

extract

made it in



China

the personal experiences and lessons of
international entrepreneurs who have built
successful companies in the hottest
business locations around the world

Graham Jeal
Simon Cann

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“ The world, indeed, is flat. And those leading the “flattening process” are early entrepreneur pioneers. Made it in China tells the real world tales and experiences of nine entrepreneurs who have “been there, done that”. Learn from them-now! ”

Jack Daly

CEO, Professional Sales Coach, Inc.

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Foreword

For businesses outside the country, China presents three key opportunities:

- **A new market to sell goods (especially consumer goods).** China represents over 20% of the world's population: the world's population is rising, China's percentage of the world's population is rising, and personal wealth in China is increasing, making China a true growth market in every sense and by any measure.
- **A low-cost manufacturing base.** Chinese manufacturing has become emblematic of the rise in low-cost offshore manufacturing. From clothes to iPods, over the last few years consumers have come to expect falling prices (and for technology products, falling prices coupled with increased functionality). For many companies there is now apparently only one way to compete in this new marketplace: manufacture in China.
- **A new place to do business.** The booming economy and the industrialization of China have led to many people leaving the land and moving to the cities. This huge and unprecedented change in the largest society in the world has created an extraordinary new place to do

business (particularly for those helping to build China's infrastructure).

However, China is different and proud to be different. There are a whole range of new cultural, political, legal, and economic challenges to be faced, even for businesses with experience of the country. It is a confusing market for those who do not understand it: the vast majority of businesses that go to China fail, and fail for reasons they don't ever get to comprehend and many major global organizations have had their fingers burned due to their incomplete grasp of the country and its culture.

Made it in China shares the insights of a group of non-Chinese entrepreneurs who give their first-hand account of their experiences in the country. These are people who have gone to China, invested their own money, got their hands dirty, and have built successful businesses. These people are the real deal and (at the time of writing) are all actively working in (and on) their businesses in China.

Each chapter focuses on the practical experiences of one individual as they grew their company in this new and developing market with each entrepreneur focusing on a different aspect of doing business and talking about their area of expertise. The stories are both practical and entertaining, combining first-hand anecdotes about the challenges they faced and how these were met, with their own observations and thoughts for dealing with each situation.

Introduction

Welcome to China: Understanding China

For 19 out of the last 21 centuries China was the richest and most advanced society on earth. Under imperial domination, civil war, and then the Great Leap Forward, China moved backwards relative to the rest of the world.

The situation within the country started to change in the late 1970s and although the Communist Party remained in power, market reforms were introduced. Since the early 1980s, China has witnessed the longest sustained period of growth in any modern country. Hundreds of millions of people have been lifted out of poverty and a changing world, with China at the steering wheel of the global economy, is taking shape.

For many years China was a well kept secret. At the start of the 21st century the Financial Times and Wall Street Journal mentioned China sparingly, maybe once every couple of weeks. Today, China is mentioned in some way or another every day. After the dot com boom and bust, China has emerged as the next gold rush. History will judge whether this is another economic fad, but the length of this growth period is unprecedented and the shift in the center of gravity of global economic power appears unstoppable.

Coming to China

Most people who now arrive in China find a country that has mapped the shortest and most direct path from Maoism to prosperity, and a country that is surprisingly far down that path.

When people first arrive, they find a warm, friendly, and open country, with a highly-educated population and yet at the same time, in many ways the country may appear quite simple and quaint to the outsider. China is a world of contradiction and confusion. It is one of the world's largest countries, but it is run like a mom-and-pop shop. It's impatient to get rich, and get rich in a hurry. It's eager to learn and anxious to ensure that the foreigners stick around.

For the Chinese people, foreigners are like a canary in a coal mine. While the canary is still singing, the Chinese will be spared a repeat of the more colorful chapters in their history. The Chinese people want and need the modern world, even if the modern world is unsure about them. The Chinese are keen to put the miseries of previous generations behind them and they are in a hurry to do this.

Perhaps the most confusing place is the most international place: Shanghai, the heart of modern business-focused China.

To the outsider arriving in the sparkling Pudong International Airport, Shanghai is a gleaming modern city of freeways, subways, suits, and cappuccinos. However, go into a supermarket and the world changes. There's no chance to buy bread or cheese, but if you want chicken's feet or duck's tongues you'll have no problem. And this is the contradiction that is China. It combines cities with all the excesses and internationalism of Western cities, uncomfortably grafted over thousands of years of doing things differently.

As Richard Robinson notes in his analysis of business start-ups in Chapter 3, for the entrepreneur there is probably no better place in the world to be at the moment. There are opportunities to be found everywhere in this resurgent super-economy and the attractions of China are many and varied. Not only are the opportunities plentiful, but the barriers to entry are low and the cost of doing business is (generally) equally low, meaning that entrepreneurs can take the time to develop their business.

Trying to Understand China

China is vast and has a huge population. It is always difficult to give precise population figures (especially in China where the records may not be accurate in many rural areas), but to give a rough idea of the scale of the population and some comparisons:

- The population of the United States is around 300 million.
- The population of the European Union is around 500 million.
- The population of China is at least 1.3 billion, and by some estimates, it may be as high as 1.6 billion (in other words, twice the combined population of the US and the EU).

Most people who come to China and who have had experience of doing business outside the country find that they have to invest twice the amount of money, twice as much time, and twice as much effort to get half the results they wanted. However, China is a place of such scale and opportunity—even after doubling all of the investments and halving the returns—that it still often makes sense to do business in the country.

To begin to try to start to understand China, you need to get a grip on the country's history and its culture. China is a new country operating in the constraints of an ancient civilization that is fully aware of its place in history. Understanding Chinese history and traditions helps explain the Chinese approach to business. Montgomery Singman explains this background and its implications in Chapter 6 where he talks about the challenges of fostering creativity in his firm.

In order to do business in China it is critical to understand the motivations of the Chinese people and to realize that nothing can be assumed. Only then can you look at training the workforce to work in a modern economy. Bob Boyce discusses this in more detail in Chapter 5 where he explains the development of his family management style, and how it applies to the national restaurant chain he has built.

Dynastic China: the Communist Dynasty

Many people are confused about how the Chinese can wave a red flag and sit behind a bust of Mao and Marx in what is one of the world's most rampantly capitalist states.

