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The Strategic Challenges of Decoupling

Navigating your company's future in China

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Spotlight

FOR U.S. POLITICIANS and the public, shortages of N95 masks and other key medical equipment at the beginning of the coronavirus crisis highlighted just how dependent the United States had become on production in China. The Trump administration's aggressive policy toward China was broadly popular, despite potential negative side effects. In the first 10 months of 2020 the exact phrase "decouple from China" or "decoupling from China" appeared in three times as many articles as in the previous three years combined.

But most business executives don't want to decouple, and it's easy to understand why. As one told us, "We spent 13 years getting into China. It's impossible for us to just pull out." That view is common: No executives we've met want to see the time, effort, and investment they've put into developing a presence in China go to waste.

With the Biden administration likely to take a less confrontational approach, CEOs may hope that the issue will blow over. If decoupling were just a twist in U.S. politics, it might. But for more than 15 years—spanning the Bush, Obama, and Trump administrations—China has followed a strategy of reducing its dependence on foreign technology and capabilities. Moreover, it has projected that strategy forward another 15 years. Decoupling will play an important role in the future, with significant implications,

Photograph by **BARTHOLOMEW COOKE**

which we explore here, for the strategies of global corporations.

Our observations draw on decades of research and consulting, which have taken us to China on more than 120 occasions, including multiple stints as visiting professors at leading Chinese institutions. We have interviewed scores of Chinese government officials, from the national to the municipal level, and have talked with more than 200 Western business executives who are working and living in China. We have authored a dozen in-depth case studies and advised numerous companies on how to effectively compete in China up and down the value chain, focusing not just on their Chinese rivals but on the nation's competitive strategy as well.

The China Vision

Widely publicized tit-for-tat exchanges over tariffs in the past four years have reinforced the popular view in the United States that decoupling largely involves discouraging imports so as to safeguard or repatriate U.S. jobs and ensure the safety and security of America's civil and military infrastructure. From the Chinese perspective, however, decoupling is a strategic shift whereby China switches its focus from economic growth to economic control. (See the sidebar "China's Decoupling Strategy.") To that end, it is pursuing three key objectives: (1) eliminating its dependence on foreign countries and corporations for critical technology and products; (2) facilitating the domestic dominance of indigenous firms; and (3) leveraging that dominance into global competitiveness. The term *dual circulation* is often used to refer to these objectives, with the first two considered internal circulation and the third considered external circulation.

The implications for foreign enterprises are staggering. For example, today Intel exports billions of dollars' worth of microchips to China, whose market accounts for about 50% of global semiconductor demand. Domestic-content targets have forced Intel to increase its local production, but if China meets its market-share goals, over time Intel's revenue in China will be squeezed by rising domestic champions.

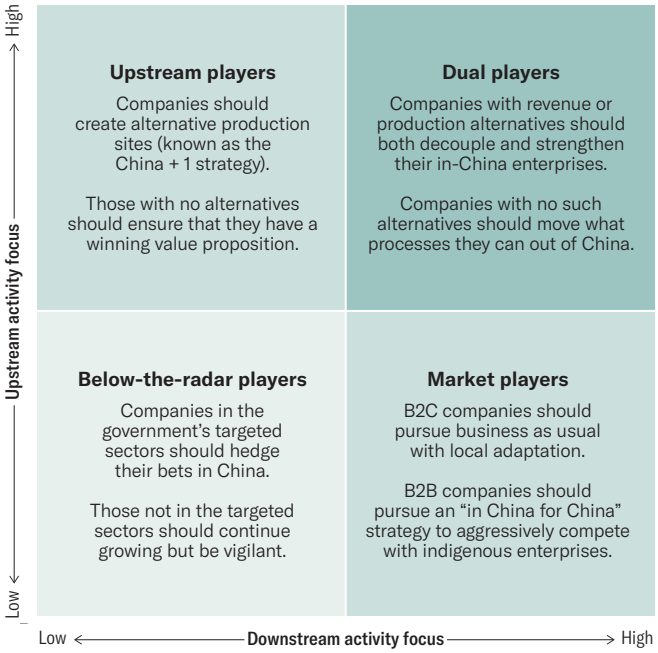
How do China's government and companies plan to achieve its objectives? Through three core mechanisms:

