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Asian companies and the China challenge

Soaring dragon, busy tigers

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The rapid industrial rise of China is the third shock in quick succession to companies in neighbouring economies. How are they adjusting to it?

ITS name, Giordano, sounds Italian. Its business model, too, rings western—as a fashion retailer, similar to Gap, Giordano trades largely on its brand name and makes money by maximising "asset turnover" (sales divided by assets) and other management ratios beloved of Harvard Business School. Even its ownership seems Anglo-Saxon: Giordano's shares are publicly held and no single owner has control. All of which makes Giordano something of a rarity, for it is Asian.

A typical description of a traditional company from Hong Kong, Giordano's home, or from the other "tiger" economies in East Asia, would be the exact opposite. There would be no concept of branding. The business model would be based not on pushing more sales through fixed assets, but on asset-trading—buying a property or other commodity and selling it for profit at the first opportunity, with no attempt to build a lasting franchise. A founding family would control the firm and run it one transaction at a time.

If that business model is now in decline, and gradually being replaced by the one that Giordano espouses, it is thanks to three powerful economic shocks. The first—severe, but nonetheless short—was the financial crisis of 1997. The second—also severe, but now also looking ephemeral—was last year's collapse in the region's western export markets. It is the third shock, the rapid industrialisation of mainland China, that is now proving the biggest, and most lasting, catalyst for change.

East Asia's tigers industrialised in the 1970s, 1980s and early 1990s, when China was just starting to re-enter the world economy after its long Maoist isolation. In those years, tycoons in the tigers could count on two things in their favour. The first was an advantage in labour costs over rich countries, which allowed tiger firms to out-compete their western rivals in manufacturing anything from shoes to ships. The second was predictably rising prices, which made the tycoons' asset-trading a sure bet. Companies such as Sun Hung Kai, Hong Kong's largest property developer, and OUB, one of Singapore's top banks, rose to riches simply by riding inflation.

The China comparison

China's gradual re-entry into the global economy during the 1990s, and its recent acceptance as a member of the World Trade Organisation, mark the end of this phase. The relevant cost comparison in labour-intensive industries is no longer between the tigers and the West, but between China and everybody else—and China, with average manufacturing wages of 60 cents per hour, usually wins hands down. Moreover, China, with overcapacity in nearly every export sector, is now spreading deflation to the rest of Asia. “The Asian crisis was a one-time shock,” says Andy Xie, an economist at Morgan Stanley in Hong Kong. “But China means that the whole region can never return to inflation and mere asset-trading.”

China therefore spells doom for many once-illustrious companies in the tiger economies. Giants such as Formosa Plastics, once a Taiwanese petrochemicals blue chip, or Henderson Land, one of the biggest Hong Kong property developers, have already become mere shadows of the empires they used to be. But others are more nimble. Corporate re-engineering, a fairly new term in East Asia, has begun.

It comes in three main forms, of which two are easy and opportunistic, and one is difficult and far-reaching. The first two are about companies decoupling from their home economies. On the cost side, this often means moving factories to mainland China. Already, for instance, over half of the information-technology products of Taiwanese companies are actually made on the mainland. Acer, Taiwan's best-known computer brand, looks increasingly like a mainland company with a head office in Taipei. The same shift is also happening on the revenue side. South Korea's Samsung Electronics, for instance, is hoping to triple its sales in China to $7 billion in three years.

It is the third form of restructuring, however, that is transforming the soul of companies: changing their position in what consultants call the “value chain”. Here, China is the catalyst, but the change affects how tiger companies are situated not in China, but in third-country markets or at home.

Traditionally, tiger companies have been good at “back-end” functions such as trading, production and logistics, reckons Mark Daniell of Bain, a consultancy, and bad at “front-end” stuff such as marketing, design, innovation and packaging. “Now China is the ultimate back-end machine,” says Mr Daniell. This forces tiger companies to build a front end.

Mostly, this means concentrating on intangibles. Take, for instance, semiconductors, a business in which South Korea, Taiwan and Singapore are strong, but into which China is now aggressively moving. What does, say, Taiwan Semiconductor Manufacturing Company, the world's largest non-branded chip maker, sell that China's mushrooming foundries cannot offer? Morris Chang, TSMC's chairman, says that it is “trust”, not only in quality but also in the security of a customer's intellectual property.

The most successful tiger companies often restructure in all three ways. Consider Giordano again. These days, it sources some 90% of its garments from mainland China. The mainland, where Giordano already has 500 outlets, is also the biggest sales contributor. More fundamentally, however, in recent years Giordano has changed its corporate culture to concentrate on such soft skills as inventory management, store layout, service and style.

The key intangible that China is forcing Asian companies to cultivate, says Peter Lau, Giordano's chief executive, is “differentiation”. A shirt, for instance, is a commodity; and Mr Lau thinks there is no money in competing with mainland China in selling commodities. But take a shirt and turn it into an image (a promise of hipness, say), aim it at a specific customer segment (such as young Filipinos in Hong Kong), and display it to them in the right setting and with enthusiastic service, and you have both differentiation and a winning business model.

There is, in other words, nothing mysterious about the effect that China is having on corporate strategy in the rest of East Asia. Companies in the tiger economies are undergoing the same sort of evolution as those in America and Europe once did. Indeed, they would probably have started thinking about differentiation anyway, even had China remained closed to the outside world, says Usha Haley, an expert on Asian business from the University of Tennessee. It is just that now the change is no longer one of ambition, to be pursued at leisure, but one of survival, to be started at once.