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China

## **A tale of two Chinas**

By Gong Li, Andrew Sleigh and Paul F. Nunes

The rise of a new economic superstructure in China—featuring companies that are already world-class—is one of two sides to the new China story. The other side is the extent to which many other Chinese companies are struggling.

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## About the research

To build up a comprehensive picture of high-performance business in China, Accenture applied its proprietary financial analysis to examine 13 industries in the country—the second year running that we have done so. The latest candidate pool included 30 additional companies that now meet the criterion of being publicly listed for five years or more. We created a detailed survey that was answered by nearly 100 senior executives from large, publicly listed Chinese companies. We also gathered valuable input by discussing our findings and

theories with several board-level representatives of Chinese high-performance businesses.

Out of the pool of 200-plus companies, 36 met Accenture's definition of high performance—companies that are unequivocally outperforming their local peers in terms of returns to shareholders, revenue growth, profitability, consistency and positioning for the future.

Zhejiang province, with its entrepreneurial spirit and small businesses producing low-cost goods, has in many ways been emblematic of China's extraordinary economic growth. Following its own development model, the eastern coastal province became one of China's richest; in 2007, it boasted a GDP of about \$255 billion and per capita disposal income for its urban residents of \$2,800.

Then the global economy hit a wall.

Today, China's businesses stagger under the burden of rising costs, sinking demand, talent shortages and tougher regulations. As export activity sags and Beijing encourages the phasing out of "backward production practices," a major shakeout is well under way in many industries. And in once-booming Zhejiang in the second half of 2008, companies were shuttered at a rate of more than 200 a month.

China's companies find themselves caught in a kind of economic perfect storm. The world is sinking deeper into recession just as these enterprises are losing their traditional competitive advantages of low-cost labor, natural resources and capital.

However, recent Accenture research suggests that although no company in China will escape the effects of the downturn, some businesses are dramatically better positioned than others to weather this storm. During the past decade, the country's strongest companies began to open up noticeable leads over others in their industries (see "About the research," above).

Lately, their leads have widened. The research indicates that the choices that put these companies on a path to high performance before the crisis will also enable them to ride out the current turmoil and emerge even stronger.

The rise of this new economic superstructure in China—featuring companies that are already world-class in their successes today and their positioning for tomorrow—is one of two sides to the new China story. The other side is the extent to which many other Chinese companies are struggling.

The implications for global business leaders are profound. On the one hand, they need to recognize just how muscular China's top performers have become and adjust their strategies accordingly. Yet they must not generalize about Chinese

The frailty of many Chinese businesses gives the country's solid companies new opportunities for growth.

competition; instead, they need to assess the myriad opportunities now being revealed as so many other Chinese companies lag behind.

China's leading companies are pulling ahead of their peers at an astonishing clip. Companies such as computer maker Lenovo, Gree Electric Appliances and China Mobile are achieving world-class levels of performance, moving smartly up the value chain with higher-priced, higher-quality products and services whose improved features appeal to carefully targeted customers. In fact, nearly 90 percent of China's high performers are prioritizing investments that will add more value to their products and services over the next three years (see chart, page 4).

By contrast, half of the low performers are still relying on the low-cost advantages that have served Chinese companies so well until recently.

At the same time, many of their local competitors are struggling now that the basis of competition has changed so dramatically. Earlier this decade, China's poorest performers, powered by their low-cost advantages, were growing nearly seven times faster than their global peers. But in the past few years, they have fallen behind them in revenue growth.

In terms of profitability—generating returns on invested capital higher than the cost of capital—the picture has been consistently gloomy. Measured over the long term, Chinese companies have achieved lower and even negative economic profits compared with their global counterparts. In the short term, China's high performers have made huge strides to narrow the profitability gap with the world's best companies. But the nation's average and low performers have actually destroyed economic value.

This widening performance gap has serious implications for competitors, Chinese and non-Chinese alike. By learning what propels China's most successful companies—the Grees and Lenovos as well as the next wave of strong players, such as Wuhan Iron and Steel Corp. and pharmaceuticals giant Yunnan Baiyao Group Co.—business leaders in the rest of the world will be better able to compete with them in global arenas.

