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A Chinese Approach to Management

by Thomas Hout and David Michael

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China Inc. might appear to be an improbable source of fresh management thinking. Its state-owned enterprises are, for the most part, regulated giants that are experimenting with Western management practices. China has yet to produce a world-class company like GE or Samsung, and outside the country most of its businesspeople are better known for amassing wealth than for innovative management ideas. Yet China offers more management lessons today than do most other countries.

Sure, China's best private companies aren't yet pioneering radical new management approaches, as Toyota and other Japanese companies did 50 years ago with total quality management, continuous improvement, and just-in-time systems. Instead, Chinese companies teach us management's current imperatives: responsiveness, improvisation, flexibility, and speed. These abilities give them a critical edge; studies (such as those by Qiao Liu and Alan Siu of the University of Hong Kong) suggest that China's private unlisted companies earn higher returns—14%, on average, versus the 4% earned by state-owned companies.

Chinese companies have learned to manage differently over the past 30 years because they've had to cope with a turbulent environment. What's commonly perceived to be the highly controlled march of state capitalism is in reality an enormous and quickly evolving ecosystem, in which companies must scramble to keep pace with runaway growth and dramatic slowdowns, massive urbanization and huge rural markets, fierce competition and endemic corruption.

Some scholars, such as Harvard Business School's Paul Lawrence and Jay Lorsch, have linked companies' management systems to the economies in which they grow. Stable, complex markets, their thinking goes, require structured organizations and managers capable of tackling several dimensions, such as functions and customer types, simultaneously. Rapidly changing markets favor loosely structured management systems, which can process new information quickly, and managers who can act independently. Chinese companies (barring state-owned enterprises) tend to fall into the second camp. They are higher in energy and much more nimble than most Western corporations are.

China's business leaders also manage people very differently. They're culturally predisposed to see the members of their organizations as family but, in return, demand a lot from them. CEOs often come from humble beginnings: Three of China's legendary company founders—Haier's Zhang Ruimin, ZTE's Hou Weigui, and Wanxiang's Lu Guanqiu—all started on the factory floor and fought to free their companies from state or collectivist management. Other enterprises were started by traders, teachers, or clerks. These companies build alliances constantly, develop new products prolifically, and venture into unrelated businesses all the time. They expect to sustain high rates of growth and are comfortable with a heady pace.

Business leaders in China also share two distinct perspectives. One is the view that they have to create their own ecosystems. The Chinese founder-manager believes that he or she will need to build almost everything—basic skills in recruits, suppliers, government ties, capital sources, and often schools for employees' kids—from scratch and on a large scale.

This is what Zhang Yong, who founded the fast-growing hot pot restaurant chain Hai Di Lao, does when he enters a new market. One of his key success factors is the ability to spot, recruit, and retain teenagers capable of growing into store managers by the time they are 21. Zhang tests trainees by assigning them tasks above their responsibility level, such as negotiating the takeover of a rival chain. That allows him to weed out those with low potential.

> Hai Di Lao’s Key Success Factor: The ability to spot, recruit, and retain teenagers capable of growing into store managers by the time they are 21

Because management bench strength is the biggest constraint on his company’s growth, Zhang deepens managers’ commitment by offering generous incentives, trips outside China, housing, and education for their children. He creates his own suppliers by offering wannabe entrepreneurs contracts that promise lots of business in the future. He is also a master at pulling together the capital he needs from varied sources: local governments that offer financial incentives and subsidies, Chinese Communist Party angels, provincial investment funds, and friends of friends. To a large extent, the ability to do that depends on forging personal relationships and showing that he can help bureaucrats meet their goals. Credit ratings aren’t necessary; it’s about who can be trusted.

The second view the Chinese founders share is that they have to be as adept at managing the state as they are at managing operations. For decades the Chinese Communist Party barely tolerated private companies. Start-ups had no standing, so conventional sources of raw materials, talent, and money were closed to them. Chinese businesspeople still have to tap officials to get licenses to operate, lease space, find workers, import materials, and raise capital. However, they’ve learned to make the system work for them.

The results would have fascinated Charles Darwin, whose research focused on how different species evolve in response to environmental pressures. If there’s a business equivalent to the Cambrian period of explosion and extinction of species, China from 1991 to the present is it. Many entrepreneurs fail in China, but the survivors become resourceful, flexible, and fierce competitors. Indeed, they may well be the vanguard of an era in which the ability to adapt quickly, navigate messy environments, and use unproven talent yields competitive advantage globally.