Purchase and investment. The Made in China 2025 (MIC 2025) plan, launched in 2015, states that the central government will "support enterprises to perform mergers, equity investment, and venture capital investment overseas" to reduce China's dependence on foreign-owned technology. In 2016 the value of Chinese acquisitions of U.S. firms grew 376%, to about $55 billion, prompting the U.S. Committee on Foreign Investment and other agencies to scrutinize acquisitions on national security grounds. Dealmaking fell back to less than $9 billion in 2017 and to just under $3 billion in 2018. Similarly, according to the private equity data-tracking company Preqin, VC deals in the U.S. with at least one Chinese investor soared 700% from 2014 to 2015, to $8 billion, and stayed at that level until reaching a record of close to $11 billion in 2018, when the United States passed a law allowing government agencies to review investments by Chinese VC funds and requiring those funds to disclose their funding sources. Such investments subsequently nearly halved.

Subsidies and funding. Our analysis of MIC 2025 initiatives suggests that the Chinese government has set aside more than $500 billion in various funds to support indigenous R&D in technologies and products for which China currently depends on foreign companies. Some notable ones are the special constructive funds ($270 billion), the Shaanxi MIC2025 Fund ($117 billion), MIIT and China Development Bank ($45 billion),

Four Strategies for Foreign Companies in China

A foreign company's strategic response to decoupling will depend on where it lands in this grid. The vertical axis measures the importance of the market opportunity in China, and the horizontal axis measures the importance of China's production capabilities to the company's strategy there.



the Gansu MIC2025 Fund ($37 billion), and a fund to support the development of semiconductor capabilities ($31 billion). Not included in these amounts are subsidized loans and other assistance to bolster local champions. In fact, our analysis finds that debt held by state-owned enterprises as a percentage of GDP will soon exceed 100%.

Extraction. An investigation by the U.S. Trade Representative determined that "China uses foreign ownership restrictions, such as joint venture (JV) requirements and foreign equity limitations, and various administrative review and licensing processes, to require or pressure technology transfer from U.S. companies." The U.S.-China Economic and Security Review Commission concurred: "As part of China's licensing documentation procedures, commercial firms are required to provide detailed product and process information to Chinese government agencies at the local and central levels…that is typically not required in other markets." In some cases China moves beyond extraction to outright theft. In 2010 American Superconductor (AMSC), a leading provider of the software used to control wind turbines, discovered that its Chinese partner Sinovel paid Dejan Karabasevic, a Serbian engineer employed at AMSC's Austrian development facility, $1.7 million for AMSC's full source code. Although the U.S. government filed and in 2018 won a criminal case against Sinovel, two Chinese Sinovel executives, and Karabasevic (who served a year in prison), AMSC has estimated that 20% of the wind turbines deployed in China in 2020 illegally continued to use its software.

Clearly, China's efforts to control technology and extract know-how have served to stoke U.S. and European suspicions, especially in the context of slower growth following the 2008 financial crisis and, more recently, the Covid-19 pandemic. Although the Biden administration, as noted, will most likely temper the decoupling rhetoric, China's efforts to pursue its ultimate goal will continue. Thus foreign companies doing business in China are caught between a rock and a hard place. Their response to this challenge will largely depend on why they are in China in the first place.

Strategies for a Decoupled Future

Although more than a million foreign companies operate in China, we can put them into four categories by examining them along two dimensions: the extent to which they are focused on upstream activities, such as raw materials, components, and production; and the extent to which they are focused on downstream activities, such as China-based distribution, marketing, and sales. This two-by-two categorization scheme allows us to better understand the challenges a company faces and how it can best respond to them. (See the exhibit "Four Strategies for Foreign Players in China.")

Below-the-radar players. These companies have a low focus on both upstream and downstream activities. Some are at an early, experimental stage of engaging with China. Others may be taking a "follow the leader" approach and don't want to be left out. Executives in this category had a hard time articulating for us clear and compelling reasons for their small presence in China.

A surprisingly large number of U.S. companies are below-the-radar players: A 2020 report by Goldman Sachs found that among the S&P 500, revenues from China made up less than 2% of their total revenues, on average, and many of those companies had quite limited upstream activities as well. For example, even though International Paper generates more than a quarter of all its revenue outside the United States, less than 2% comes from China, and the company has sold off most upstream assets it had there.

