



# The State's Long Apron Strings

China's multinationals, powerful as they seem, are still beholden to the Party. That's both a blessing and a burden. **BY FREDERIK BALFOUR**



**THE AGE OF THE CHINESE MULTINATIONAL** is upon us. Companies few Westerners had heard of two years ago now make the headlines almost every day. TCL Corp., a Chinese consumer-electronics manufacturer, controls the venerable RCA brand. Lenovo Group Ltd., China's No. 1 computer maker, owns IBM's PC business. Haier, a white-goods maker, roiled the waters with its ultimately failed bid for Maytag Corp. CNOOC Ltd. riled Washington before withdrawing its \$18.5 billion offer for Unocal Corp. Add the exploits of Huawei Technologies and ZTE in telecom gear, the overseas deals of Shanghai Baosteel, and the expansionist plans of phone company China Netcom, and it's easy to imagine that the next decade will belong to China's blue chips.

If China's multinationals do emerge as power players, many of them will have the state to thank for their success. These companies have implicit or explicit backing from Beijing and can build on China's other strengths as well—low wages, vast internal markets, and rapid economic growth. But having the

state as either parent or mentor can be a burden, too; rivals often say the support gives them an unfair edge. Ultimately it may be the Chinese companies that transcend their state origins—or those that are entirely private—that really excel.

A number of Chinese companies have carved out a smallish piece of their businesses—typically the most profitable chunks—and floated them either in Hong Kong or New York. But the listed company is usually majority-owned by its parent, which re-

IMAGECHINA.COM

mains in state hands. In an initial public offering in 2000, oil and gas producer PetroChina Co. raised \$3.1 billion from investors including Warren E. Buffett. But it's still 90% owned by China National Petroleum Corp., which is 100% state-owned. Same goes for Unocal's former suitor, CNOOC Ltd. Its parent, state-owned China National Offshore Oil Corp., holds 70% of its shares. China Mobile Communications Corp.—again, entirely state-owned—owns 75% of cellular operator China Mobile (Hong Kong) Ltd., a popular issue whose New York-traded depository receipts have jumped some 40% since January.

## SHADOW MANAGEMENT

STATE OWNERSHIP DOESN'T necessarily mean these outfits are constantly under the thumb of Party bureaucrats. Managers often have free rein in running their companies, and there's no Chinese equivalent of Japan's Ministry of Economy, Trade & Industry, the government body that plotted that nation's postwar rise to industrial might. Although the Chinese leadership clearly wants to build global champions, there's also no indication that the recent push is part of some grander plan handed down from Beijing. Lenovo Chief Financial Officer Mary Ma says the IBM purchase was "a pure commercial and business decision" and maintains that Lenovo doesn't get any special breaks. "People say our success came from government protection," Ma says. "This is not true."

But even if it doesn't interfere in day-to-day matters, the state—really the Communist Party—still has plenty of clout. Every state-linked company has a Party organization that acts as a kind of shadow management and vets all senior appointments. The state-owned Assets Supervision & Administration Commission (SASAC), a sort of über-holding company with a controlling stake in nearly 200 big enterprises, keeps a close eye on the results of China's giants, tracking metrics such as return on equity, gross margins, and sales growth just as closely as Wall Street might.

Like activist shareholders in the West, SASAC also sometimes shakes up management. In November, SASAC rotated the heads of rival phone companies China Telecom, China Unicom, and China Mobile without any explanation. And Wei Liucheng, who earned praise as chairman of CNOOC, was promoted to governor of Hainan Province in October. "Senior managers have to keep their finger on the pulse of their business, but also on the pulse of the Communist Party," says George J. Gilboy, a researcher at the Center of International Studies at Massachusetts Institute of Technology. "They ignore either one at their peril."

## Beijing: Lenovo's "Open-Minded" In-Law

**"A Commercial Decision:"** Lenovo CFO Mary Ma on China's gentle role in the purchase of IBM's PC business

**A Venerable Name:** TCL Multimedia will use the RCA brand outside China while pushing its own name at home, says CFO Vincent Yan

**"The Private Sector Can Only Go So Far:"** Edward Tian, CEO of China Netcom, talks about the appeal of running a state-owned business

**BusinessWeek** online

[www.businessweek.com/go/china-india/](http://www.businessweek.com/go/china-india/)

State control can clearly give these businesses advantages at home. In the early 1990s, when China began embracing the market economy in earnest, state-owned companies in key industries were chosen to lead the country's development drive, landing lucrative contracts or receiving tariff protection, cheap land, easy credit from state banks, and preferential access for listing their shares. Legend Group, which owns 60% of Lenovo, is 65%-owned by the Chinese Academy of Sciences, the country's top research body. Its staff of more than 60,000 has lent a hand in developing Lenovo's PCs and servers.

