The McKinsey Quarterly

Reassessing China's state-owned enterprises

China's state-owned companies, like China itself, are diverse. Many of them would make better partners for multinationals than some of their private-sector counterparts. Openness, not ownership, is the key.

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July 2008

For many years, the West has viewed China's state-owned enterprises in black or white. In one portrayal, they are infiltrators to be viewed with suspicion. An example: Aluminum Corporation of China's (Chinalco) recent multibillion-dollar purchase of a stake in Rio Tinto has raised fears about China's agenda for the acquisition of Australia's resources. The other version sees state-owned companies as muscle-bound goons: without the smarts of a private company but with plenty of brawn. In this characterization, they are relics of a failed economic experiment that still dominate the national economy, controlling natural resources, utilities, and many other vital sectors. Their power and influence—particularly their links to the ruling Communist Party and government—give partners and competitors pause.

Both views, however, fail to recognize that as the Chinese economy evolves, it is no longer so easy or desirable to pigeonhole state-owned enterprises. The line between them and private-sector companies has blurred considerably. Over the next five years, as the economy and business climate continue to shift, the ownership structure of state-owned companies will matter much less than the degree of openness they show in their business practices and management—that is, their transparency and receptiveness to new ideas.

An out-of-date impression of state-owned companies distorts the picture of China's competitive landscape and masks both opportunities and threats facing multinationals. A more current view would, for example, have them consider more favorably the value that certain state-owned companies might bring to a global partnership. A realistic multinational must also recognize that they will become more attractive to top talent and, probably, more innovative. Both developments will ratchet up the level of competition.

Today's state-owned enterprise

Many observers define a Chinese state-owned company as one of the 150 or so corporations that report directly to the central government. Thousands more fall into a gray area, including subsidiaries of these 150 corporations, companies owned by provincial and municipal governments, and companies that have been partially privatized yet retain the state as a majority or influential shareholder. The oil company China National Offshore Oil Corporation (CNOOC) and the Chinese utility State Grid Corporation of China (SGCC), for example, are clearly state-owned enterprises under the first classification, while the computer maker Lenovo and the appliance giant Haier are less clear-cut cases, in which the state is the dominant shareholder. A majority of the equity in the automaker Chery belongs to the municipal government of Wuhu.

State-owned companies of all kinds have gradually been losing some of the advantages once conferred by their relationship with the state. Since the 1980s, the Chinese government and the ruling party have followed a policy of *zhengqi fenkai*, which formally separates government functions from business operations. The policy has been applied gradually, first to the consumer goods industry, then to high tech and heavy manufacturing, and, more recently, to banking, as officials have attempted to strengthen domestic businesses and the economy to prepare them for unfettered global competition.

As a result, government favoritism toward state-owned companies is fading. Top officials have started holding them more accountable for their successes and failures. Their access to capital at below market rates has been severely limited. From 1994 to 2005, 3,658 state companies failed, according to official statistics. More such bankruptcies are likely.

Many state-owned companies remain encumbered by legacy assets, including obsolete equipment and technology, as well as broad social obligations such as health care and worker pensions. Nonetheless, China is addressing these issues. As the government progressively institutes universal social security, the burden of providing health care and pensions is shifting from businesses to the state. Physical assets (for instance, hospitals and school buildings) that don't contribute to the core business can be sold at a profit on the open market. In fact, the government's pervasiveness in society gives China's state-owned enterprises freer rein to confront these issues than their counterparts in more open societies enjoy: the Communist Party controls both labor and management, eliminating the overt tensions that make public-

sector reform difficult elsewhere. Over the past decade, tens of millions of workers have been laid off by state-owned companies striving to become leaner organizations.

As the distinction between a state-owned and private enterprise blurs, the challenges that both face are converging. Chinese companies, in the public or private sector, must gain approval from government officials for cross-border M&A and other global activities. Even the top-tier state-owned companies—those reporting directly to the central government—struggle with many of the same problems confronting their private-sector counterparts as they move beyond China's borders. In particular, they struggle with the toughest of these problems: integrating newly acquired businesses and employees. Since most Chinese companies large enough to pursue global aspirations have some connection to the government in its capacity as financier, customer, or tax authority, they face similar political obstacles in making headline-grabbing international investments. When Lenovo bought IBM's personal-computer unit, for instance, the Chinese company had to accept certain restrictions after US politicians raised concerns.