This confusion neglects to look at Chinese history where for thousands of years the country has been run by dynastic families. In the middle ages there was the Ming Dynasty and the Qin Dynasty founded much of what we recognize as China today.

Today we have the Communist Dynasty. Mao was the first Emperor and Hu Jintao is the latest Emperor.

The thought processes, decision making, and ways of getting things done in society are surprisingly similar to any time in Chinese history. In today's modern world the emperor and his mandarins have to ensure that the common man is better fed, housed, and educated than in the middle ages, but essentially the same forces shape policy. In Chapter 2 JC Lim gives us a lesson in Maoist teachings that are relevant for business in

modern China. He tells us how he has taken the lessons and widely understood themes in Chinese history and applied them to build a Chinese sales army.

Taking the essence of Chinese tradition in another direction, in Chapter 8 Grace Liu tells the story of how she took her passion for Chinese craft and tradition, and turned it into a modern international business.

You Will Never Be Chinese

China is more than a country or nation state, it is a nation continent. For the foreigner learning to deal with this nation continent is one of the biggest challenges. But the foreigner needs to understand that he or she will never be Chinese. You can live and work in the country for 25 years, marry a Chinese person, get a passport, learn the language, have Chinese children, wear the clothes, and wave the Chinese flag, but you will always be a foreigner.

In addition, there are the ethnic Chinese who had the “misfortune” to be born overseas—for instance the ABCs: the American-Born Chinese—who the Chinese firmly believe will one day all flock to the motherland. The Chinese regard these people as ethnically part of the same group, much in the same way that people might be Irish or Jewish—it’s a matter of “being” not simply place of birth or religion.

This notion follows through in the territorial integrity that the Chinese leadership has given to China—the Middle Kingdom—throughout history. The Middle Kingdom is as much an ethnic concept as a territorial one.

China Works

There is, of course, much to criticize about China, much in the same way you could identify criticisms of the US or Europe. But there is one unassailable fact—much to the disbelief of everyone who studies the country—China seems to work. If all the foreign-owned businesses were to leave, it

would definitely hurt the economy and shave a few percent off of the growth rates, but the growth rate would still be impressive.

It is naïve to compare a developing country such as China to the developed world: we will leave that comparison to future generations. Instead, we point to one of the greatest governmental achievements of the last century, where the Communist party has followed policies that have taken hundreds of millions of people out of poverty. Most people are educated, most people are fed, most people are clothed, and most people have opportunities that simply do not exist in other comparable countries.

The Legal Framework

The Chinese legal system is very different to the legal frameworks in the rest of the world. Equally, the Chinese attitude to the law and in particular, the comparatively new concept of contract law, is very different.

Unlike other countries, there is no Roman law or common law history to the Chinese legal system. Instead, all of the business laws in China have been passed since the country opened itself up to market forces. This means that the most experienced lawyers and judges only have about 20 years' experience and there is no significant history of case law from which the lawyers can draw.

Perhaps the hardest concept for non-Chinese nationals to grasp is that in essence, everything to do with business in China is illegal—*everything*—unless you have a license. In the West, everything is legal unless it is prohibited by the law. In China the government tells you what you can do through the licensing process and so the entrepreneur operates within those constraints.

In practice most business activities are acceptable as licenses can be vague. The Chinese language used is often imprecise allowing flexibility to interpret a license in a certain way which means that any company can be constrained at any time. This issue is illustrated in Chapter 7 where Scott Barrack talks about how he ensured his business is not adversely affected by seemingly arbitrary licensing decisions.

The Role of the Notary Public

Some of the best legal advice comes from notary public officials and not lawyers. Notaries have been working in the legal system for longer than the lawyers. They take a far greater role in China than in the West, and don't just witness things, they provide legal advice that can be better than lawyers can offer, and they write contracts.

Chinese Contracts Are Written In Poetry

If you get a contract translated you may be horrified about how imprecise it is. Concepts that are familiar in the West “you will do this, by then, and if not, this will happen” rarely exist in Chinese contracts. Instead, the terms in a Chinese contract may say “party A causes a troubled feeling to people near party B, money will help”.

Think of contracts as being written in poetry and you will start to get an idea. In Chinese contracts, much is left open to interpretation. This is one reason why it is often better to go to arbitration rather than litigation. In Chapter 9, Henry Winter details how he sought and achieved a legal resolution in China through the arbitration system.

There are some important points to understand about contracts. The Chinese believe that the person who writes a contract has a greater obligation to keep to the terms than the other signatory. This is why there are far more “standardized government contracts” and contracts written by notary public officials than you would expect in the West.

Apparent Disregard for Contract Law

Many people have seen a foreigner screaming at their Chinese business partners “read the contract... can you not see what it says in the contract”. These people have missed the point.

In the West contracts are seen as a destination: something cast in stone. The Chinese see a contract as a starting point in a relationship—the starting point of a journey. Often the Chinese don’t even keep a copy of the contract as they know that everything is subject to revision and discussion as and when things change.

In Chapter 4 Graham Jeal takes us on a journey through the board rooms of the Yangtze delta on a crash course in negotiation with hard nosed Shanghai property developers. As Graham explains, while trying to negotiate a contract is tough, getting the agreement documented can be harder still, especially when a Chinese business partner can’t see a necessity for the documentation.

Intellectual Property

The Chinese attitude to intellectual property is very different to the attitude taken in the West. Get over it and get on with your life.

There is little history of copyright or patent enforcement within China. However, in Chapter 1, Paul Stepanek outlines an intellectual property story with a happy ending for one of his clients.

A much better attitude is to acknowledge (but not endorse) the poor practice and work around it: make your business immune to copyright infringement (or other unwanted business practices). In Chapter 5 Montgomery Singman explains how he changed his business in light of the environment, turning the product into a service that generates a

monthly income. In this case the reaction to a problem has led to a more robust business.

If You're Going to China... Then Go

If you're going to do business in China, then you need to go to China. You must be on the ground conducting business on a day-to-day basis. Businesses that are managed remotely generally fail in China. You cannot make decisions or carry on negotiations on a one day business trip to China made every six months: you need relationships, understanding, and expertise.

