

# How To Research & Evaluate Outsourcing Opportunities In China

A White Paper by Daniel Park, Associate Consultant, B2B International

**E-mail** [info@b2binternational.com](mailto:info@b2binternational.com)  
**Web** [www.b2binternational.com](http://www.b2binternational.com)  
**Blog** [www.b2binternational.com/b2b-blog/](http://www.b2binternational.com/b2b-blog/)





## FIRST THOUGHTS

page  
1

Imagine you are the CEO of a medium-sized manufacturing company operating in Europe. Recently you have lost a major piece of business to a competitor that has offered equivalent quality product to yours at a price well below the level that your company can meet, and this competitor is bringing in the product from China. Just the other day you were reading something about the acceleration in migration of manufacturing into Asian countries to serve not only established Western markets but also the growing markets of Asia as they advance at world-leading growth rates. Is outsourcing from China becoming a necessity for your company in order to survive, let alone develop? Is it possible to research a “buy/import” opportunity in a similar way to a “sell/export” opportunity? What are the opportunities and pitfalls? What are the risks in entrusting a part of your product range – either a critical component or a wholly finished product – to a distant source in a very different culture? What do you have to find out? How do you find it out?

Let us step back and start by considering China and the way in which this vast country and diverse society are moving in the 21<sup>st</sup> century. We need to look at both the economic and business dimensions.

## THE ECONOMIC DIMENSION – CHINA’S PERFORMANCE AND POTENTIAL

China existed in a relatively impoverished and near-isolated state from the end of the Second World War up till the late 1970s, maintaining a cold-war hostile stance to all but a few small fundamentalist Marxist states. What has happened in the past 25+ years, since the then leader of the Communist Party, Deng Xiaoping, introduced the “Open Door” policy in 1978, has been nothing less than a true cultural revolution that has propelled China into the 21<sup>st</sup> century, with the prospect of becoming a leading (as well as a large) economy within the next 20 years.

Consider what has been achieved from a start-point as a backward agrarian economy with a heavy burden of military expenditure in changing into an increasingly diverse and globally active economy. Here are the main significant issues.

- China is the world’s fastest-growing major economy – around 9% per year sustained over the past few years.
- China is the world’s third-largest trading economy – US\$ 1,000 billion per year in foreign trade value.
- The technological level of the Chinese economy is rising rapidly – Chinese growth is **not** based exclusively on utilization of cheap labour.
- China’s foreign exchange reserves exceed US\$ 500 billion.
- China is fully accustomed to trading in world currencies – this is one reason why its dollar (and other hard currency) reserves are healthy.
- China is a member of the World Trade Organization.
- China’s population of 1.3 billion is becoming increasingly affluent.
- China has put a man in space; is a significant nuclear power; and some parts of its manufacturing industry compare favourably with the best in the world.
- China is the biggest spender on research and development after the United States and Japan.



- New foreign direct investment is running at about US\$ 50 billion per year and is growing.
- Chinese expenditure on overseas mergers and acquisitions topped US\$ 2 billion in 2003 and looks set to reach US\$ 4 billion in 2007.
- China is taking steps to end the fixed relationship with the dollar and to allow exchange rates and interest rates to become market-determined.

Let us look at this economic background in a little more detail.

There is plenty of theoretical debate as to when China will join the top 3 or 4 economies in the world and how this is measured. Leaving this theory aside for the moment, there is near-unanimity amongst economists that it looks set to happen during the next 20 years or so. A more important point is the remaining potential of China after this position is reached. When China reaches the same economic size as the USA, its GDP per capita will still be much lower. Assuming that Chinese economic policy-makers succeed in avoiding the excessive debt at national, corporate and individual levels that now plagues several major economies in the developed world, this growth can continue further as (a) the technological sophistication of the economy rises, driving demand for industrial products and systems, and (b) a greater proportion of the huge population gets more affluent and is in a position to afford more sophisticated goods and services, driving up demand in the consumer sector. Note how much significance has been given in the recent (February-March 2007) full parliamentary session to questions of raising the consumption component of GDP and introducing more modern mechanisms of consumer finance and credit into the Chinese economy.

