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80
Press Contacts
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THE NEW WAVE OF LOCALIZATION

Why Foreign Companies Are Building a 'Second Home' in China

In the past decade, views on China have noticeably changed — driven by trade-related tensions, political differences, a perceived reversal of opening-up policies, and, last but not least — the pandemic. Opinions of both Western politicians and the public have turned considerably negative. According to the Pew Research Center, 71% of the German population had a very or somewhat unfavorable opinion of China in 2020, compared with only 37% in 2002. The results are even more striking in other countries. For European parliamentarians, it is now common to refer to China as a 'systemic rival.'

Increasing Relevance of China Business Despite Negative Sentiment
Despite these fundamental changes in the relationship of China with the rest of the world, there seems to be a very different sentiment when it comes to consumption patterns, purchase decisions, and business strategies.

In 2021, China traded more with the rest of the world than ever before. USD six trillion in export and import value shows that China remains deeply connected with the global economy. Pushed by demand from the EU and US, the country recorded its biggest trade surplus to date. Consumers in both Europe and North America still do not want to miss products made in China. For Germany, China was once again the largest trading partner last year.

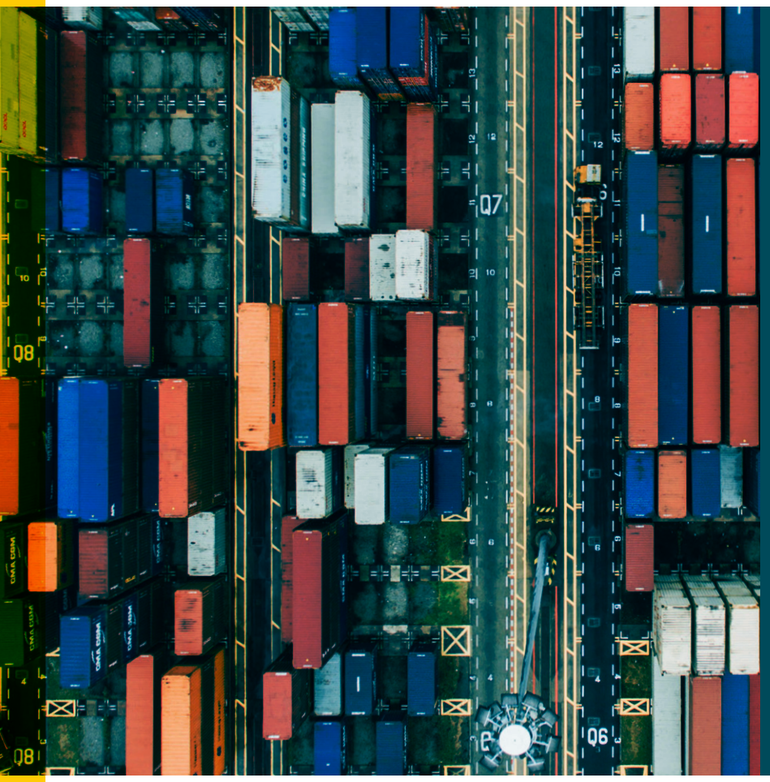
Another indicator: Foreign Direct Investment (FDI) inflows reached a new all-time high. According to the Ministry of Commerce, the used foreign capital in China hit a record of USD 173.5 billion in 2021 — increasing by 20% YoY. China overtook the US and is now the largest recipient of FDI in the world, accounting for roughly 25% of the total, based on OECD numbers.

But it's not only national economies — private companies are also highly intertwined with China, either for supply chains or as a market. The average China revenue share of DAX companies stood at 15% in 2019 (Handelsblatt) and has most likely further increased throughout the last two years. For US-American S&P 500 enterprises, traditionally mostly focused on their strong home market, the China turnover share is 7% (JP Morgan, 2021).

Apart from sales, more and more research centers are opening in China: By now, almost all major global corporations — from DuPont and Airbus to Tesla and Lego — have set up innovation or R&D centers in China. Examples of openings or extensions in 2020 and 2021 include German companies such as Volkswagen, Boehringer Ingelheim, Henkel, Beiersdorf, EOS, Siemens Energy, Rheinmetall, Vitesco, and Continental.

This also extends to collaborations with Chinese partners. For instance, the venture capital arms of large enterprises such as Merck, BASF, Bosch, or Evonik have been investing in promising local startups.

Infineon CEO Reinhard Ploss sums up how a sizeable share of managers of MNCs have acted over the past months: "We never considered to move away from China. We strengthened our China production and will continue to do so."



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Reasons for Increasing Localization of MNCs: Internal and External Forces
Underneath the prevailing China narrative, there are several reasons why foreign firms see the need to increase their exposure in the Chinese market and invest in upgrading their China value chain as well as organizational setup:

- China's dynamic rebound from COVID-19 in most industries and the above-average economic development has turned local subsidiaries into global growth drivers for many enterprises. This trend is likely to continue for most companies, even when GDP growth rates normalize.
- High revenue and/or margin contribution of the China subsidiary for most MNCs with a share of global above 20% is not uncommon. This is especially true for automotive OEMs or machinery manufacturers.
- Localization pressure either through governmental 'Buy Chinese' purchase policies (e.g., MedTec industry) or B2B customers who need to increase the local component share in their China factories (e.g., automotive industry).
- Widening differences between China and the home market in terms of B2C/B2B customer requirements, digital ecosystems, and regulatory environment (e.g., China's data protection law).
- The risk of not participating in the world's largest market is often regarded as higher than the risk of failure/ over-extension – especially by performance-driven financial investors. This also includes closer observation of market trends and Chinese competitors, who might eventually become global players.