Many of the entrepreneurs featured in this book have found that in their years of working in China no serious non-Chinese competition has emerged largely because nobody sent anyone to come and live in China, get under the skin of the country, and understand how the system worked.

For Western companies, the use of Western advisers that are based in China (in particular in the area of operations) is often helpful, as is employing locals as directors/advisers. But decisions have to be taken daily and based on a variety of factors that you can only understand when you see, live, and breathe China. Successful businesses cannot be run from afar.

However, those who do go should be aware of Skyscraper Hypnosis—a disease that particularly afflicts Western businessmen who come to China gaze around at what has been achieved in such a short time, look starry-eyed at the fancy cars that choke the roads of most major Chinese cities, swallow all of the partnership propaganda, and throw their money (or their company's money) at deals that they would never do in the West.

Manufacturing in China

But for a conversation with a neighboring librarian, Paul Stepanek may not have ended up in China. She told him that the “next big thing” would be China—from that point he set his sights on the country.

Having had some work experience in Taiwan, a friend introduced him to a Mid-West company that was looking to move its manufacturing operations to China. Paul grabbed the opportunity with both hands and helped move their manufacturing facility to China where he remained and ran the factory.

The company grew and Paul got the opportunity to open and run other factories in China. After 7 years it was time for a change and Paul set up USActive, a consultancy specializing in helping foreign financial institutions and manufacturing companies with their initiatives in China.

Paul has considerable experience from his time running the factories and his work with USActive, and is highly sensitive to the issues that frequently arise in China, especially in manufacturing. He has made it in China by making things in China and by helping others to make it in China.

After visiting and working with literally thousands of factories I have found that most of the time we could have reduced the intensive audit process for possible partners for our clients to two simple observations. One—if

you can smell the toilet from the front door, or two—if you do not see the expansion plans in the general manager’s office, then they are not a viable operation.

These two simple observations often reveal as much as more analytical research can; more quickly and more graphically. If the factory tour reveals that you cannot smell the bathroom from the front door, then the factory probably has good basic management skills. If the general manager does not have construction plans for factory expansion in his office then that is a warning too. In a growing market anyone who is not riding the wave must be doing many things wrong.

Of course, this is a generalization—and the dynamics of the market have significantly changed in 2008. Even so, our auditors have had some fun as they winked at each other when they could smell bathrooms before they were seated in a meeting room.

Getting to China

When you want to go surfing, go where the big waves are...

I was 12 years old when I read an article about Japan being a boom economy. They progressed from making plastic flowers to athletic shoes to electronics and automobiles. Real estate prices and wages were going through the roof. I thought to myself that by the time I reached working age I would have already missed out. I wanted to front-run a boom and I wanted to find someplace which would boom after I had already been there long enough to position my surf board. After speaking with a number of people whom I respected as being worldly—it was clear that China would be that place.

I made my plan. I was going to study engineering—work for a few years—get an MBA or MIM—then work for a few years—and then get sent to China by some company which shared the vision that China was going to be the future. The

plan was longer than my patience, so I flipped it on its head. I decided that I would go to China first—learn the language—and then I would have the tools to get jump-started.

I hunkered down, started Mandarin language courses in the US and won a fellowship to study in Taiwan. Back in the late 1980s Taiwan was still booming. It was the perfect place for me to learn the language and have a first-hand look at what the future of China would look like when her economic reforms started getting traction. Taiwan was meant to be a stepping stone in getting positioned in China and so after some years in manufacturing there I quit my job and did a tour of the Mainland.

I visited over 30 different cities to get a feel for what was going on and where. This was the early 1990s and it was clear that the timing was right for the first tier cities. I zeroed in on Shanghai as my target and then went back to the US to get “sent” to China. Now that I had the language and some manufacturing experience I was sure that it would be relatively easy to find a company which I could help to enter China. This proved to be a longer search than I expected to find a fit.

This company had its manufacturing base in southern China, and although this was not my exact target, I justified it to myself since Shenzhen was a lot closer to Shanghai than Milwaukee. So off I went. A handful of factory start-ups later I had made my way to Shanghai.

During these early years I spent long hours making sure that production lines were running and customers were happy. In my free time I was out exploring the countryside, often on a mountain bike. This passion for exploring turned into a hobby which then turned into my first business in China, **BOHDI® ADVENTURES** (bohdi.com.cn), which gets people out to have fun—hiking, biking, and team building.

In 2000, I had completed the set-up of another factory in the Shanghai area. I had always enjoyed the thrill of helping companies be successful in China. I have been successful in doing that on a very tight budget and time line. The excitement of orchestrating all of the moving pieces to create an organization which produces something has brought me a great deal of gratification.

It is a very tangible process: bulldozers clearing the land, contractors constructing the building, hiring and training staff, installing production lines, sourcing materials, product moving out the door. It is very clear if you are making progress and if you have been successful.

There are no half measures here. You are either shipping qualified product—profitably and on time—or not. I had been successful in making it happen for my employer time and again, and wanted to be able to share those skills with all the other companies which would benefit from that knowledge as they too executed their China initiatives—thus USActive (us-active.com) was born.

USActive started out with a very simple vision of helping companies be successful with their China business. It started with the philosophy of creating open, honest, and fair relationships with our employees, suppliers, and customers. Over the years we have expanded our service offerings and geography. We work with financial institutions and manufacturing companies which benefit from our experience and ability to implement and execute in this environment. We have stuck to our vision and our values which have made their way into our processes, so our people are constantly reminded of the excellence for which we are striving.

Communism and the Cultural Revolution

During the period of the Cultural Revolution (from 1966 to 1976) the country was suppressing its poets, sending its scientists out to break rocks, and taking anyone with an education and making them into farmers. People who were highly educated, and may have had many decades of experience, were pushed out to the countryside. During this time there was no real development in industry or business.

In spite of how unfair this seems, it is amazing how resilient the people are who endured such treatment. I have not heard a single bitter story from the people who lived through that part of China's history. They simply say it was the way it was back then.

The Cultural Revolution stopped education for everybody. Coming to do business in China, one will often go into a company and find there are very few people in the office who are over 35 years old. When you do the sums, anyone over 35 or 40 should have been going to school during the Cultural Revolution. The result of the Cultural Revolution is that a lot of people have been left without the advantage of an education. Mao shut the doors to the country and it wasn't open again for business until after the Cultural Revolution.