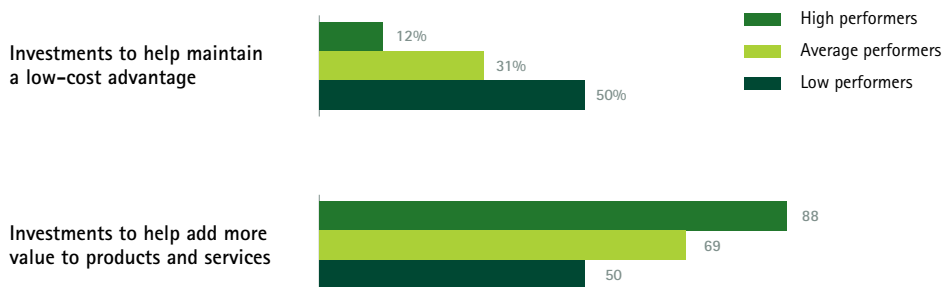
At the same time, the frailty of many other Chinese businesses gives the country's solid companies new openings for growth. Understanding what creates high performance will help the average contenders to reach parity with the best Chinese companies and thereby allow them to tap into new opportunities afforded by the wide-ranging domestic stimulus package now being implemented by Beijing.

The downturn, coupled with the performance gap, has also revealed to non-Chinese companies opportunities in China that the country's blazing economic expansion has obscured until now. Those already with a presence there are well placed to capitalize on the push to boost domestic demand. Not only can they promptly gauge local customer needs—for example, assessing where the rural component of the government's stimulus and reforms will offer the most opportunities—but they already have the commercial and political links and the established distribution channels to quickly take advantage of those opportunities.

At the same time, they are positioned to decide which of China's weak performers are worth trying to acquire, or at least to acquire key assets from. Others that have yet to engage—perhaps in the belief that most opportunities were spoken for by tough domestic players—can now envision how to participate in China's next wave of growth, possibly through acquisitions or joint ventures.

## Investment priorities

Accenture recently surveyed a wide range of Chinese companies. They were asked what their most important investment priorities would be over the next three years.



Source: Accenture High Performance Business China survey, 2008

### Positioned for excellence

Just how have China's high performers excelled as rising costs have eliminated past advantages? And how have they positioned themselves to prevail in the face of global recession?

Accenture's research has isolated nine attributes mastered by China's top companies—traits that not only offer insight and example for other Chinese enterprises but that serve as important reminders for all business leaders of what it takes to excel in today's ferociously competitive climate—economic downturn or no. Here is how China's best companies have extended their industry leads—and why they promise to be highly competitive in global markets.

#### 1. They are moving up and across the value chain.

Chinese high performers are guided by the overriding need to add value to their products and services. They know that when customers instantly associate their brands with quality and service, they can expect to see substantial improvements in margins.

They also have a clear understanding of how to actually capture more of the source and flow of that value. They are building higher-end products that command higher price premiums and greater profit margins, and they are expertly capturing more value by taking greater control of other parts of their value chains—either upstream, on the supply side, or downstream, in their sales and distribution channels. An increasing number of leading companies are using mergers and acquisitions to realize these goals.

The Erdos Group, China's flagship cashmere producer, has made concerted moves to control its entire industry's value chain. The company, which accounts for 30 percent of global cashmere production, owns many farms from which it sources raw materials. It also runs its own product design, development and production centers, and it has built a national cashmere product engineering and technical research center.

The latest chapter in the Erdos growth story: The company has opened seven international sales

Chinese high performers look beyond the nation's borders to obtain the tools for profitable growth—talent, capital and innovative ideas.

companies and 30 branded retail stores in cities where the fashion industry is prominent and where overseas demand for cashmere products has been strongest—Los Angeles, London, Tokyo, Moscow, Köln, Hong Kong and Milan. At the same time, Erdos, like other Chinese cashmere producers, is shifting its reliance on exports to a greater emphasis on domestic sales. The company will invest nearly \$118 million over five years to set up 100 flagship shops in China.

By contrast, Accenture's survey found that China's low performers are less likely to be diversifying or planning to diversify into other parts of their own industry value chain. Less than one in five low performers indicated any intention to move upstream within their own industry over the next three to five years.