Another big benefit: The government has steered foreign joint-venture partners to these national champions to ensure they have access to imported technology and management

## 20 Power Players with Ties to Beijing

Chinese companies are starting to make their mark outside the mainland, but most of the leaders remain largely in state hands

COMPANY	2004 SALES (\$BILLIONS)	BUSINESS	SHARE OWNED BY GOVERNMENT
Sinopec	73.6	Oil production and distribution	84%
PetroChina	70.4	Oil production and distribution	90
China Mobile	23.6	Cellular operator	75
First Auto Works (FAW)	14.0*	Auto maker	100
China Minmetals	12.1*	Mining	100
Shanghai Automotive (SAIC)	11.8*	Auto maker	100
China Life	8.1	Insurance	73
China Netcom	7.9	Fixed line phone operator	75
Baoshan Iron & Steel	7.1	Steel	61
CNOOC	6.8	Oil exploration	71
TCL	4.9	Consumer electronics	25
ZTE	4.1	Telecom networking equipment	53
Lenovo	2.7	Computers	50
China Merchants Bank	2.6	Bank	18
Haier	1.8	Appliances, consumer electronics	30
Konka	1.6	Consumer electronics	24
Sinochem	1.6	Petrochemicals	43
Changhong Electric	1.4	Consumer electronics, appliances	54
Dongfeng Automobile	0.7	Auto maker	70
Cosco	0.2	Shipping	52

\*2003 data

Data: BusinessWeek, company reports

# THE NEW CORPORATE MODEL



CNOOC OIL RIG  
U.S. lawmakers stressed  
the oil company's ties  
to the state

knowhow. When Arcelor, Europe's top steelmaker, and Tokyo-based Nippon Steel were on the prowl in China, the government hooked them up with Shanghai Baosteel Group, which needed help with the technology for making the high-grade steel used in car manufacturing. The result is a \$785 million state-of-the-art plant in Shanghai that will churn out 1.2 million tons annually of cold-rolled steel for the auto industry.

## TOUGH LESSONS

ABROAD, THOUGH, THOSE STATE TIES can suddenly start looking less advantageous. Chinese companies' government links and their easy access to loans from state banks are likely to dog their foreign adventures again and again. CNOOC, for instance, is generally considered a well-run company and has been traded in Hong Kong since 2001. But U.S. lawmakers focused instead on its government ownership and access to cheap credit. Provincial electrical-appliance maker Sichuan Changhong Electric Co. last year saw its U.S. color-TV sales dwindle to nothing after it got hit with antidumping duties of 25%—not necessarily because it was actually selling its goods below cost but because its government ownership made it appear to have an unfair advantage over privately owned rivals.

Despite the coddling, mainland companies haven't yet matured into true world-beaters. While the governments of Japan

and South Korea walled off their home turf from outsiders as they groomed their giants-to-be, China's borders are much more open to foreign competition. That, plus a cut-throat domestic market where thousands of rivals cut prices relentlessly, means Chinese companies often venture abroad not from a position of strength but of weakness. And lessons learned in China don't always translate abroad. "The management tools Chinese companies used to become the world's leading factory are not the same as those they will need to lead global innovation," says Darrell Rigby, a partner at consultant Bain & Co. That's one reason Lenovo insisted that IBM execs stay on board after it acquired Big Blue's PC business. Indeed, consultancy McKinsey &

Co. says China will need 75,000 executives with international experience in the next five years. Today it has at most 5,000.

China's listed multinationals are trying to look more like their global rivals. They're hiring Western-educated execs, engaging the likes of Bain and McKinsey, and beefing up investor-relations teams. CNOOC Chairman Fu Chengyu has a master's in petroleum engineering from the University of Southern California. China Netcom CEO Edward Tian, who got a PhD from Texas Tech University, was recruited after he made a fortune taking the software company AsiaInfo Holdings Inc. public on the NASDAQ in 1999.