Judging by openness

In view of these changes to the Chinese corporate landscape, a company's ownership structure is no longer a legitimate test of its merit. Lenovo and the chemical producer China National BlueStar, a subsidiary of China National Chemical (ChemChina), for example, both have significant state shareholdings but are nonetheless valuable partners for suppliers and customers, as well as astute managers. And in China as everywhere else, private-sector ownership is no guarantee of success: D'Long International Strategic Investment, one of China's largest private-sector conglomerates, had to be rescued from the brink of collapse in 2004, when the state intervened.

A better way to judge a Chinese state-owned company (and a private-sector one as well) is to examine the openness of its organization. Experience in developed and developing markets alike shows that open companies, in either the public or the private sector, have a greater chance of prospering. An open company is institutionally more adept at understanding the context of its business and pushing through the necessary responses to change.

One important indicator of a company's openness is its approach to talent: open companies are willing to bring in external managers, including foreigners, as needed. Other indicators of openness are the efforts that companies make to broaden their investor base, to adopt best-practice governance systems, and to embrace new ideas no matter what the source might be. Open companies are also more transparent and have a greater awareness of risk, particularly during overseas expansion, because they take part in a broader dialogue with their stakeholders and are more willing to challenge internal shibboleths. All told, open companies are more likely to understand and adapt to different environments; closed ones are much less flexible.

Further blurring the traditional differences between state-owned and private-sector companies in China, market forces unleashed by government reforms are pushing state-owned companies to become more open. The need for capital and the desire for new markets abroad are significant factors. International IPOs, even when they represent a small fraction of total shares, create more transparent reporting requirements. Likewise, managing supply chains, communicating with business partners and acquired companies, and integrating an expanded workforce all compel state-owned companies entering the global market to become more open—or to stumble if they don't. A few years ago, for instance, the consumer electronics maker Changhong failed in its attempt to enter the US market, largely because it relied too much on a small Chinese distributor instead of focusing most of its attention on getting to know the critical big-box retailers. Lessons like these are being watched by other state-owned companies. Meanwhile, some private-sector companies—especially family-owned ones—maintain a decidedly closed management style.

Evaluating Chinese companies by their degree of openness and not their ownership is more than an academic exercise. By accepting the idea that a state-owned Chinese company can be an open one (and that a private-sector Chinese company can be closed), competitors and potential partners alike can more accurately assess the threats and opportunities posed by state-owned companies entering global markets—and respond with knowledgeable rather than reactionary strategies. For multinationals, four areas will be significant.

Partnerships

Corporations outside China should increasingly see the country's open state-owned enterprises as partners in global markets rather than only as conduits into the Chinese market. Such companies, which have global aspirations and easier access to capital than their private-sector counterparts do, will help to propel a larger, more sustained wave of Chinese cross-border acquisitions than we have seen thus far. They should be accepted as peers capable of adding value to joint ventures around the world and as credible buyers of assets.

Some multinationals already view Chinese state-owned enterprises in this light. Since 2002, GM, for example, has partnered with the state-owned Shanghai Automotive Industry Corporation (SAIC) in the South Korean venture GM Daewoo, which builds cars and sells components to GM's US operations. A US

power generation and distribution company is actively discussing global alliances with Chinese state-owned power-equipment manufacturers. And last year, the French specialty-chemical maker Rhodia, following in the footsteps of many other multinationals that have found willing and credible buyers in Chinese state-owned companies, sold its silicones unit to BlueStar.

Talent

Now that open companies—state owned and private sector alike—lead the development of China's corporate sector, the war for talent will get much tougher. Multinationals that do business in the country must radically improve their talent proposition to compete with successful, open state-owned companies that can offer high-performing Chinese workers an opportunity both to "serve the nation" and to receive good compensation in fast-growing businesses. Foreign talent too will be attracted to the challenge of nation building accompanied by good pay.