2. They are globally aware and "super local."

More than three-quarters of the Chinese high performers surveyed already consider themselves global or at least regional companies. (Only a third of the low performers think of themselves that way.) But although many have robust sales outside China and some have a presence overseas, the key difference between Chinese high performers and their peers is that they have global mindsets. They look beyond the nation's borders to obtain the tools for profitable growth—talent, capital and even the innovative ideas that are the lifeblood of long-term growth and profitability (see chart, page 6).

At Baosteel Group Corp., a global mindset means that more than 1,000 of its employees have been trained in Japan, and the company has absorbed lessons from General Electric and other US companies about building a stronger and more predictable supply of experienced managers. At power generation

equipment maker DongFang Electric Corp., getting involved in the global market means carrying out technology transfers with non-Chinese companies.

A global view of intellectual capital is called for as well. Pockets of specialized knowledge exist worldwide; for example, Chinese companies in the biotech business are able to forge close relationships with their counterparts in the centers of biotech research and clinical trials in Singapore.

The high performers' global outlook complements rather than conflicts with their sharp focus on domestic markets. Yantai Wanhua Polyurethanes Co. is proof of that. The polyurethane producer sees its efforts to attract international talent and management know-how as valuable for helping it grow at home, where its greatest opportunities currently lie.

However, China's best companies are careful to identify the domestic markets with the most immediate potential. Although the government is pouring stimulus incentives into poorer rural communities, nearly 90 percent of China's high performers identify metropolises such as Beijing and Shanghai as the heart of their business. So the bulk of their investments in new, higher value-added products and services are geared to China's larger cities.

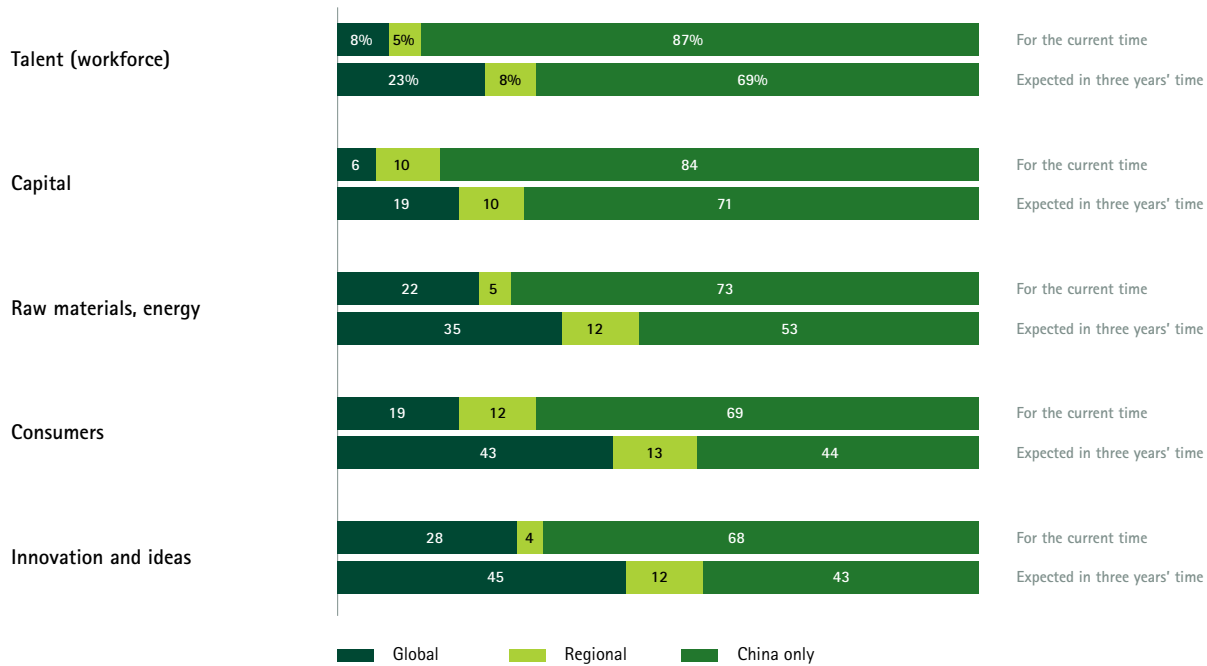
Beverages leader Yantai Changyu Pioneer Wine Company is a prime example. Most end customers for its wines and spirits are higher-income consumers in cities in China's coastal region. Sales of the company's higher-end products are growing rapidly.