For below-the-radar players in MIC 2025–targeted industries, the odds of surviving in China are poor. Take the medical-device maker Fresenius. China accounts for a low single-digit share of its total sales and a small share of its upstream operations. Because its products sit in the crosshairs of MIC 2025, it could easily lose ground to Mindray, the national champion, which is more than twice as large as its closest domestic competitor and growing faster in China than any of its major foreign rivals—largely because government directives require Chinese hospitals to increase their purchase of domestically sourced medical devices to 70%. Fresenius and other below-the-radar players whose products are targeted by MIC 2025 would be wise to hedge their bets in China by placing significant ones in other markets.

For below-the-radar companies not targeted by MIC 2025, the immediate implications are less severe. Assuming that they continue to remain small-scale sellers and producers in China, the strength of their value propositions and business models, not Chinese policy, will determine their fate in the medium term. Longer term, of course, the government's strategy is likely to ripple across even currently untargeted sectors, putting pressure on foreign enterprises in every category. For example, Black Crows, a French maker of freestyle skis, sells some but not many skis in China and has minimal upstream activities there. Because skis are not a

In 2010 China overtook the United States to become the largest value-added manufacturer in the world.

targeted segment, as long as its products are superior to those of Chinese rivals, it may be left alone to grow. But the acquisition of Amer Sports (maker of Armada, Atomic, and Salomon skis) in 2019 by a Chinese consortium led by Anta Sports should cause Black Crows some concern. It could be squeezed out as Chinese competitors buy the technology and brand power needed to dominate at home—and abroad.

Staying competitive in China may be difficult for below-the-radar players for another reason: In addition to being small in China, their operations there are almost always small within the global scope of their own companies. Thus the unit heads have difficulty capturing the time and attention of executives at the corporate level and getting the resources needed to stay ahead of their local competitors. For example, over the past decade Carrefour's revenues in China never exceeded 5% of global sales, so in 2019 the company sold 80% of its China business to the local retailer Suning. Similarly, a number of other big foreign companies, including Etam, Tesco, Amazon, Forever 21, and Uber, never reached a critical threshold in China and subsequently closed or sold off their Chinese operations, ceding control of the market to indigenous rivals.

Upstream players. The Florida-based toy maker Basic Fun is a classic example in this category. It sources most of its raw materials (cloth, plastic, wood) and components (batteries, small electric motors) in China and concentrates nearly 90% of its global production there. It then exports nearly all its products to more than 60 other countries; China accounts for just 2% of total revenues.

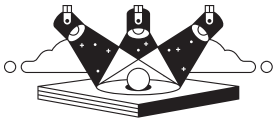
Over the past 20 years China has been extraordinarily successful at attracting upstream players, and in 2010 it overtook the United States to become the largest value-added manufacturer in the world, accounting for 28% of all global production by 2018. To achieve this dominant position, China has done more than just leverage its size and abundant low-skilled labor. It has also invested heavily in education to expand its skilled talent pool, increasing the number of college graduates from one million in 2000 to more than 8 million in 2019, 5 million of whom earned degrees in science, technology, engineering, and math, giving China more STEM graduates than India, the United States, Japan, Germany, France, Italy, the UK, and Canada combined. It has also upgraded its physical infrastructure by spending more money on building roads, rails, and airports than the U.S. and Europe combined.

A danger for upstream players comes from U.S. tariffs. If foreign companies in China send a significant portion of their China-based production to the United States while tariffs continue to be a dominant decoupling tool under the Biden administration, the impact on revenues and profits could be severe.

Many upstream players have been planning for this scenario by applying a strategy often labeled China + 1. For example, F-tech, which had a brake pedal factory in Wuhan that supplied Honda's final assembly operations in both China and Japan, also had a sister plant in the Philippines that primarily supplied Honda production facilities in Canada and the United States. When the coronavirus hit Wuhan and F-tech had to shut down the factory, its China + 1 strategy allowed it to increase output in the Philippines to partially supply Honda's demand in Japan until the factory in Wuhan could get up and running again.

China + 1 is more easily proposed than implemented. As noted, China has become "the world's factory" not just because it has abundant labor but because that labor force is increasingly higher skilled and includes more than 200 million people who can flexibly move across producers as demand fluctuates. As Jay Foreman, the CEO of Basic Fun, has put it: "China offers a suite of benefits...a highly trained labor force, a well-financed infrastructure, a great safety and quality control regimen, excellent transportation and communication points...." He acknowledges that moving operations would be really difficult. "For example, if we went to Vietnam...it's only 10% of the size of China. So if you just moved 5% or 10% of Chinese production into Vietnam, you're going to max out the capacity.... You can go to India...but India's infrastructure is really not set up for this."