No longer do the multinationals have a monopoly on meritocracy; open local companies offer comparable environments. In response, the multinationals must make more senior positions available to their Chinese talent in China and—especially if their fortunes in the country have a direct impact on global operations—create organizations that not only train Chinese talent but also retain it for senior-management roles. That will often mean relocating a larger portion of a company's global structure to China. To compete in this more challenging talent market, multinationals must become more Chinese in the composition and location of their management.

Sourcing

Multinationals that have relied primarily on the Chinese private sector for their sourcing must monitor their supply chains for signs of failure and be ready to cast a wider net. Dependence on a closed family-owned supplier, for example, is probably riskier than partnering with an open state-owned enterprise: rising costs, thinning margins, and increasing pressure to add more value could be too much for many closed companies, no matter who or what owns them. Experience shows that closed companies are rarely flexible enough to counter rapidly changing conditions.

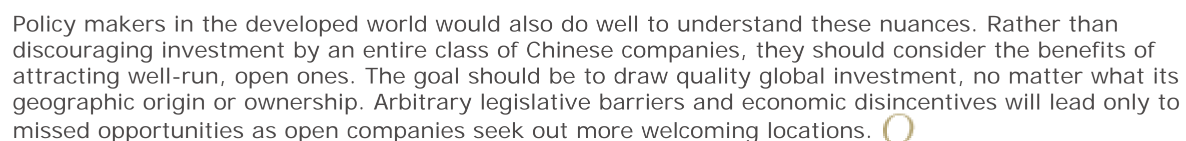
Multinationals that now use closed suppliers will have to compare the costs of helping them meet the challenge or of switching to more open suppliers of whatever ownership. Improving the current supply chain could require major investments—for instance, to help suppliers optimize their own supply networks, to improve their plant operations, and to enhance their order-forecasting ability. Since a current supplier already understands the products of its customers and has existing relationships with them, helping it meet the challenge may be the better option. If not, multinationals should feel comfortable considering more open replacements in the public and private sectors alike.

Innovation

Open state-owned companies with ready access to capital are likely to increase their investments in research and development, so breakthrough innovations from China will come sooner rather than later.[1] R&D spending there has grown rapidly over the last few years: the Organisation for Economic Co-operation and Development (OECD) estimates that in 2006, China became the second-ranking investor in R&D, just passing Japan but still behind the United States. It also placed second in the OECD rankings for the number of researchers employed (926,000, compared with 1,300,000 in the United States). Multinationals jealously guarding their intellectual property against theft in China could find that the real threat is obsolescence, not piracy.

The Chinese telecommunications company Huawei, which invests about 10 percent of its revenues in R&D, illustrates what can happen when open companies get a head of steam: the company ranks among the world's top ten telecom-equipment vendors; last year it won more new contracts for UMTS[2] telephony equipment than any other company and ranked fourth in the world in the number of international patent applications. Multinationals should therefore reconsider a wide range of established thinking, such as their ability to trade technology—often older technology—for access to the Chinese market and the benefits of locating R&D in China.

Global leaders—public and private—must recognize the importance of taking a nuanced view of China's state-owned companies. On closer inspection, many are quite different from the stereotypes. Multinationals that recognize this reality will be a step ahead of the game as Chinese state-owned companies pursue their global ambitions.



Policy makers in the developed world would also do well to understand these nuances. Rather than discouraging investment by an entire class of Chinese companies, they should consider the benefits of attracting well-run, open ones. The goal should be to draw quality global investment, no matter what its geographic origin or ownership. Arbitrary legislative barriers and economic disincentives will lead only to missed opportunities as open companies seek out more welcoming locations. Q

About the Author

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Notes

[1]For a broader discussion of innovation in developing markets, see John Seely Brown and John Hagel III, "Innovation blowback: Disruptive management practices from Asia," mckinseyquarterly.com, February 2005.

[2]Universal mobile telecommunications systems, one of the third-generation mobile-telephone technologies.

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