Since China has opened up for business it has seen the kind of growth in decades that other countries have seen during a century of industrial revolution. With this explosive growth, wages and responsibilities have gone up at an incomprehensible rate.

However, there has been inching progress for people working at a state-owned company that essentially has been frozen in time for 40 years. More than that, these people haven't been trained to cope with this change and having lived for most of their lives under this ideology, they don't have the skills

to chase the opportunities that are part of the current day China.

Guanxi-ocracy...

In capitalist societies, people are (to a greater or lesser extent) rewarded for the benefits or merits that they bring to an organization.

During the 40 year rule of Mao, the size of the pie was fixed. The only way to get a bigger slice of the pie was through *guanxi*—through your relationships. This wasn't meritocracy—this was *guanxi-ocracy*. As the pie was not getting any larger, people developed and honed their skills for finding who had control of resources and building relationships with whoever could provide what they wanted or needed.

So if Mr Wang was in charge of allocating apartments, and I was in charge of rationing cigarettes, and my wife was in charge of sewing needles—we would make sure Mr Wang's daughter had enough sewing needles and he had enough cigarettes—then maybe he would find us a bigger or more desirable apartment.

People fine-tuned their skills to survive in a *guanxi-ocracy*. They didn't have a chance to develop technical, managerial, or value-adding skills, or skills to take an organization forward.

In 1979 things started to open up. Deng Xiaoping went to southern China and said it doesn't matter if a cat is black or white, as long as it catches mice. There are different interpretations of what he said, but many people in China interpreted it as meaning "we're Communists... nudge, nudge, wink, wink. We'll keep the spelling..." In other words, it was an end to communism in all but name. Deng's approach was both practical and pragmatic.

After a decade of change the results were impressive: the experiment was considered a success and the opportunities opened further. The Chinese jump-started their economy

with light industry and allowed investment with a lot of change coming in through southern China (where the first experimental economic zone was) via Hong Kong.

...to Meritocracy...

With the changes, for the first time in living memory there were people who were finding out that if they worked harder they got paid more. Or if they were a smart engineer that their boss was going to offer ever increasing opportunities, or that they would be able to go and find a better paid job at a place that valued their set of skills.

Suddenly there was a change from the old relationship-based economy to an economy where the value someone provided was rewarded and the size of the pie was no longer restricted. It ceased to be a zero sum game: if you worked hard, it didn't take away work from someone else—instead, everyone got rich—and in the words of Deng Xiaoping, “to get rich is glorious”!

The parents of these children were stuck with all they knew: the mindset that it's all about relationships. Naturally they were fearful—they all had iron rice bowls (in other words, jobs for life)—and didn't want to leave their state-run company because the state controlled their job, their housing, their medical attention, and their children's education. For them, the state was a one-stop provider and there was no perceived safe option for incremental change. Only the extremely brave were willing to try for a position in the new economy.

...to an Upside-Down Society

Despite the parents' practical concerns, the kids were keen to take advantage of the new opportunities. For the younger generation who were not so directly affected by the Cultural Revolution, their worst case scenario—if everything failed—was to go back and live with mom and dad who had an iron rice bowl.

When the kids are out there taking risks, working hard, and earning as much as they can, junior soon started to earn more than dad.

The norm (which is the current situation) soon became that as people graduated they would go and work for private companies rather than state-owned enterprises. These companies are paying a multiple of what state-owned enterprises pay (but obviously offer a different overall package, so for instance, housing is not included). Added to which, how can companies stay competitive if they have people who don't want to or can't change? There are fewer options for people who have never used a computer in their life.

So you reach a situation today where junior can be making 5- to 20-times what mom and dad are making. Usually someone works his way up, and even if he earns more than his parents, it takes a long time to accumulate the assets and wealth of his parents. However, in China today if mom and dad have been able to save anything over the last 40 years, it can be completely dwarfed by junior's earning power.

The net effect is to put the power of society in the hands of those who are making the money, and so in China today, in many instances, the younger generation is in charge.

A practical example of this power can arise if a son offers to buy his parents an apartment. While this may be a kind offer, the apartment will be in Shanghai (or another major city where junior lives) so that the parents can help with childcare. Mom and dad won't necessarily want to go, but they have little option. While their children control the purse strings, parents grin and bear it.

But while junior has the power, he doesn't necessarily have the maturity. Teenagers (and people in their early 20s) will not necessarily make the best decisions: they lack life experience and maturity. They are adolescents and they will do

what adolescents do. As the country becomes an even more significant world player, we will all benefit from the additional years and experience.

How to Manufacture in China

There are two main business models for manufacturing companies that want to manufacture in China:

- set up your own factory, and
- contract the manufacturing to an established factory.

There are benefits and drawbacks to both.

Setting Up Your Own Factory

Take a company which has proprietary manufacturing processes, which would like to participate in the global market by selling into China. This type of company would be likely to benefit from having a manufacturing base in China due to the geographical proximity to the market. This proximity would also allow the company to be in closer contact with its customers and to respond more quickly to their needs.

These companies are typically business to business suppliers. An example of this is a company which supplies assemblies to the automotive industry. Any company which considers itself to be a global player must have operations in China. This example company is no exception: it has capital-intensive proprietary manufacturing processes which are critical to their products. Without owning the manufacturing facilities in China its clients would not buy from this company. Period.

These factories are often world-class and, other than the cost of land and labor, are not any cheaper to build and operate than in the developed world.

Contract Manufacturing

On the other hand, contract manufacturing is valuable for fast moving consumables where companies have strong design, sales, and marketing.

This type of company would not benefit by investing in costly equipment or processes that could limit the flexibility of the company. From generation to generation of product, they can find the most suitable supplier (which has the most appropriate processes and capabilities) and take advantage of someone else's existing overhead. This allows the company to leverage the "local knowledge" that a contract manufacturer has, whether that be an ability to maintain a low-cost supply chain or effectively manage labor costs.

An example of this is an earphone manufacturer with highly stylized designs. The guts of the product are similar to, if not the same as, many other brands of earphones. This company lives and dies by making its sales based on having the latest, coolest, hippest designs (and the identity of the contract manufacturer is unlikely to be a consideration for the customer as the customer is buying the brand).