In summary: localization is fueled by the unique characteristics and rising competitiveness of the Chinese market, as well as government policies.

Localization Strategies: Value Chain, Organization, Partnerships
Long gone are the times when China was purely a manufacturing hub or a "copy-paste" market in terms of products or marketing approach. Nowadays, products are increasingly designed and produced locally. A large portion of the value chain is in China.

In the 2021/2022 Business Confidence Survey conducted by the German Chamber of Commerce in China among its member companies, participation in domestic innovation was mentioned as the second most important business opportunity. Furthermore, 71% of surveyed companies plan to increase their investments in China in the next two years – mainly in manufacturing facilities and R&D. While around 30% of companies are already fully localized in terms of production and marketing & sales, the number is lower for R&D. However, 2/3 of respondents say they plan to either fully localize or at least increase localization in the future. The German Chamber calls this trend "Localization 2.0."

One example of succesful localization is KONE, the Finnish elevator specialist. With China accounting for 30% of global revenues, the company defined a country-specific strategy early on. This includes the development of products 'in China, for China,' localized management teams, a nationwide footprint across tier-1 to tier-4 cities, and a 'Dual Brand' strategy for a diversified approach of different local market and price segments. As KONE CEO Henrik Ehrnrooth stated in a 2021 public interview: "The old mentality of many international companies has

traditionally been: what we know in Europe or North America we will bring to China. But I think it has actually become the opposite now."

Some companies have even started calling China their second home market and acknowledge that this also requires building an appropriate local organization to manage it – with similar functions and competencies as in the headquarters back home. However, getting there is usually a complicated and lengthy process that requires a lot of internal alignment:

1. Discussion and clear definition of market strategy, growth drivers, and required capabilities – both cross-regionally as well as within the China organization.
2. Check of maturity of the Chinese organization in terms of current (management) capabilities and global governance frameworks.
3. Prioritization of key levers and enablers for step-by-step buildup of capabilities in most important areas.
4. Alignment with functional leaders in the HQ where adding resources, decision power, or value generation in China makes sense.
5. Stronger integration into the local (innovation) ecosystem via partnerships with Chinese companies, CSR activities to build government ties, or investments into Chinese startups.
6. Proper documentation and design of new processes in the implementation stage so that the local organization can grow sustainably.

A company that is currently undergoing this development is Hansgrohe Group, the Black Forest-based manufacturer of premium quality fittings for showers, bathtubs, basins, and kitchen sinks. Their impressive growth story over the last years can be partially attributed to ongoing localization efforts. Now, the company is enhancing its presence in the Chinese market with more product development capabilities, higher local value generation, and an upcoming Innovation & Experience Center in Shanghai. Thomas Stopper, Group VP Sales Asia, comments: "China's consumers are probably the most demanding consumers around the globe, and they are increasingly shaping their own trends and preferences. To win in China we must feel the pulse of the market and be able to quickly translate those insights into winning product and service concepts in China for China."

Balancing Act: All-in or Nothing

In the end, there is no one perfect recipe for each company and industry. Localization might not be the best strategy for everyone — potential risks of such a "full-on China" strategy cannot be neglected:

- High reliance on local economic development, as well as exposure to (geo-) political risks and possible supply chain hiccups.
- Possible leakage of Intellectual Property and loss of control, especially given COVID-19-related travel restrictions.
- Widening divergence of products, internal tools, and branding approach between China and other markets.
- Difficult global governance due to cultural barriers and different opinions on investment priorities (e.g., legacy roots vs. fresh ideas, "only the best" vs. "good enough" mindset).
- Fast result-oriented organization ramp-up might lead to insufficient internal processes and documentation of workflows.

Bettina Schön, Vice President of the EU Chamber of Commerce in China, summarizes some of the points above nicely in a comment for The Economist: "Companies might be forced to have two different systems running: one for China and one for the rest of the world."

Rather than a true decoupling from China, it is more the local operations of MNCs that are increasingly decoupled from global structures.

Current developments increasingly leave companies only the choice between losing market share or pursuing a full-on China strategy. Global management of medium-sized companies and some "hidden champions" needs to check if their investments in China are enough to sustain competitiveness.

While some foreign brands will be slowly crowded out of the market by Chinese or more localized foreign players, others will strive and arrange themselves according to the market realities – including a lasting strategic and political balancing act. The next five years will completely change markets worldwide, so foreign companies have to decide on how they want to play in China: all-in or nothing.

Marco Beba is a Managing Consultant at EAC International Consulting in Shanghai, advising clients on China market entry and growth strategies. Founded in 1992 in Munich, EAC has been supporting foreign companies in Emerging Markets for more than 25 years.