Dig a little deeper, though, and many of these companies still resemble their state-owned parents. Tian, for instance, had to renounce his U.S. green card before taking the helm at Netcom. And he drives a company-owned Audi A6 with a 2.4-liter engine. Nice ride, but not as nice as the 2.6-liter version given to company directors, who hold the same rank as vice-ministers. Tian says he still finds it daunting trying to manage 100,000 employees while juggling the interests of shareholders and four state-owned parents—the Ministry of Railways, the city of Shanghai, the Chinese Academy of Sciences, and the State Administration of Radio, Film & Television. "I have learned the skill of how to survive in a large state-owned enterprise," he says. "That means 50% business and 50% communications for finding the right political balance." If these companies focused 100% on business, the results could be formidable. ■



CHINA WHAT'S COOL

## Online Games

### Slaying Sinister Beasts, One Click at a Time

What's that giant zapping sound? It's a half-million Chinese dragon slayers in action. China's Net cafés are packed with teens who spend their days

and nights in a time when monsters, tigers, and seething dragons roamed the earth. They're playing online games such as *World of Legend*, from Shanghai-based Shanda Interactive. In that contest, as many as 550,000 people at a time hunt mythi-

cal beasts and negotiate dark and dangerous fields and forests. To get ahead, they buy and sell virtual weapons and digital armor, and form alliances—even holding New Year's fêtes and staging weddings for their online characters.

# It's Getting Hotter In the East

After years of frustration for U.S. companies, China starts to pay off. **BY DEXTER ROBERTS AND MICHAEL ARNDT**



**FOR MORE THAN TWO DECADES**, Western bosses chased the China dream. They professed to love the scorching Maotai served at those endless government banquets celebrating yet another costly and complex joint venture. Just as they began noticing rising profits from sales of cars or telecom gear, they'd get blindsided by sudden rule changes favoring local players, demands for new technology transfers, or cut-throat pricing from Chinese imitators unconcerned about profits. Some early entrants ended

up writing off huge investments. But more often, CEOs groveled before their boards back home, begging for another \$100 million to sink into a mainland venture that was always just about to turn the corner. This was China, after all. Everybody had to be in China, right?

Finally, the long march is reaping benefits. Of more than 450 U.S. companies surveyed by the American Chamber of Commerce, 68% today say they are profitable, and 70% say their China margins equal or exceed their global average. Such an answer would have been unthinkable just five years ago, before China entered the World Trade Organization and had to open its economy wider to foreign companies. The biggest beneficiaries are the pioneering multinationals—such as Procter & Gamble, Caterpillar, and United Technologies—that arrived in the 1980s, then stuck it out in the worst of times. But now even small and medium-size U.S. companies are realizing they have to play their China hand or lose out altogether.

If a company stays the course, the results can be remarkable. China contributed 9% of Motorola Inc.'s \$31.3 billion in sales last year, and thanks to smart products and marketing the Schaumburg (Ill.)-based company is battling with Nokia Corp. for leadership in the world's biggest handset market. Low-cost exports from China, and the brainwork done at 16 labs, have also helped revive Motorola's fortunes. For many products, "China will become a larger market than the U.S.," says Motorola Asia Pacific Senior Vice-President Simon Leung. "And it helps our global operation from the perspective of costs, quality, and time to market."

The prospects of some companies, in fact,

may be brighter in China than at home, where they have entrenched competition or are saddled with high-cost operations. "In China, nobody has home-court advantage," says Jonathan Woetzel, McKinsey & Co.'s Greater China director. "You can play a new game and get a new lease on life." While Hewlett-Packard Co. has been in crisis mode in the U.S., its China sales have risen 20% annually for four years. Booming China is one of the most important markets for slumping General Motors Corp.

And it is a godsend for financially troubled auto-parts giant Delphi Corp., whose China sales have been growing 30% annually for 11 years and hit \$637 million in 2004. Delphi has just opened a tech center on a still-muddy site in Shanghai's Pudong district where, by 2010, 1,500 engineers will design parts for the explosion of new models rolling off the assembly lines of customers like GM, Volkswagen, and Nissan. "China is our company's hope for a growth machine," says Delphi Asia President Choon T. Chon. As China liberalizes to meet World Trade Organization commitments, new opportunities are opening in fast-growing areas such as finance, retail, and tourism. It's also easier to make acquisitions. "The beauty of China today is that all options are open," says Stuart L. Levenick, group president of Caterpillar Inc., which has recently bought several Chinese construction machinery makers.