3. They are implementing controlled and pragmatic growth.

There is a marked difference in approach between China's strongest

## Global sourcing

Survey participants were asked to identify the primary geographic sources for five key resources (all companies).



Source: Accenture High Performance Business China survey, 2008

and weakest performers when it comes to managing growth. Although there is still a widely shared concept in China that success means being the biggest in an industry, only the high performers have learned how to harness scale's real advantages. They realize that increased size brings opportunities such as economies of scale, distribution networks and negotiating power, and, unlike their peers, they have built processes and operating models to take advantage of those opportunities so they have greater control of their future growth.

The high performers are also particularly pragmatic about growth. To begin with, they work hard to ensure that their growth rewards a variety of stakeholders, not just shareholders (see chart, page 8). Rather than focusing solely on narrow financial metrics when developing strategy—tending chiefly

to shareholders' near-term concerns, as most average and low performers appear to do—China's high performers realize that the best way to deliver long-term value is by taking good care of their customers, their employees, and the communities and society within which they operate.

This perspective puts customers at the forefront of the high performers' mindset. China Mobile offers an example of customer consciousness in action. The company spends significantly to improve its service and promises customers that "if the bill is wrong, we return double." To back that promise, the telecommunications leader has invested in a differentiating technology—a sophisticated billing support system.

China Mobile is one of many high performers that also place a premium on meeting employees' needs. The

More companies are filing for patents, or suing to enforce patent rights, in China than anywhere else.

rationale: Engaged and contented staff members are more productive, more attuned to customers' needs and more willing to "go the extra mile." At consumer electronics company Hisense, business leaders emphasize the importance of a culture of cohesion for improving employee retention. Companies like Hisense are unlikely to reduce investments in training or career development for the sake of improving results in the next financial period.

#### 4. They put a premium on innovation in many forms.

The performance gap is readily apparent in terms of approaches to innovation. China's top companies want to extend their leads using new products and technologies fitted to their customers' needs; the poor performers tend to focus more on incremental improvements of existing products (see chart, page 10).

Nearly nine out of 10 of the high performers surveyed see investments designed to help add more value to products and services as their most important spending priority over the next three years. "A product's advantage is temporary," Li Chunbo, board chairman of Zhejiang Medicine Co., said recently. "If we want to lead the market, we have to have a keen passion for product quality and for R&D. In fact, the quality of our products reflects the company's overall quality and strength."

Superior distinctive capabilities, one of the building blocks of high-performance business, stem from innovation on many levels—not only in terms of new-product development but in business processes. China National Offshore Oil Corporation, known as CNOOC, is a case in point. In 2003, the company introduced an innovative new talent management process that gives all employees—for example, technicians as well as professional engineers—an opportunity to climb the career ladder.

The new approach circumvents the talent challenge often found in such companies, where technology staff and those from service functions are not on a defined "management track" and therefore are unable to reach senior positions. In addition, CNOOC staff are not restricted to conventional Chinese pay scales when they are located overseas. Now CNOOC can offer attractive expatriate compensation packages—as global rivals like ExxonMobil Corp. and Total do.