China's Unique Management Practices

Over the past five years, we've studied more than 30 large private Chinese companies. We found that most of them display a trading mentality that values high asset turnover and good timing over perfection; a Confucian preference for simple organizational structures, with everyone reporting to the top; a deep fear, stemming from China's past instability, of too much debt; and skill in dealing with different levels of the powerful state. The good companies, however, are defined by something more: high aspirations and an openness to experimenting with radically different management techniques and practices.

Structuring organizations simply.

China's business leaders are notorious for controlling companies from the top, but what is less well known is how much they decentralize, which helps them respond to market shifts and rapidly add new business lines. In China the need for adaptation is constant, and it involves keeping pace not just with the market but also with differences in the development of each province and the power of local officials.

Because such differences can be stark, Chinese companies create structures that give business units nearly total autonomy. Consider Midea, China's second-largest home appliances maker, based in Shunde, a city across the border from Hong Kong. Midea manufactures everything from vacuum cleaners and small water heaters to microwaves and air conditioners. Most of the major product lines operate as independent businesses rather than as parts of a larger matrixed organization. Each business has a leader responsible for its P&L, who has the authority to build a sales force, line up suppliers and retailers, and construct factories where the best incentives are available. The notion of synergies across units has been largely set aside; the focus is on autonomy and accountability.

Midea employed 126,000 people and generated $18.7 billion in sales in 2013; by comparison, Whirlpool had 69,000 employees and $19 billion in sales globally. Thus, Midea had nearly twice as many employees per unit of sales, reflecting some of the duplication of effort inherent in its organizational approach. Of course, Chinese companies produce more in-house and pay employees less than their Western counterparts, so Chinese enterprises can afford to employ more people. And in a country with little business infrastructure such as logistics providers, distributors, and retail chains, companies need a lot of manpower to grow.

The Chinese founders we've studied have as many direct reports as possible; these leaders take the idea of decentralization and flat structures to the extreme. Haier, China's dominant home appliance maker, comprises thousands of minicompanies, all reporting to the chairman. There are no pure cost centers; even the finance department functions independently, providing financing and advisory services for a fee. Though Western companies believe that multiple reporting lines protect them from risks, such as uneven product standards or hiring practices, while enabling scale efficiencies and learning benefits, most Chinese founder-CEOs eschew this notion. They chase topline growth at any cost and believe in structures that support rapid expansion. Indeed, improvisation and speed, coupled with low costs driven by economies of scale, create considerable disruption inside and outside China.

Companies in China operate in two time frames, executing today's business while preparing to double in size in anywhere from three to five years. This involves not just adding resources but incubating new business models and launching new brands. In the United States or Europe, the business unit head would normally handle both time frames, but Chinese founders usually appoint two managers, each autonomous and responsible for one time frame and, effectively, competing for resources. Chinese leaders prefer direct conflict to more complex, cooperative management structures that involve all their reports but operate out of their sight. Most would rather hire more arms and legs than create new cross-organizational roles.

Smart Chinese executives make decisions in an ad hoc manner and are micromanagers. The most-sought-after employees are entrepreneurial, ready for the rough-and-tumble, and less likely to be top-of-the-class candidates, who tend to gravitate toward state-owned enterprises. Trouble is, entrepreneurial people tend to leave as quickly as they sign on, which is why turnover in China's private companies is upwards of 20% a year. Moreover, most companies have invested little in talent retention and (unlike Hai Di Lao) are weak when it comes to coaching, feedback, and training.

Localizing value propositions.

Most of China is still developing, which means that it is marked by inexperienced customers, undercapitalized companies, no-name brands, and unique local business customs and traditions. The definition of quality, for example, reflects local needs. Construction companies will pay a premium for cement that dries quickly or can be poured in freezing temperatures, since they want to build at maximum speed and operate seven days a week. They will not pay a premium for cement that lasts 50 years instead of 30. Similarly, a Chinese retail chain will not pay for longer-lasting fixtures; if you remodel stores every six months, durability isn't what you want. Localization provides companies a way to capture value—through what they offer customers and partners, and how they go to market.