Chinafy the Process

People who want to take advantage of manufacturing in China will benefit by understanding how to China-fy their processes. Equally, they will benefit by understanding the compromises that people will try to make in China and only accept these compromises if they are the right thing to do.

Less automation gives more flexibility. The US, Korea, Japan, and Europe have all put in heavily automated systems for manufacturing. On the whole these systems are not flexible, for instance, if you want to reduce the thickness of the plastic casing for a product, that is not a simple change. This lack of flexibility means that companies in China which tend to be less automated can adapt more rapidly, and following

this example, they are able to use less plastic—perhaps only 1 gram less—and so cut their costs. Each incremental change keeps them a little bit ahead in the game.

By having their production lines rely heavily on manual labor, many factories can swiftly adjust for different types of production. It also allows for rapid and easy changes when the component mix changes or when the component design varies.

While this approach may seem counter-intuitive to Westerners—and it is certainly not without its disadvantages—this is the reality of manufacturing in China today. Remember that for all of its many and huge strides forward, there are still 800 million peasants in China: it's going to be a long time before the boat gets floated for that many people.

Of course this approach does mean that costs are going up and will continue to go up. For coastal regions costs—for instance, the cost of real estate and the salaries of manager-level staff with bilingual capabilities—may be nearing Western levels. But there are still a lot of people who would like to see their standard of living rise and so there will still be somewhere in China that will be cheaper. This means many factories will be able to adopt this flexible approach to manufacturing.

As you would expect, by taking a more manual approach you lose something in quality. While it may not fit with the conventional Western approach, if you can take out some of the capital intensiveness and replace it with some manual labor (with a suitable quality process) that is not always a bad way to go.

Managing Growth in Times of Chaos

In China past, companies were able to employ ten people to do one person's job because labor was so inexpensive. The

mentality was to throw bodies at a problem rather than take the time to understand the root cause of the problem and systematically remove these issues. In China today, only companies that design an efficient process—and continually improve it—will survive.

The more chaotic and inefficient companies will not fail for a single reason, but for a whole combination of reasons. For instance they will not be competitive because they will not get their processes right, they will not continually improve, they will not get their efficiencies, they will have too high a percentage failure rate, and so on. No one issue will be fatal, but when you add all the pieces together you get a company which will not be able to compete.

In my experience over the last 20 years in China, successful companies are usually the ones who are taking the time to:

- manage and continually improve their processes
- manage and grow their people
- understand their costs and market prices, and
- grasp how they can add value for their customers.

These are the companies that will survive and thrive. The opposite are the companies who will throw another body at a problem rather than go back and fix the root cause.

Let me illustrate some of the madness that is out there. I was in discussions with a company that is quoting on doing some plastic injection molding. As part of the molding they will build a tool and make parts. One of the engineers said that if the part came out of the tool warped they could put it in a cooling tank and hold it down with cooling fixtures so that it doesn't warp.

He couldn't see that he had just added two or three processes and made the end process less consistent than it could be. We don't want those added processes that will also have a

potentially detrimental effect on quality. Unfortunately the engineer was not focused on quality and efficient processes. His sloppy and lazy approach was to throw bodies at the problem rather than designing an efficient method to produce a high quality part the first time. He didn't have the mindset that it would be preferable to build a better tool rather than add more processes to compensate for poor design.

There are many companies and people with this mentality and they won't make it. This issue isn't unique to China, but it is more prevalent with the ready availability of cheap labor.

During recent factory visits near Shanghai, one factory owner reported that one-quarter of the factories in that area had gone bankrupt in the past months. These were mainly metal bashing companies (involved in stamping, forming, and welding). So while there are lots of cheap manufacturers in China, lots of businesses are able to cope and it's the inefficient ones that aren't surviving.

As overcapacity peaked and demand slowed at the end of 2008, we saw many of these less efficient factories simply close their doors for business—probably never to open again.

When the Price Is Too Good

Pricing is a symptom of incredible growth and lack of depth, experience, and maturity within companies. The whole process is incredibly frustrating, but at the same time, while I don't condone the practice, I understand how and why this happens.

How the Quotation Process Works

Let me try to explain what usually happens. Take a typical company that would like to know how much it will cost to have their product made in China. They send an RFQ (request for a quote) to a number of factories. A manager will receive the RFQ (which is likely to be one of many received that day)

and will flip it to a 20-year-old kid in the office and say “give me a quote by 5pm”.

The kid will be confused, overloaded, and distracted. He will have a stack of quotes on his desk left over from last week and he doesn't know how he will ever get to the bottom of the pile. He will be sending SMS (text) messages to his girlfriend between the eight concurrent chats he has going on his computer screen. He will do an incomplete job and pass the quote to the manager who will glance at it, sign it, and the half-baked quote will go out.

Only if the factory gets the business will they figure out what the customers wants and what it will cost to make it. This is incredibly frustrating if you're on the other end. Unfortunately, this is more often the case than not.

With our clients we will do the homework but we still find that when the first order is placed the factory will say “oh no, we can't do that”. Our process involves a manager level employee going through the bill of materials, specifications, and quality requirements—item by item. Even so, we still run into gaps of understanding.

Once the purchase order is placed, it could be months from the initial sourcing and quotes, and cutting a potential supplier loose at that point could leave the project behind schedule. To rectify this situation, we will work through the gaps of communication.

In spite of having a signed quotation, the supplier may throw up their hands and say it cannot be produced for the price they quoted. Sorry.

This brings to mind a recent project USActive handled to manufacture some exercise equipment. We requested pricing from a few factories on behalf of a client. The factory we chose was 40% cheaper than the closest competitor. When tooling was completed the factory nearly doubled the price!

They claimed a variety of reasons from the exchange rate, to material price increases, to a change in labor laws (all increasing their costs).

This was frustrating to us and to our customer. To better understand the options, USActive re-surveyed our supply base and found the other suppliers had also increased their prices albeit not by as high a percentage as the chosen supplier, but significantly nonetheless. Armed with the additional pricing information we were able to let our customer know that even though the original supplier doubled their price they were still within the new market price.