Because the Chinese currency (renminbi) is at the moment pegged to the US dollar, Chinese exports have become cheaper as the dollar has declined. This position will change as part of the financial transition agreement in China's accession to the World Trade Organization, and the renminbi will relate to an international basket of currencies. A convertible currency and market exchange/interest rates will change China into as much of an opportunity as a threat.

Somewhat differently from the earlier experience of other high-growth Asian countries, China is not building an export-led economy based on cheap labour coupled with high import tariffs and quotas. China recognizes that it requires raw materials, technology and know-how from the rest of the world and therefore takes the long view on the desirability of an open economy.

There is still a widespread view that Western organizations can concentrate on higher-value products and leave China to concentrate on low-specification, price-sensitive goods. This is an extremely dangerous and self-deluding view. China is developing an increasing number of companies – both indigenous and also in collaboration with Western partners – that can compete at the highest standards in any sector anywhere in the world.

The way ahead has, however, some problems.

The majority of the rapid growth in the economy comes from the coastal cities and Special Economic Zones and this has created an economic imbalance. Though much of the former state-owned sector has now been privatized, it is seriously inefficient and is increasingly a drag on the aspirations of Chinese economic managers. Major programmes for upgrading



technology and systems are being introduced, along with Western management techniques, in order to increase the efficiency of this vast sector and to create new, smaller businesses in the supply chain as the inevitable re-structuring comes. China is consuming vast quantities of raw materials, particularly energy, steel and other basic inputs, contributing to the recent hardening of world prices for these vital commodities. There are programmes of conservation and improvement in material conversion efficiencies that address this major issue.

Perhaps most importantly, working with and through the Hong Kong financial and industrial community, Deng Xiaoping's successors through to Zhu Rongji and Hu Jintao, have continued the process of privatization and technological upgrading of Chinese industry.

Understanding the economic dimension is the first part. Let us now turn to the business dimension.

## THE BUSINESS DIMENSION – HOW TO GET STARTED

The typical response to a perceived opportunity in China goes something like this. In addition to the market potential you believe that outsourced manufacture is worth a look. So you go out to China on a trade mission; attend an exhibition subsidised by the government in one of the major cities. During the exhibition you exchange dozens of business cards with executives of Chinese companies and provide details for supply quotations to the companies that you believe are a good fit based on what you seen and heard at the exhibition. You return to your home base and in due course examine the quotations you receive. In most cases you will then make a cost-based decision and ask for a sample or trial batch of products. When you receive the sample or prototype products; they are as good as anything you could produce yourself; and you cannot believe they can do for the price (in some cases they probably cannot, and they may not actually have made the samples themselves).

The situation now is that you are hooked. You do a deal and start to run down part of your own supply facilities and ramp up your Chinese operation. You feel you can now compete with a cost-down approach. You are now working on the assumption that the good experience you have on the trial batch will translate to the full production volume. It is at this stage most companies fall into the trap of not understanding the culture or having the necessary experience to handle the communication with the Chinese supplier if things start to deteriorate. If you now start to experience (very common) quality or service issues as the volume ramps up, the costs you hoped to save will be of little use if you cannot meet the needs and demands of your customers. You must also never forget the need – even with commoditized products – for product evolution and be confident that your chosen partner is capable of achieving this with you.

Unfortunately, as in many cases, you find that there is a major problem as you have run down your home-based supply sources (internal or external). Moreover, your personal relationships (“guanxi”) that are so important in doing business the Chinese way are not yet established, and the problem is happening over six thousand miles away.

There is a better alternative. It starts with careful market research, applying contemporary tools and techniques to appraisal of markets, products, suppliers and customers.



If you look closely at companies that have had successful experience in operating in China, you see two related things that almost all of them have in common; (i) they partner with an Asian (particularly a Hong Kong) company that already knows China and/or (ii) they learn how to partner directly with the best Chinese operations in creating a business for the long term.

Perhaps surprisingly, the big issues in getting started in outsourcing in/from China are not related to product and process, but to the cultural, legal and operating dimensions. It is here that delays and unanticipated costs and problems are found. Let's look at each of these in turn.