#### 5. They build innovation systems.

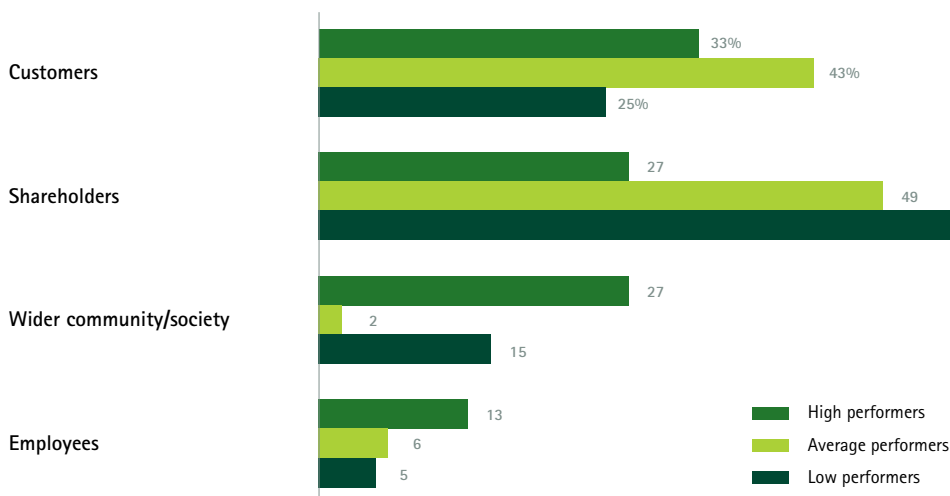
Chinese high performers' approach is to make innovation repeatable, not accidental. So they foster processes and structures that signal the strategic importance of innovation, encourage knowledge sharing and collaboration, and provide the right kinds of incentives to their employees. One example: Seeking out top technology talent, Web search firm Baidu uses the Web itself to tap China's engineering savvy, sponsoring a yearly programming competition that asks entrants to create, for instance, a martial arts character using the fewest lines of computer code possible.

Further, the high performers do not limit their evaluation to incremental revenues from new products; they place enormous importance on the enduring value of a strong intellectual property portfolio. More companies are filing for patents, and suing to enforce patent rights, in China than anywhere else. News reports say that China's State Intellectual Property Office received nearly 700,000 patent applications in 2007, far greater than the number received in the United States. Chinese patent filings are climbing at more than 20 percent a year.

Says Yunshu Zhou, general manager of pharmaceuticals company Jiangsu Hengrui Medicine Co.: "Only when we have new drugs with intellectual

## Multiple stakeholders

Survey participants were asked to indicate which stakeholders are given top priority when they formulate strategy.



Source: Accenture High Performance Business China survey, 2008

property rights can we move beyond low-price competition.”

Like any other business process, innovation must be monitored and measured if it is to be done properly. China’s high-performance businesses understand the importance of quantitative measurements of their innovation activities. They track metrics such as incremental revenue from recently developed products and the number of patents or trademarks granted. By contrast, almost half of the country’s remaining companies do not carry out such activities.

### 6. They build businesses with the customer at their core.

This is another attribute where there is a stark difference between China’s strongest companies and its poorest performers. The former prioritize investments that enhance customer satisfaction and loyalty; the latter continue to chase new customers (see chart, page 11).

The high performers know they can develop distinctive capabilities if they can ensure positive customer experiences at every point of interaction between company and customer. They understand that there is little point in developing higher-margin, value-added offerings if they can’t provide equivalent levels of customer service to cope with the ever-rising expectations of their customers.

They are also becoming highly proficient at understanding and focusing on the needs of many different customer segments over a wide range of “touchpoints.” China Mobile’s GoTone service, aimed at its high-value customers, is a tiered loyalty and service program that includes a dedicated hotline for inquiries as well as access to VIP airport lounges across China and reduced membership rates at golf courses. The provider’s M-Zone plan, targeting teens and twentysomethings, hosts

China's strongest corporations are expanding their involvement with the nation's education system to help ensure that future graduates have the necessary skills.

special events for members, such as appearances by pop stars.

#### 7. They are “talent powered.”

China's high performers steadily acquire the skills and make the right investments in human capital that allow them to compete more easily in sophisticated markets and to extract more value from their products and services. One example: Meat processor Luohe Shuanghui Enterprise Group Co. now controls many aspects of its value chain, including 700 company-run retail stores. In a recent interview, Shuanghui CIO Liu Xiaobing explained his company's perspective: “If we can get appropriate talent—especially senior management—we will control every part of the value chain ourselves.”

These globally minded companies are casting the talent net wide, reaching out to expatriates they hope will join the flow of *hai gui*, or “sea turtles”—returning Chinese who bring a wealth of global work experience.