Many Westerners think that Chinese factories are trying to take advantage of a situation. Sometimes they are, but quite often they're not. Often these are honest mistakes because the factory staff are so busy and not necessarily very organized. It is frustrating that companies don't take a higher degree of responsibility or pay greater attention to detail, but that is just part of the game in a hyperactive economy. It is certainly an advantage when you work in China if you can handle a degree of uncertainty and change. If not then you will find China to be a very difficult place to do business.

The Chinese Approach to Contracts

In a Western contract-driven legal environment, the event (a contract) kicks off a process intended to achieve the results. In China, often a contract merely signifies an agreement to work together. Even though there are terms in the contract, these are often considered to be flexible and re-negotiable. It could be mistakes (such as a miscalculation on pricing) or changes in the business environment (material price increases) that will have you back at the negotiating table. When you go back it will be important to bring some "Ps"—patience, persistence and maybe even a bit of practicality. After all—when in Rome...

Renegotiation does not signal an intention to ignore a contract, or to minimize any of its terms, but it is important to understand that the terms and conditions may be revisited many times during its life. Each time the contract is revisited the provisions must be reasonable for both parties.

Working through contract changes in as fair a way as possible will build goodwill and respect on both sides. The relationship is not an event: it is a process. How you engage and handle the challenges that arise will be more important than the signing of the contract.

Management by Walking Around

Another point to remember is that patient persistence is a way of life in China. The squeaky wheel—the nagging—will often get attention. The Western business that tries to operate remotely (without having people on the ground in China) will not be able to keep on top of its contracts and manage the “process” during the life of the relationship.

I have found that when doing business, especially when implementing an agreed contract, it is important to know who you are working with, and there is no better way than being in contact regularly.

It's only by having people on the ground in China, who are regularly in contact with your business partners, that you will be able to verify the common understandings, or to see the earliest warning signs that something may not be on track. I always try to be clear on what I want up front, but the needs of all businesses change. This makes it even more important to have someone understanding and reviewing any changes between partners on a regular basis.

Getting a Proper Quote and the Devil

While it's great being able to understand why quotes are so variable and most people can understand why terms will change during the life of a contract, that understanding isn't

much use for a business that wants to get a reliable quote on which it can base its business plans.

So how do you get a proper quote?

The first thing to repeat is that, like many things in China, it's all a process and not an event (you will notice that I've said this before, and I make no apologies for the repetition). It is impossible to take the same approach that you would in Germany or Japan—you will not be able to nail down every detail. We always try to be as accurate as we can but we still have to work with the dynamic environment.

When USActive finds a company that:

- seems reasonable
- has the capabilities, and
- is interested

then we then spend the time. It is important to understand that each quote represents the first step in a process that may end in failure or success. Our team will go out to that facility and will go through the quote item by item, to make sure the company understands what they have quoted. As part of this process, among other things, USActive will go through:

- samples
- the original drawings
- the material specifications
- component lists, and
- function tests.

I have found there is great value in reviewing the specifications or getting them to read the specifications to us. During that review we probe further and ask practical questions—how will you make the wall thickness—can you machine to

that tolerance—what equipment will you use—do you have capacity—how much?

USActive is relentless and persistent, and looks at the challenge from as many angles as we can to ensure we narrow down the possibility of any misunderstanding. These questions also help highlight areas where the factory may not understand what is required and at the end of the process we at least know that the producer has been forced to think about what is required.

Also, as we will be receiving a number of quotes, we will be able to notice obvious discrepancies and follow up on these. So if one factory is quoting higher than the others, that may be an indication that they are intending many more manual processes.

The face-to-face interaction opens the door for further dialog where there may be other misunderstandings or where they will need additional information. The only way to get close to a reasonable quote is to get into the detail, make sure that the quoting party understands what they are being asked to do, and then check and recheck. There simply is no short cut. As the saying goes, the devil is in the detail.

Getting What You Order

In two decades of manufacturing in China I have never seen a set of drawings and specifications which matches the samples of the product currently being made. This is not a China problem: this is a manufacturing reality.

This is how it usually happens. Joe designer does the drawings. Bob makes the tooling according to the drawings. Steve starts to manufacture the product and it does not fit together. Steve goes back to Bob and says: part A and part B would fit together if you would make part B a little bit smaller.

Bob obliges, Steve can now make the product, and the boss is happy as they have something to sell.

But nobody told Joe and the drawings do not reflect what is actually being made. So when it comes to the point that the boss would like to outsource to China the company sends out drawings to get quotes. They find some good pricing, they make a contract and place an order, and the product does not fit together.

Nobody is happy. The boss is mad and says “can’t you guys make a good product?” The factory fires back “we made it to YOUR drawings”.

It seems obvious, but it is imperative to have clear, complete, and correct drawings and specifications. Too often this is not the case and it is the fault of the customer. In these instances, the China factor—with new business relationships, distance, and language barriers—only makes things worse.

Who is to Blame When It Goes Wrong?

To a great extent, I have found that you get what you order in China, but that is the same the world over. However, there are China-specific issues.

The biggest issue is communication: the interface between two parties. Often we just need to get two guys to sit down together in a room and one to explain the issue to the other and for the other to respond. It may seem blisteringly simple, but the root of virtually all problems in China is communication.

As with manufacturing anywhere in the world, hours and hours are spent in meeting rooms trying to figure out what the client intended or what the specifications mean. One thing it would be difficult to do in China would be to over-communicate during the process of getting what you want. However, there are aggravating factors such as the language,

the distance from the customer, and time zones that mean that working with the Chinese can be more of a challenge.

If you're a manufacturer and you're working with a toolmaker who might be five miles down the road (as opposed to a Chinese toolmaker who could be a full ocean or continent away from you) then you can go to lunch with him on a weekly basis. If this toolmaker is in China, lunch presents more logistical challenges and so the "how's it going"-type conversations don't happen. The informal back and forth isn't there and so issues tend not to surface. If the issues don't surface, they can't be fixed.

Another important factor to remember is that the Chinese do not (at the moment) have an ingrained business culture which looks to quality and improvement. The default for the Chinese company is "how can we make it cheaper?" The tendency is not to ask how it can be better.

They don't think about adding a bell, a whistle, or some new feature. They think how can we make it thinner, how can we make it faster, how can we slip in some filler so it's less expensive. It is atypical for them to consider added benefits.