Concerning *cultural* issues, China is first and foremost an ancient civilization and its business and social culture ("the way things are done around here") is based on a very different history and system of customs, behaviour and values. The main cause of the difference can be characterised as a collectivist rather than an individualist set of norms. The importance of consensus is paramount and this can lead to what Westerners can mistakenly view as indecision and bureaucracy. Seniority tends to be based on age and length of service: that is why top managers – and even CEOs – of quite substantial Western companies have to get personally involved in the early stages of negotiations. To entrust this to a high-flying young middle manager just would not work- especially in these important early stages. Part of this is the issue of "face". This can be characterized as the avoidance of any embarrassment in interpersonal dealings that would result in loss of "face" if your Chinese counterpart were to appear inferior in rank, professional standing or knowledge. "In-your-face" toughness, a confrontational negotiating style and "shooting from the hip" simply make you look immature in Chinese eyes. The fundamental – and critical – issue here is to develop relationships at a very personal level. It is the personal dimension that determines whether you will move on to discuss product and process and ultimately conclude a deal.

The *legal* dimension is an area in which careful advice and preparation are needed. There is little in Chinese law that relates to Western concepts. This stems partly from the points made earlier concerning personal relationships, and "guanxi" (the hard-to-translate Chinese word for "connectedness") is key to getting anything off the ground.

The main point in relationships is that Chinese at all levels are only just beginning to absorb Western legal concepts and management practices, and the extent of absorption varies across industrial sectors. However, the rate of learning and change is impressive, especially in the main coastal cities such as Shanghai and Shenzhen (a city just over the border from Hong Kong), and in the special economic zones.

In *operational* terms the Chinese respect hierarchy – and this in no way contradicts the previous point made about the collectivist dimension in society generally. Decisions are made at the most senior relevant level, whereas in the West we have become accustomed to ever-increasing levels of delegation. Teamworking is a long-established Chinese concept, but it includes the view that there is a team leader who has seniority, decision-making responsibility and accountability. This combines so much of modern management thinking with a very old-fashioned management structure. Leadership and authority are not resented: indeed these are basic requirements of effective executive behaviour in China. Many Western executives, now damaged by managerial political correctness and unaccustomed to a "directive" style, often find this a difficult dimension of the transition to the Chinese business and organisational culture.



## THE OPPORTUNITY

So what are the choices for a medium-sized company, with finite resources and no prior experience of China, in getting involved in this fast-growing area as a source of cost-competitive supply, or as a rapidly emerging market, or both?

Western companies are permitted to set up wholly-owned companies in China, to own assets in China and to operate as independent entities. However, this is not always the best way of going about it – at least in the early phases. As stated earlier, the sustained success stories are almost all found in companies that have a Chinese partner, and the significance of Hong Kong figures highly in this. As a kind of checklist to start exploring the costs, risks and rewards the following guidelines are useful.

- 1. Research and engage a specialist Asian company that has high-level professional and political contacts and a proven track record in managing its own operations in China.**

There is no substitute for working with an organization that has already succeeded in China. Much of Hong Kong's own manufacturing activity has migrated into China over the past 20 years and the learning process is very much shorter if you can take advantage of the experience of such an operation. You can accelerate your own market entry and avoid many of the pitfalls and delays that can be encountered in dealing with Chinese regional and local officials. Involving Hong Kong operations as co-investors and/or operating partners is proving to be a strong mechanism for approaching China.

Also recruitment of the initial workforce is a nightmare to an outsider. It's not just the question of language; the more important aspect is how to manage on a day-to-day basis a workforce from a very different social and business culture. This is particularly important if you have to secure Western quality standards from Day One. Whereas Chinese workers are generally well educated at the technical level, many have experience only in state-owned operations, where the overriding performance target has been volume output against "The Plan". Managing multi-product operations is a particular challenge, where the principles of minimal inventory and rapid changes (for example, changes in tools and dies with minimal downtime between product runs) are still relatively unfamiliar.

The route to a solution can be summarized within the concept of "the deal and the learning". German companies have been successful because, as one German executive once stated to me, "we supply a short-term mini-university as well as capitalize on a business opportunity". Using this approach, it does not take long to understand one reason why the economy is growing so quickly: the Chinese work hard and take learning seriously. Accept this and build in a budget for training.