Like their counterparts elsewhere, China's strongest corporations will continue to struggle not only with finding top talent but with retaining it. Besides rethinking compensation packages, they are expanding their involvement with the nation's education system to help ensure that future graduates have the necessary skills. For instance, appliance maker Gree, in an effort to identify the best talent for recruitment, has held a series of competitions in universities around the country to encourage students to come up with innovative new design ideas.

And whereas many of their rivals emphasize salary and benefits, the top performers think more broadly, in terms of talent development—a blend of factors, including well-defined career paths, training and education, knowledge sharing and an amicable working environment,

that collectively can do much to improve retention and upgrade workforce skills.

#### 8. They use IT as a source of competitive advantage.

Most Chinese companies can leapfrog several generations of hardware and software because, as a rule, they are not burdened by the legacy IT systems that their global counterparts struggle with. Many of the high performers are exploiting this advantage to the fullest, actively deploying enterprise resource planning systems—SAP and Oracle suites just like those used by global leaders elsewhere.

Although most high performers continue to use IT to keep a lid on costs, some are also moving to adopt new technologies that can help them transform the ways they work with their customers, suppliers and employees.

China Mobile views its IT function as a potential source of revenue. Its executives are looking at offering other corporations the technologies and services that the telecom company has developed to fulfill internal demand and improve its own competitiveness. The company is also constructing a B2B e-business platform that uses IT to integrate its supply chain, greatly lowering costs and risk for its business partners as well.

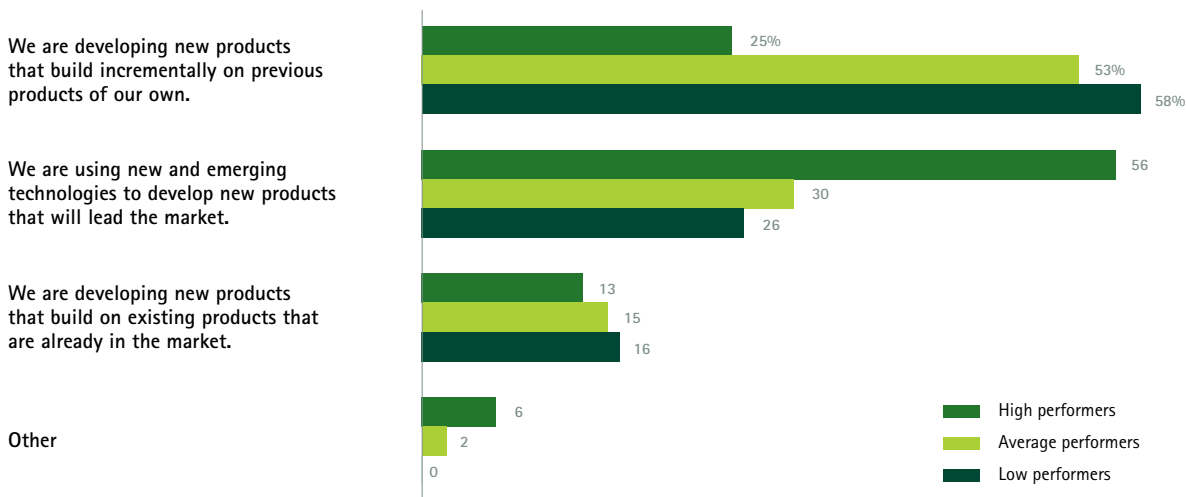
#### 9. They practice sustainable growth.

More Chinese high performers see long-term benefit in serious efforts that reduce their impact on the environment. They know that consumers (and investors) will keep pushing for stronger “green” efforts from business. One 2007 poll revealed that nearly seven out of 10 Chinese consumers said they would prefer to buy products and services from green companies.

Sustainability efforts will be critical to those companies intent on com-

## New technologies, new products

Survey participants were asked to characterize their current R&D strategies.



Source: Accenture High Performance Business China survey, 2008

peting in higher-margin markets outside China. For the companies focusing on markets inside the country, there are opportunities to appeal to the newly awakened environmental sensibilities of Chinese customers while staying ahead of China’s increasingly active environmental regulators.

