China, research has found that excessive relationship-building may not be cost-effective for multinationals. One study, in particular, suggests the more embedded companies are politically, the higher the degree of cost-inefficiency when the market is increasingly liberalised (Sun, Mellahi and Thun, 2010). Taking Volkswagen China as an example, the company had huge success in earlier years, thanks to its connections to the Chinese government and local networks. At a time of increasing market liberalisation, however, the company became ‘locked’ into these relationships and could not move along with market changes, and quickly lost its market leadership to GM China.

Lesson number four concerns learning by late entrants in China. While early foreign entrants had to rely on their Chinese partners for gaining local knowledge, newcomers can learn from these early entrants. However, the benefit of learning also comes at a cost. The companies you want to learn from the most are often your major competitors. My research, based on Japanese foreign subsidiaries in China during 1979–2001, indicates that if you lack China experience, it is better to stick with your peers geographically and learn from them, because this is when the benefit of learning exceeds the cost of being exposed directly to competition.
Waiting for the dragons

My analysis suggests that in the past decades, Chinese firms have learned effectively from Western firms in China, to the extent they are now at the gate of Western markets. Among Chinese firms, private firms have benefited the most from knowledge spillovers. Indeed, SOEs are not likely to be the major contenders of Western firms. So far they have been acquirers of energy and natural resources in international markets. Their linkage to the Chinese government is their major advantage, but such an advantage cannot be easily transferred to overseas markets. Moreover, this linkage can become a constraint on SOEs in a free market, as profit maximisation may not be a top priority for the government and its officials who oversee the SOEs.

The Chinese private firms, on the other hand, will likely become a force to be reckoned with in international markets. These firms have been treated unequally in the Chinese domestic markets (Xu, Zhou, and Phan, 2010), and so they are eager to come to the international markets with better property rights and investor protection. Their technological advancement has often been neglected or ridiculed. Nevertheless, they have shown that they have the absorptive capacity to learn from and imitate their competitors. Their major disadvantage overseas is their lack of high-end brands, but such a disadvantage can be made up for by a large home market, which helps drive costs down (Xu and Meyer, 2013). If they can somehow combine the brands they acquire from Western companies with this huge home market size, they’ll be able to secure a unique competitive advantage the Japanese and Korean multinationals were not able to achieve in the past.
This large home market notwithstanding, a common weakness in most Chinese firms is a poor governance structure that limits their potential. We know that the managers of many large 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 and even Party secretaries. These facts are often neglected, or pretended to be forgotten, when people analyse Chinese firms. But the truth is, regardless of their ownership form, the fate of Chinese firms is inevitably affected by political events and processes inside China.

Conclusion

I believe that for the most part, inward FDI has benefited local firms in China. Such benefits are differentially distributed, favouring firms that have the willingness and capacity to learn. Some Chinese firms have learned from Western firms fast enough to have come to the international markets now. This of course doesn’t mean Western firms have failed in China. It’s a win-win situation: Western firms have learned in and profited from China, and Chinese firms also benefited. The arrival of Chinese firms internationally is not necessarily a bad thing. I chose to use the metaphor of dragons, because in Chinese mythology, dragons, while powerful, are not malicious or evil. Among other things, they bring rains for the crops. In the worst scenario, if one day Western firms find themselves in a competitive disadvantage against Chinese entrants, they just need to learn from the Chinese firms, just as the Chinese firms have once learned from them.

References


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