Will it change? Absolutely. The reason I can be so confident is by looking at Taiwan, where that country started, and how much they have achieved in everything from processes, products, culture and life.

Think about Honda or Hyundai: these brands have all moved up the chain over the years. It's only a matter of time before the Chinese start innovating—maybe they'll come up with a new drink flavor. Maybe it will be something more conventional like a car design: there are Chinese automobile brands but currently the designs aren't too sexy and the way everything fits together isn't that great. But it will change—and how exciting it is to be here to witness!

Moving From Manufacturing to Innovation

The single most significant factor which is needed for the Chinese manufacturing industry to take the next (huge) step forward is innovation. But this is not a simple evolution: China is a country that has not placed value on design and creativity. There is a joke (which is unfortunately true in so many instances) that R&D stands for receive and duplicate.

In China, companies will copy anything and everything. They will take *any* shortcut to make a quick buck.

The comparison with India shows how far China needs to go on design. To give a simple example, India is able to design (from the ground up) a car to meet a market at a specific price point, and to meet that design aspiration. In China such a notion would be ignored in favor of swifter routes to riches. But again there is the comparison with India where you have family-run companies that are generations old—this means you have the experience and maturity, and there is perhaps a calming effect giving an environment where things happen a little more methodically.

China will evolve and will incorporate design: it's a basic need of survival. It is not just the efficient companies that will survive but those who are able to create. To take the next step forward China needs to be able to make components designed with an understanding of what the customer wants. Until that happens (and it is happening) China will remain a copy shop—a place where “I can do it cheaper” is a louder voice than “I can do it better”.

R&D is coming, but it is part of the evolutionary “development” process—there is little research currently underlying this development. As Western companies get their product directly from the manufacturer in China there is an increasing trend for Chinese companies to recognize that they could be the company to bring a new product to market.

Artisan Class

To design, China will redevelop an artisan class.

This is where the damage of the Cultural Revolution shows. They stole the wind out of the sails of a whole generation of people who were teaching the youngsters about their experiences. These were people of many talents: painters, poets, writers, engineers, business men, and lawyers. This means that people aren't able to reach out to an older generation—there is no one with grey hair that can share their stories and give sagely advice.

China is slowly getting back that culture. It's going to take a while to rebuild—to get a generation of people who have learned a skill, who have developed a skill, and who have managed people with a skill. As part of this they need people who have developed a well-defined interest in something beyond the notion of financial reward. Currently the focus is on money.

Eventually the artisans will resurface. These people will be less focused on money and will be passionately focused on doing what they do better simply for the beauty of their end product.

Moving Up the Value Chain: Westerners Giving Up on R&D

A big mistake made by some Western companies who outsource their manufacturing is to give up on R&D. I can best illustrate this with a few examples.

Take Schwinn bicycles: this used to be the only real bike brand in the US and was a major seller. Every kid growing up in the US had a Schwinn bike (me included). The company designed and made bikes and sold them through mom-and-pop bike stores.

Schwinn found that they could make bicycles cheaper in Taiwan and so they outsourced their manufacturing. Then

Schwinn got lazy and asked their manufacturer to design the next year's models, and so the manufacturers took on design.

While this was happening, the world started to change. Mom-and-pop bike stores started to get competition from “pile ‘em high, sell ‘em cheap” big box retailers. The world of bike selling changed: you don't need to pay a premium for a product that just needed its tires pumped up.

Schwinn was locked into a declining network, it had lost design control, and the manufacturer then decided that not only could it manufacture bikes, it could also design and sell under its own brand (Giant) and sold the bikes through big box retailers. It was a near perfect storm for Schwinn.

That evolution is a typical scenario for many products and industries. Several things happen at once: the sales channel goes from intimate to mass market, and the company that used to have manufacturing and R&D at its core has given up those core skills to become a sales organization.

There are many similar stories. I know a hand tool manufacturer that was founded on a deep understanding of what its customers wanted. Then they got someone else to make their tools for them. This was fine. Then they decided that their manufacturer also had some interesting products and so instead of designing their own products, they filled out their own product line with some of their manufacturer's other products. And in so doing, they lost a core competency—design.

Who Owns the Design?

As well as giving up on design, other companies don't make the right investment and see things through. Often this is naivety about intellectual property ownership.

Usually what happens is a company comes up with a concept, but they don't want to pay an engineer to take that concept to drawing, and then from drawing to prototype, then back

to the drawing board a few times to get it right. Instead, they start with a concept and work with a Chinese company to get it made. During the process, the Chinese company will develop a set of drawings and make incremental improvements on the design and tooling to make the product functional.

So who owns the design?

The foreign companies think they have prior art. Chinese companies think “you haven’t paid me a dime, not for revision 1, not for revision 301. Do you have a set of drawings?” It’s at this point that the foreign customer gets angry and frustrated, then looks meek and humble, and slightly scared. It happens again, and again, and again.

Retaining the intellectual property is important, as is making the investment in research and development.

The Legal and Political Background to Manufacturing

Underlying the day-to-day working relationships with any Chinese manufacturer, there is the Chinese legal and political background. China is a country which is seeing huge changes, many of which are intended to rectify years of disastrous and destructive government policies.

As a country, China has a deep hunger for the future and is racing to that goal as quickly as it can. In this race some people are getting trampled underfoot. However, to balance this, there is a maturing view about the necessity for the rule of law and the consistency of the law’s application.

When the Village Tells the Factory to Move

With the rate of development of the country, and more to the point, if things are going to change quickly enough to pull the huge population out of poverty, then some changes need to be made “for the greater good” which may have short-term

negative implications for individuals. These changes are a regular occurrence.

A client of USActive had eight years left on a long-term lease on a factory building. The village government came in one day and said “time to move”. A year later after dragging our feet and negotiating we were able to get a settlement which left our client with RMB1 million in the bank after paying for the move related costs.

Situations like this do not always come down to legal or moral arguments. However, there will usually be some compensation when the other party is not fulfilling its obligations. The best approach is to take the compensation and get on with life. There’s no point in moaning because no one will listen or care. In the case of our client’s factory, the moral of the story was to not be in too much of a rush. Use the time to investigate alternatives, use the “Ps” to your advantage and wear them down with some of your own persistence. In the end you will likely be able to work out something that works for both parties.