Sany's march to the top of the construction equipment business in China illustrates how different the task of adapting to local customers and government is there. The company's two biggest product lines are ready-mix cement trucks and excavators, which in developed countries are sold to contractors and expected to last decades. In China they're mostly sold to local leasing companies, which rent them to local contractors on a job-by-job basis. The leasing companies, though small, are well connected, so they compete on their preferential access rather than on durability, and demand financing so that they can keep their capital commitments down.

Sany's Key Success Factor: Adapting its equipment offerings for local leasing companies, who need low capital

commitments, not durability

Sany builds low-end machines, has very local distribution systems, sells with little or no down payment, and offers the most service. It uses more managers who know more people, in more places—a very different way to go to market. Multinational rivals like Komatsu and Caterpillar, in contrast, serve the upscale market, selling higher-end machines to the few better-capitalized construction companies. Sany's business model has generated tremendous economies of scale, so it now has raised its sights, acquiring the German Putzmeister brand and moving into a number of overseas markets.

Developing products quickly.

The speed with which Chinese companies develop new products from existing technologies and ramp up large-scale production is often impressive. It's a key reason that the Chinese have come to dominate the global silicon-based solar-panel business, forcing U.S. and Japanese producers to focus on more-exotic thin-film solar technology. Goodbaby International Holdings, China's market leader in baby carriages and child car seats, beats rivals by introducing 100 new products on average each quarter. Fast-food chains in the country, including KFC China, introduce more new products each year than their U.S. counterparts, because local variations in taste demand it.

The ability to launch new offerings is a by-product of heritage. Companies like Midea, Wanxiang, and Goodbaby started out manufacturing goods they didn't design. They learned how to prototype swiftly to meet buyers' demand for quick turnaround; to adapt designs to use different materials when the original materials were too expensive or unavailable; to modify equipment so that they could make different products; and, above all, to keep costs down. That flexibility helped Wanxiang, for instance, move from making bicycle parts out of scrap metal, to manufacturing components for Detroit's Big Three, to buying and turning around the factories of struggling U.S. automotive component makers.

Wanxiang CEO Lu's approach to the United States was homegrown and experimental and leveraged his trading instincts and low-cost Chinese factories. Lu sent his son-in-law, Ni Pin, to run the American operation. Wanxiang did not have superior production technology or product designs, so it focused on three other levers. One, it brought in cheaper parts from its factories in China to feed the higher-value machining and finishing processes in the United States. Two, it invested in several companies that Wanxiang doesn't control but from which it sources and to which it provides lean management coaching. And, finally, Wanxiang built stronger relationships with American managers and employees than the component operations' earlier owners had cared to.

> Wanxiang's Key Success Factor: Investing in the companies from which it sources and coaching them in lean management

Another company that takes a fast and flexible approach is the Broad Group, based in Changsha. It constructs buildings with remarkable speed and in an environmentally friendly fashion, using factory-built modules. Using a modular approach isn't new, but the company has redesigned the risers and box work that frame a building into smaller, more manageable pieces that can be built more efficiently in the factory, and has created material-handling systems that move the modules around swiftly and allow new layers to be added easily. The units have all the utilities embedded, are plug-compatible, and are shipped to building sites in 40-foot containers for round-the-clock assembly.

As these examples illustrate, the skills Chinese companies rely on are mainly downstream industrial competencies. They don't involve the upstream creation of technology, original designs, selection of materials, and design of equipment, or customer knowledge and marketing savvy. (The Chinese are just beginning to acquire design capabilities and the higher cost structure they entail.) Because of their downstream orientation, the practices of Chinese corporations differ from their Western counterparts' in some key ways:

Chinese companies generally keep engineering and manufacturing

close, often colocating them.

Multinational firms usually maintain greater organizational distance between the two functions.

Chinese companies tend to acquire new technologies either through formal licensing deals or by reverse-engineering them, but they keep the physical work of experimentation and production in-house.

Multinationals, with their opposite resource endowments, do the opposite.

Chinese companies hire more midlevel engineering and manufacturing people, even though they're getting expensive.

Multinationals' process design is usually driven by the desire to save production steps and labor hours, but the added engineering and manufacturing bandwidth gives the Chinese the luxury of tinkering, which can solve difficult problems. As many people know, when Apple had to redesign the screen of its first iPhone at the last minute, its Shenzhen supplier roused its engineers out of bed, developed a better screen, and overhauled the production line—in just four days' time.