**2. Do more research. Take advice from China-based specialists and draw up a short list of potential Chinese partner-companies that have been evaluated by such specialists.**

If you ask a Chinese company whether they can make a component/product for you, the answer will almost always be “yes”. This is mainly because the answer “no” would involve loss of face. Additionally, many Chinese operations can meet Western standards at relatively low volumes in the early stages of a venture and yet when the volume builds up the quality and reliability above a certain point can start to drop. Predicting the probability of this and the point at which it might happen is extremely difficult for an inexperienced Western team, and even a good-looking Chinese operation cannot be taken at face value. Because of the Hong Kong experience in migrating manufacturing operations into China and building them up fairly rapidly, a Hong Kong partner knows what to look for, how to assess capabilities and how to anticipate problems.

This preparation is particularly important in addressing the issue of capability in operating at Western quality levels. Though the best Chinese operations have ISO accreditation and can operate at six-sigma standards, the levels of quality can be uneven between companies even when they clearly have comparable and appropriate technologies and systems. It is vital that you use the expertise of on-the-ground specialists in pre-qualifying candidates for your short list. One significant positive indicator is whether the senior management is Hong Kong Chinese or ethnic Chinese educated in Hong Kong, North America or Europe – and there is a rapidly increasing group of such individuals at the top levels of Chinese operations.

Additionally, the right short-list will comprise Chinese operations that take a long-term view of relationships with Western companies and can therefore be relied on to accept a Western company’s requirements in the areas of patent protection and observation of intellectual property rights. The experience and judgment of the Hong Kong partner are vital in dealing with this dimension.

**3. Put together a presentation on your company and its product/service offerings.**

Chinese businessmen find illustrative rather than verbal material easier to assimilate. The phrase “a picture is worth a thousand words” is certainly true in this context. Generally a first presentation should be 15-20 minutes against home-country standards, because if you have to use an interpreter the time taken to deliver will be a little more than twice as long. Again this is where an experienced Asian-based team can be a great asset, because once that team truly understands your business and shares your objectives they will be able to present directly on your behalf without the need for interpreters. This said, the speed at which Chinese commercial and technical people are learning English is breathtaking, and this is found particularly in enterprises located in the fast-growing coastal cities and Special Economic Zones. Within the next few years it is likely that English will become a “first business language”.



#### 4. Visit the short-listed companies to start establishing relationships.

The market research team should now be in a position to hand over the prospect to your internal management team. Senior managers need to be prepared to risk one visit to view the potential manufacturing partner with their own eyes. After the initial visit much of the routine communication can be handled directly by an experienced Asian partner. This can then go right through to the prototype manufacturing stage; there may be a requirement at this point for a visit by experienced quality or technical personnel to give the final OK, this all depends up on the complexity of the products in question and the experience and knowledge of the Hong Kong partner/Chinese manufacturer. The attitude of “can do, want to do” existing in China ensures the time scale to get to this stage is considerably compressed compared with most Western companies.

An experienced partner should normally get you to the point at which a go/no go decision can be made after the third/fourth visit to a potential Chinese company. Top Chinese managers do not waste time. The generally positive attitude ensures that it is rarely necessary to have lengthy visits – though the individual working days can be very long.

It is at this stage that questions of quality systems, adherence to environmental and social norms, ethics and other possibly critical issues should be addressed. As part of the conditions of entry to the World Trade Organization, China is required (and has agreed) to take into account international standards in all spheres and this includes working practices, employee relations, environmental matters and “marketization” of the economy. Despite the political strictness that has characterized Chinese society, there is an acknowledgement that change will have to be made if China is to become, as desired, a full member of the international business community. There are clear signs that this is happening very rapidly.

#### 5. Make a final selection of Chinese partner(s).

Though many Chinese organizations are now starting to adopt Western standards of disclosure and financial reporting, there is still a long way to go before Western-type due diligence can be undertaken with the same speed and to the same level of detail as that to which we are accustomed here. So however good the deal looks, do not be rushed in final-phase evaluation unless you can assess and manage the possible risk. Hong Kong companies and the Hong Kong financial and legal community are used to this situation and can deal with it best on your behalf.