Companies that are heavily dependent on China for their upstream activities may face difficulties independent of tariffs or labor supply. For example, Daikin, the leading Japanese air-conditioner maker, recognized that to grow it had to expand outside Japan, but to do that it would need to make more-affordable AC units. In 2009 its executives decided to move production to China. In the process, they gave their Chinese rival Gree Electric access to Daikin's advanced inverter technology in exchange for being able to tap into Gree's low-cost mass-market production capabilities. Daikin succeeded in producing price-competitive AC units in China and exporting them to the rest of the world. In fact, it grew international sales to the point where they account for 80% of its total revenue. But Gree leveraged the IP it extracted from Daikin to become the number one domestic player. It and other indigenous companies (notably Midea



Spotlight

China's Decoupling Strategy

China's strategy began in 2005, with the launch of its Medium- and Long-Term Plan for Science and Technology Development (2006–2020), or MLP, in which the government called for increasing domestic content in 11 sectors to 30% by 2020 through import substitution. Ten years later, with the launch of the Made in China 2025 (MIC 2025) plan, it increased those goals, calling for domestic content of 40% by 2020 and 70% by 2025 in 10 sectors: information technology, robotics and AI, aerospace, shipping, railways, energy, materials, medical equipment and medicines, agriculture, and power equipment.

MIC 2025 also set market-share goals for domestic corporations. For example, the plan envisioned that Chinese makers of electric vehicles and energy equipment would capture 80% and 90% of the domestic market, respectively. In the fall of 2020 President Xi announced his China Standards 2035 plan, which would establish China as the global standard setter for technologies including 5G, the internet of things, and artificial intelligence. Thus, while significant domestic-content targets push foreign companies to increase production in China, high market-share targets ensure that indigenous firms will dominate the Chinese market.

and AUX) control more than 70% of the Chinese AC market, which a little over a decade ago was dominated by foreign players such as Daikin, Lennox, Electrolux, Carrier, and Trane. In line with the Chinese government's strategy, Gree is leveraging its strength at home into global competitiveness, generating $3 billion in international revenue (about 10% of its total) and growing twice as fast as Daikin has over the past six years. Unfortunately, Daikin's story is not unique; companies should think carefully about the medium- and long-term risks of an all-in upstream strategy in China.

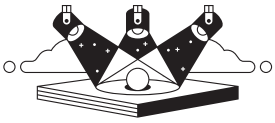
Market players. These companies import finished products to sell in China's huge and increasingly wealthy markets. A good example in the B2B space is provided by the Italian company Danieli, the second-largest supplier of steelmaking equipment in the world.

In 1990 China produced just 8% of the world's steel. By 2000 that share had doubled, and by 2013 China was producing more steel than the rest of the world combined. Virtually all the steel produced in China was made by Chinese companies. To capture such a large percentage of global steel production, the Chinese manufacturers needed steelmaking equipment. Danieli set out to win as much of that business as possible. In 2003 its global revenues stood at $740 million. By 2010 they had more than quadrupled, to about $4.1 billion, mostly from the sale and installation of products made in Italy to Chinese steel plants.

China's dramatically rising per capita income provided similar opportunities in the B2C space. In 2005 China had approximately 236,000 millionaires; by 2020 that number had soared to 5.8 million. The Swiss watchmaker Rolex was determined to capture a share of wallet from those affluent consumers. Its strategy in China, like Danieli's, involved no local manufacturing: It imported 100% of its watches, nearly all from Switzerland, and attracted demand by focusing its downstream activities on distribution through high-end retailers, celebrity endorsements, and event sponsorships. By 2019 China was Rolex's second-largest market, and sales there had more than quadrupled since 2010.

The implications of China's competitive strategy for market players vary depending on whether those companies are focused on the B2B or the B2C segment and whether they fall within sectors targeted by MIC 2025 or their home country's export controls. B2C companies outside the MIC 2025–targeted sectors, such as providers of luxury goods, are unlikely to run afoul of import substitution efforts by China or export controls imposed by the U.S. or other home countries in the near term. But few of them are tied to the dominant Chinese social media platforms, such as WeChat (with more than a billion unique users), or digital pay ecosystems such as Alipay and WeChat Pay, which control more than 92% of all digital payments in China. B2C market players, therefore, will have to integrate with those China-specific platforms and the ecosystems around them to better access and deliver to consumers. And as domestic brands gain credibility, some market players will need to adapt their value propositions to evolving local tastes and growing levels of sophistication.