This isn't to say China has suddenly become an easy place to do business. Indeed, it remains one of the world's riskiest and most complex markets. Intellectual property is

**■ WITH LOWER COSTS AND SURGING SALES, CHINA OFFERS A BETTER PROFIT CLIMATE FOR MANY COMPANIES THAN THEIR MARKETS AT HOME**



ANSWERED CALL  
Motorola's Beijing R&D  
center turns out phones  
for the local market

brazenly ripped off and contracts are violated with little recourse. Corruption is rampant. The baffling regulatory environment is a work in progress. Growing capacity gluts and fierce competition from Chinese companies—some aided with cheap state loans—still can keep prices and margins low. Then there is the sheer pace of change, making it necessary to constantly adapt to stay ahead.

## LOCAL TALENT

STILL, MANY MULTINATIONALS that invested the time, effort, and resources have begun to learn the lessons needed. Among them, obviously, are that *guanxi*, or connections, and investing early do matter, as Motorola's experience has shown. Partly as a reward for staying the course after Tiananmen, Motorola was allowed to own 100% of its key operations, while its telecom rivals had to form ventures with state partners.

But succeeding in today's China is about a whole lot more than *guanxi* and getting your products past customs. The big winners are investors who have nurtured Chinese managerial talent and given them the reins to run vital operations. They localize manufacturing, parts sourcing, and R&D to the greatest extent possible to lower costs and leverage China's immense talent pool. The winners treat partners as equals when joint ventures are a plus, and part ways when they aren't. They also keep a grip over distribution and after-sales service networks to

ensure customers are satisfied. And they invest heavily in training to integrate Chinese engineers and sales staff into their global organizations—and keep them motivated so they won't jump ship. "Retention of skilled workers is on every company's mind now in China," says Dayton Ogden, chairman of recruitment firm Spencer Stuart Management consultants. "You have to make your company a place where people want to stay."

Success also requires an ever more sophisticated understanding of the Chinese market. China's emerging consumer class, for example, cannot be treated as an undifferentiated mass. Tastes vary by region, and many upwardly mobile professionals see cell phones with all the latest features as fashion statements. Others demand top performance at a low price. It's also a mistake to focus exclusively on rich cities like

### GE: Turned on by India

"India is integrated into our company." Scott Bayman, CEO of GE India, on the strong ties between the country and the corporation

**Lodging for the Masses:** Steven A. Rudnitsky, Chairman & CEO of the Cendant Hotel Group, talks about budget motel Super 8's plans for the mainland

**BusinessWeek** *online*

<http://www.businessweek.com/go/china-india/>

# THE NEW CORPORATE MODEL

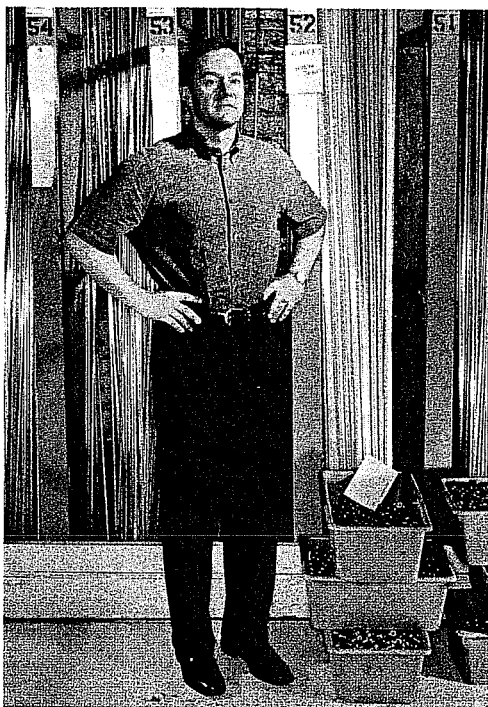
Guangzhou and Shanghai. "To continuously grow your business, you must go to level-two, -three, and -four cities," says Sun Cheng Yau, head of Greater China for HP. In smaller cities, some members of HP's growing network of 200 service reps even have to work out of their own homes.