Companies in resource-intensive industries are leading the way. Wuhan Iron and Steel, once known as a major source of pollution, recently implemented a new system in a major coke plant that will recycle more than 95 percent of the water used at the plant, compared with just 47 percent previously. The company, which plans to achieve zero waste-water discharge of this year, is now devoting 10 percent of its fixed-asset investments to energy-saving and environmental-protection facilities, according to *China Daily*.

Elsewhere, Zhejiang Medicine Co. has won ISO 14001 certification—an internationally recognized benchmark signifying high levels of envi-

ronmental management—verifying that its manufacturing operations meet the strictest environmental standards. And Lenovo points to the high marks it received in 2007 from Greenpeace for its advanced practices in handling electronic waste.

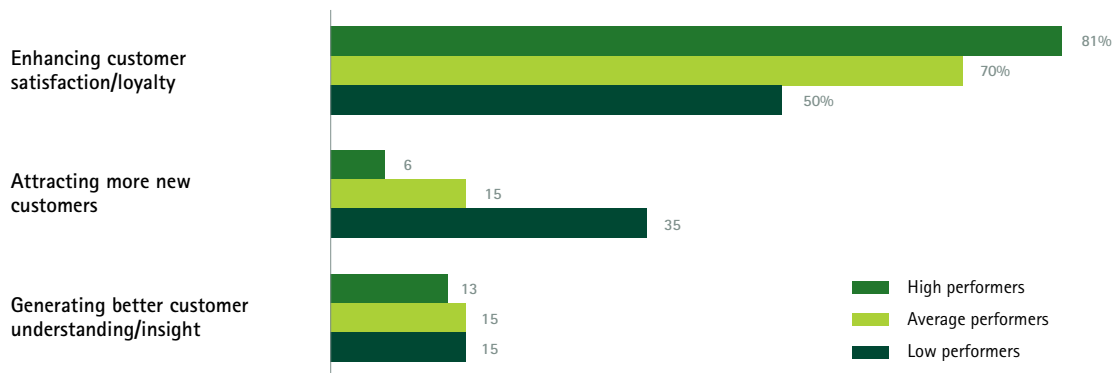
So what does this new wave of Chinese high performers mean for business leaders inside and outside China?

Imagine the business world as it could be five years from now. Harbin Power Equipment Co. is on the short list to build a massive hydroelectric project in Chile. Automaker Chery’s name flashes in lights in New York City’s Times Square. And Gree wins a giant contract to supply “green” air conditioners for all municipal buildings in Atlanta—and to service them for 10 years.

The point is not whether these scenarios actually play out; it is that, judging by detailed analysis of the attributes of China’s high performers, there can be little doubt that many of them will soon reach

## Customer focus

Survey participants were asked to identify the highest priority for their company's current customer-related investments.



Source: Accenture High Performance Business China survey, 2008

such milestones. Senior managers who think that China's most successful enterprises have succeeded largely thanks to their low-cost advantages must now accept that those companies have the mindsets, systems and capabilities to be ferocious global contenders from here on. If these companies have managed to compress into 30 years the development that took much of the rest of the world two centuries to achieve, what might they be able to do by 2040?

For the Chinese companies that rate as average performers—and for the non-Chinese companies that now have fresh opportunities to partner with them or even to acquire them—

there is no better time than now to examine the three building blocks of high performance and identify the weaknesses that have so far prevented them from joining the ranks of the high performers.

But remember: Time is of the essence. The global economic slump means that many average players could quickly share the plight of the low performers—losing momentum and fighting for the remnants of dwindling markets. And where does that leave the underachievers? They, too, have customers and resources that, coupled with Beijing's efforts to stimulate domestic demand, could make them highly attractive partners or acquisition targets.

If there is one big idea that should come from a fresh look at China's economy, it is this: Last year's assumptions about the nation's competitiveness are long out of date. Global business leaders need to face up to the power and the positioning of China's top companies—and expect to go head-to-head with them from now on. But at the same time, they would be wise to assess the myriad opportunities now being revealed as so many other Chinese companies lag behind.

In other words, there are long-term business benefits to seeing both sides of the new China story.

## About the authors

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