B2B market players in targeted sectors will be affected by decoupling. Not only will China's import substitution policies drive them to invest in onshore production, but the strength of local competitors will be bolstered by China's efforts to buy or "borrow" foreign-owned capabilities, or to build their own. In response, Danieli has strengthened its bet with an "*in* China *for* China" strategy that calls for tripling its revenues there to $1.2 billion. In pursuit of that goal, it has also tripled the number of its employees in China to 1,200, of whom only about 30 are expatriates. And it has substantially increased its investments in local R&D, design, and production capabilities. However, it is finding that its toughest competitors in China are no longer the German SMS or the Japanese Primetals but the state-owned China Metallurgical Group and two of its 15 construction subsidiaries, CERI and CISDI, which target the same Chinese steelmakers



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that have been Danieli's customers for years. Retaining old customers in China or acquiring new ones will be increasingly difficult for the Italian company, because CERI and CISDI have the benefit of state ownership, subsidized debt, and government influence on purchases of steelmaking equipment, plant construction, and modernization contracts that favor domestic companies.

Ultimately, many B2B market players may find that they must strengthen their investments in and commitment to not just their downstream operations but their upstream ones as well.

Dual players. This category includes Apple, Intel, and Nike, all of which generate substantial sales in China (20%, 28%, and 16% of total revenues, respectively) and use it as a significant base for global production. Apple assembles 100% of its more than 200 million iPhones in China each year; if its business in that country were a stand-alone, it would be among the 300 largest companies on the planet.

Dual players are the most challenged by decoupling. Apple, for example, may struggle to sell its phones in China simply because the government favors indigenous players such as Alipay and WeChat Pay over Apple Pay. And import tariffs of 10% to 25% imposed on iPhones by the U.S. (or any other country) could severely affect sales. Apple has found a way around this for the moment by exporting its phones to Singapore before re-exporting them to the United States.

The pressures will drive some dual players to an *in* China *for* China strategy for both upstream and downstream activities, effectively decoupling their entire value chains in China from those outside. For that strategy to work, two conditions must be satisfied: significant potential for revenue growth in China for the foreign player, and reasonable production bases outside China to meet the company's global needs.

Not all big dual players can meet those conditions, which means that some will struggle to maintain their existing approach. Apple may be among these. Indigenous Chinese firms, which just a decade ago controlled only 10% of the domestic smartphone market, now control nearly 90% of it and more than 90% of the electronic-payment market. Furthermore, Lenovo and other local players also sell the lion's share of laptop computers and tablets in China, further restricting Apple's market opportunities. And Apple has few if any production alternatives outside China. It employs some 3 million to 4 million workers there—a scale hard to replicate elsewhere. At least as important is Apple's freedom to flex this labor force up and down by hundreds of thousands of workers in response to seasonal demand shifts, which it couldn't do in any other country. What's more, few other countries can match the quality of Chinese workers at a comparable cost. Apple's CEO, Tim Cook, has noted: "China has moved into very advanced manufacturing, so you find in China the intersection of craftsman kind of skill and sophisticated robotics and…computer science…. That intersection, which is very rare to find anywhere…is very important to our business because of the precision and quality level that we like."

Many of Apple's technologies and products, and thus its activities both downstream and upstream, are likely to be severely affected by China's decoupling initiatives, to the benefit of local competitors. Apple has already begun to move the assembly of some units, such as iPads and Macs, out of China to Vietnam and other places.

The situation is very different for Nike, which has plenty of revenue headroom in China because the fast-growing sports shoe market there is dominated by foreign companies rather than indigenous ones. Leveraging its global brand while having the flexibility of local production to tailor products to increasingly fashion-conscious and sophisticated Chinese consumers may enable Nike to stay ahead of domestic brands such as Li-Ning and Anta. What's more, unlike Apple, Nike—which has factories in more than 40 countries—could continue to produce *in* China *for* China and still have alternatives for serving other markets. In fact, it has already increased production in some of those countries.

GIVEN THAT CHINA and the United States feel overly dependent on each other, decoupling is likely to continue even if it's a lower priority for the Biden administration. CEOs will have no choice but to confront the attendant challenges. Foreign companies must clarify why they are even in China and what their strategic intent is going forward. Inevitably, that will result in a major shakeout, as some companies hedge their bets and others double down. The latter, if they are in any of China's targeted industries, will need such compelling value propositions that Chinese customers beat a path to their door despite the government's goals. **HBR Reprint** R2103B

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