Again, the comparison with India is enlightening. Because India has democracy, the authorities can’t say to people that this week’s rules of the game have changed and it’s time for you to move. Instead if you want a road to go from A to B in India it will take a decade of consultation. In China by the time you’ve turned your head, the road is built from A to B and they’re building from B to C and anyone who was in the way will have received some sort of compensation—and the road will get completed.

At this stage in its development, China is being quite fair and quite pragmatic: the alternative is not to develop. They need this pragmatism to make things happen and the court system doesn’t slow things down. The other factor to remember is that the country is run by engineers: people who have been

trained to make things happen and who are therefore the best people to be in government. Compare that to the West where government is run by lawyers and movie stars.

The outcome of this approach is that China has been able to develop (in particular its infrastructure) very quickly. For an example of this, look at Shanghai where they are building a 26 square kilometer transportation center at the domestic airport. It will have a magnetic levitation train station, numerous train lines, hundreds of bus lines, an airport, subway, and light rail. It will be the largest human transportation hub ever built in the world. It started in 2007 and will be finished before the Expo in 2010. When China puts its mind to it—they will make it happen—and on time.

When the Government Tells the Factories to Clean Up Their Act

It's not just the village governments that have an impact on businesses.

USActive undertook a study of plating companies. As part of this study we identified over 550 different plating companies in a region. Subsequently the government decided to crack down on polluting companies—the impact for plating companies (who are big polluters) was to require them locate their facilities in a government run industrial park. The park would then handle all of the waste water treatment so that the pollution problem could be addressed and there would be no option for any company to cut corners.

From 550 companies, the government decided to allow 20 licenses. The transition from 550 to 20 was introduced over a five year period. The effect was to force consolidation, but it also made sure companies obeyed the law. Naturally, the long-term effect is China will be a greener place (albeit a more costly place to do plating).

More Laws and Less Flexibility

The law in China is black and white (and there are plenty of laws). However, the way the law has been applied varies. There are many laws that have always been there but the enforcement has been patchy depending on the region, or the people involved, or a particular political hot button. Currently there are first generation lawyers and first generation judges: the guys on both sides of the big desk have the same limited experience. This will evolve and mature, but it's not there yet (and thank goodness it is not as litigious as America!).

In addition, as the country opens there is a need for different or more relevant laws, and so the law is evolving and will be enforced with greater uniformity. There will be more transparency, more relevancy, and more consistency. As anywhere, the laws, their relevancy, and their enforcement will be a step or two behind development, and as China develops its legal system it will narrow the currently large gap.

Protection of Intellectual Property

China—quite rightly—has a reputation for ripping-off intellectual property: the notion of receive and duplicate is justified and that label will probably stick for the coming decades. However, the practice is changing, albeit slowly, and there is a growing appreciation for intellectual property rights with an increasing respect for the laws that enforce these rights.

As Chinese companies develop their own intellectual property and want it protected they will force the system to become fairer. This will happen with the growth of the artisan class.

However, all is not lost at the moment and there are other avenues for companies who have had their intellectual property rights violated. It does take a concerted and comprehensive

approach to enforce the protection as we recently found out when we helped one of our clients.

We were dealing with a US company with world-wide patents (including for China) that was producing a component that could be easily copied, and the component was being copied by Hong Kong and Chinese companies. We identified the main knock-off producers and selected the weakest. We then hired a local Chinese lawyer and set-up a bonus scheme for the lawyer so that he would be well rewarded if we collected.

USActive assisted with information collection and helped with a media campaign. We also prevailed upon the US Consulate to apply pressure and make it a political as well as a legal issue. The outcome of hitting the problem from a lot of different angles was good: we won our case and collected a substantial sum.

As far as I know, at the moment this approach is still fairly rare. However, it is getting easier to fight this battle. It's not every day that the foreign company is successful and the stories are not always happy. But the rule of law is getting stronger.

The even happier ending came the next week when we licensed the five other knock-off producers to give our client an ongoing royalty stream.

Where is Manufacturing in China Heading?

Every week I get asked whether there is a future for manufacturing in China. The short answer to that is a resounding YES!

The longer-winded version of that is as follows. As the market environment changes, China is becoming a relatively more expensive place to make things (relative certainly to where it was 10 or 20 years ago). Costs have been increasing

in US dollar terms and otherwise. The exchange rates are making it more costly to export.

Changes in government policy discourage high energy consuming and high polluting industries (through a reduction in the sales tax export rebate). Those industries are being forced to reform or relocate. Recent government policies which place more of the employee benefit burden on the company also increase the cost of operating in China.

At the end of 2008 we are seeing most of these factors being reversed—at least for the near-term. The exchange rate has stabilized. Sales tax rebates are being increased and material prices are coming down. China will continue to allow the pendulum to swing in this direction for the near-term.

Longer-term, all of these trends can be expected to continue. China would like to, and will increasingly move to, higher value-added types of manufacturing and services forcing the lower level types of manufacturing to other lower-cost countries.

That being said, China is a massive country with an enormous population. There are millions of people eager for a job, and it is those people who will continue to keep the China manufacturing engine churning out product for a very, very long time.

Lessons Learned

There are many lessons to be learned to have a happy manufacturing experience in China.

- First off, it is difficult to over-communicate. Communication has nothing to do with what you say: it's all about what the other person understands. Take the time to make sure that the other person has understood. Communicating properly includes following up

on a regular basis to ensure that the understanding is reinforced through the process.

- As well as communicating, make sure that the information you are supplying is correct. For instance, check that any drawings you send to China reflect the product you want built, and not the product as it was originally designed and before you made the changes that actually make it work.
- The costs in China can be so much lower than they are in Western markets and the desire to outsource to China is often driven by costs. This encourages cost cutting in all areas of the business. You cut every cost you can at your peril.
- Lack of control of your research and development—in particular, if you don't make the necessary investment so that you are controlling the development of a product after it passes to your Chinese counterparts for manufacturing—equates to giving away your intellectual capital. Unless your strategy is to continuously out-innovate the competition, this may not be a smart move.
- Patience and persistence do pay off. Whether setting (and maintaining!) the vision and values of your company or dealing with suppliers—patience and persistence have always proven to be effective.