Protection of intellectual property and product/process patents is a potentially difficult area. Here the role of an Asian (most probably a Hong Kong) partner is crucial. Through the pre-evaluation of potential Chinese manufacturers, the track record of the Chinese company can be examined through the “guanxi” system. Also if one works along with a Hong Kong partner, then that company’s own track record in securing protection of the intellectual property rights of Western companies is open to scrutiny.



How long does this take? There is no simple answer, but there are some best practice principles indicating that the process should take months rather than years nowadays, unless the project in question is particularly large-scale or involves highly sensitive technologies (particularly defence-related). The important thing to bear in mind is that there is no point in hoping to conclude a **worthwhile** deal on the basis of a single visit, and it is advisable to beware of any Chinese organization that appears keen to do so. This is where the Hong Kong dimension is so important. The right Hong Kong partner knows how to make “guanxi” work, and can get questions answered and interim agreements in place many times faster than most Western operators can by acting independently. This is business-effective as well as cost-effective.

## THE WORK OF B2B INTERNATIONAL CHINA

In 2006, B2B International established a subsidiary operation in Beijing. In addition to undertaking market research on China for clients based in the region, the B2B International team supports Western companies in (i) seeking an effective route for penetrating the China market and for re-export throughout the region, and (ii) identifying and evaluating opportunities for setting up outsourced operations for product supply out of China.

There are a number of possible mechanisms – (a) export selling, (b) wholly-owned direct investment and (c) alliances. This ‘White Paper’ has been concerned with (b) and (c).

The main reason that the export sales model is often of limited value to Western operations, is that China would normally wish to develop its indigenous manufacturing capabilities unless there is a very significant technological advantage in a product. There is a clear policy of import substitution and technology transfer that figures highly in China’s development plan. So that leads us towards outsourcing opportunities and co-investment. The work of B2B International in (and on) China includes research and evaluation of appropriate partners for Western clients. The tools and techniques of business-to-business market research are applied with an appropriate focus, as follows.

- Analysis of the performance and potential of established players that could become outsourced manufacturers either as independent contractors or co-investors.
- Analysis of the value structure of supply chains and the operational characteristics of inward-outward logistics.
- Risk analysis and risk minimisation/management associated with operating in China.
- Evaluation of suitability of product for Chinese and non-Chinese end-users (consumer and business-to-business).

B2B International in China can offer direct support in converting market research into relationships and intelligence. This will put you in a position to present to pre-screened companies identified via the market research process. The cost-saving and risk-reduction benefits of this are very significant. China is a potentially expensive market to research if you try to do it without an experienced team that has a good understanding of the business culture and an ability to interpret carefully the statements and claims made by Chinese executives and consumers.



Evaluating the potential for outsourced operations aimed not only at penetrating the China market but also at exporting into other regional and global markets is part of what B2B International has set up its Beijing office to do. The China market is growing quickly in terms of total GDP, and the technological level of much of Chinese industry is rising. This presents two opportunities simultaneously – domestic demand *and* an increasingly attractive manufacturing base.

Many Western companies are already taking this market seriously. Some are making good money in doing so. Others are struggling and losing time and money. The difference has nothing to do with the China market and little to do with the partnership potential of China's indigenous industry: it is about carrying out the necessary rigorous market research, analysis and learning.

*Dr Daniel Park qualified in economics at the University of Glasgow. He has been associated with B2B International Ltd since its foundation, and has acted as adviser and consultant in many of the company's international projects. Since his first visit to South-East Asia in 1978 he has made over 60 business visits to Hong Kong/China. Between 2004 and 2006 he served as a non-executive director of a major Hong Kong manufacturing company with facilities in China, employing some five thousand people and operating at 6-sigma standards for world markets.*



**B2B International**  
Americas | EMEA | Asia-Pacific

email: [info@b2binternational.com](mailto:info@b2binternational.com)

web: [www.b2binternational.com](http://www.b2binternational.com)

blog: [www.b2binternational.com/blog](http://www.b2binternational.com/blog)

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