Tencent, China's leading internet service portal, illustrates how companies gain an advantage by quickly rolling out new offerings in China. Tencent now has over 700 million users, but it is often criticized for innovating little and imitating a lot. It was launched in Shenzhen in 1998 by five founders as a free instant-messaging service named QQ, with a friendly-looking penguin wearing a red scarf as its mascot. Its key strengths are the rate at which it has added more features—such as games, search, an e-commerce marketplace, music, microblogs, and even a virtual currency called Q-coins—and the ease with which users can connect with one another. Visit a café anywhere in China, and almost everyone will be connected to QQ but doing different things. Yet, there's nothing completely new on the website, which earned profits of around $2.5 billion in 2013. Tencent just beats everyone else to it.

Using nonmarket strategies adroitly.

Building relationships with government and other institutions is critical in China; it takes more partners to get anything done there than anywhere else in the world. Smart companies work to understand the party and state agency organization charts, and the underlying power structures, in every province and city. The trick is in knowing which officials to approach for what and where their interests lie, so that mutually beneficial deals can be put together.

Chinese executives see forging personal relationships with party bigwigs as an essential way to manage costs, tax obligations, and market access. In turn, the party needs entrepreneurs to create a productive China and grow the tax base. It also needs to bring entrepreneurs into the fold as an important new political constituency. In short, the relationship between founder-managers and officials is often about problem solving rather than corruption.

During the 2008-2009 recession, for example, party secretaries and mayors wanted to minimize layoffs. In one city a large private employer was being hounded by a tax collector to settle a contract dispute in an unreliable court—a problem the city's party secretary could easily fix. The CEO struck a deal with the local party unit, promising no layoffs, and in return got his tax problems resolved fairly and quickly.

Consider also the story of China's biggest IT services firm, Neusoft, which was founded in 1991 in Shenyang by three university teachers. Neusoft bet half its capital on a desktop operating system, but it was quickly pirated. Cofounder and CEO Liu Jiren then had to scramble to develop custom software for B2B customers that would need Neusoft's services over time. Eventually, Neusoft began helping local and central governments modernize their IT systems, which made it indispensable to China's drive for modernization. Building on that base, Neusoft developed the capabilities to serve demanding customers overseas, partnering with multinational giants, such as Harman, Intel, SAP, and Toshiba, and establishing strong internal systems.

The peculiar mix of a powerful state and a weak infrastructure gives relationship-savvy founders like Wanxiang's Lu and Neusoft's Liu the wherewithal to venture into new industries, because they know how to build from scratch and have the connections to do it fast. They jump into white spaces, undeterred by lack of experience, since there are few dominant incumbents. Wanxiang, for example, is moving into the electric car business, and Neusoft into the medical diagnostic equipment business.

Chinese CEOs have plenty of room for creativity and can work around the state if they don't want to engage with it. That's what Wang Shi, the founder of the real estate developer Vanke Group, based in Shenzhen, did. Chinese property development used to be a local affair, with local governments making quick profits by repurposing agricultural land and selling it to construction companies at auction. The latter put up shoddy buildings and created poorly planned communities, leaving middle-class residents dissatisfied and unable to find housing that fit their needs.

Wang forged a different path. He avoided the auctions and bought land directly, wherever possible, from cooperatives and governments. That allowed him to reduce land acquisition costs, although the locations were not in prime areas. He then built good-quality residential complexes, created roads and shopping plazas, and turned Vanke into a reputable brand. City officials began to seek him out to do business on his terms, and Vanke leveraged its reputation to become China's largest residential developer.Chinese business is all about adaptation to the context. Management that grows from the frontierlike conditions in the country is more homemade, vertical, and local. In many ways Chinese management is a throwback to the days of Henry Ford, RCA, and Standard Oil, when national markets and professional management were just taking shape in the United States. In contrast, American multinationals today have to work hard to stay lean and nimble despite using many mechanisms to coordinate, integrate, and control their business units. The future of management lies somewhere between the top-down reform of Western corporations and the bottom-up maturation of Chinese companies. They have much to learn from each other.

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Thomas Hout is adjunct senior lecturer at The Fletcher School of Tufts University and a former partner at The Boston Consulting Group.

David Michael is a partner in BCG’s San Francisco office and the global leader of BCG’s Global Advantage practice area.

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