Few companies pay better attention to all these details than P&G. It has invested more than \$1 billion in China since 1988 in four factories and a Beijing R&D center. P&G sells 17 brands, from Head & Shoulders shampoo and Cover Girl makeup to Pringles potato chips and Pampers diapers. It leads each category in which it competes, except detergent. Even here, Tide is No. 2.

Hundreds of P&G research managers live with Chinese families in cities and on farms to learn how they use everything from detergent to toothpaste. The insights have helped P&G adopt a multi-tier pricing system for some brands. The company sells cheaper, basic versions of Tide and Crest in small cities and villages, for example. In beauty care, it has created different versions of Olay moisturizing cream—one for supermarkets and a pricier version with skin-whitening and anti-aging properties sold only in upscale department stores. "We have extended the brand to meet different needs," says Christopher Hassall, a P&G vice-president for Greater China. P&G is using the strategy for Olay and Crest in other developing nations and may try it in the U.S.

## SITTING PRETTY

SMART MARKETING ALSO is enabling some U.S. companies to succeed even in industries where Chinese manufacturers are ferociously competitive. Haworth Inc. is an example. At a time when hundreds of U.S. furniture makers are shutting down due to cheap Chinese imports, Holland (Mich.)-based Haworth is selling locally all the office furniture it can produce in its Shanghai factory—even though Haworth products usually cost 30% to 50% more than models by local producers. One of its secrets: a team of Haworth designers and psychologists who, free of charge, develop an entire workplace "environment" for potential clients after interviewing executives and staff. That appeals to multinationals, and a growing number of Chinese companies, concerned about retaining and motivating talent. Haworth also welcomes passers-by to try out its ergonomically designed furniture, and enjoy free cappuccino and wireless Internet connections, at its Shanghai



Creativity Center in the trendy Xintiandi district. "You have to give people a chance to experience your product before they buy," says Haworth Asia Vice-President Frank F. Rexach. Since adopting the strategy three years ago, "business has started to explode," says Rexach. Each month, Haworth sells more than 100,000 chairs priced at up to \$1,200 apiece and 75,000 workstations.

Carmakers also are learning to look beyond the wealthiest Chinese consumers. GM had enjoyed enormous success with its Buick Regal, which starts at \$25,138, since production began in 1998 with partner Shanghai Automotive Industry Corp. Now, GM is trying to reach the gamut of consumers by expanding its line to include imported Cadillacs like the XLR, which retails for \$158,000, locally made Chevrolet Spark sedans starting at \$5,654, and even minivans. GM has launched three Chevrolet models in the past six months. And it built a network of 1,000 distributors. "One thing you learn in China is that you have to move fast," says GM China Group President Kevin E. Wale.

Such diversification is becoming essential to remain a serious player. As China emerges as the world's biggest market for everything from cars to digital TVs, it increasingly will influence global trends. Already, many cell phones sold in China have features not available in the U.S. At Motorola's labs in Shanghai, Chengdu, and Beijing, engineers are working on phones that surf the Web and double as MP3 players.

All the lessons from the corporate pioneers will come in handy to first-time investors. But they needn't follow the same trail. Changing rules mean new entrants can leap in with different strategies. Chicago-based IGA aims to do just that in the grocery business. The nonprofit alliance of grocers would seem to have little chance against retail giants such as Carrefour and Wal-Mart Stores Inc., which have arrived in force. But IGA has signed up five Chinese retailers with a combined \$1.6 billion in annual revenue. The group is trying to convince Beijing officials that it can help homegrown retailers compete with the giants by lowering costs via group buying. IGA also can help retailers export their own packaged foods, clothing, and even DVD players under its brand through its 4,500 worldwide affiliates. "We are giving local players the chance to make contact with the international market," says CEO Thomas S. Haggai.

**MOTOR MAKER**  
Moving to China was "a matter of survival," says Phoenix' Bank

## Key Lessons for U.S. Corporate Investors

Connections, or <i>guanxi</i> , still rule	China is not just an export platform	Look for new expansion opportunities
Cultivate <b>Chinese partners, key regulators, and big customers</b> , especially in still highly regulated industries like telecom and autos.	Increasingly successful companies do <b>R&amp;D in China</b> and set ambitious sourcing targets.	Go beyond joint ventures and greenfield investments. Smart companies often <b>buy out</b> Chinese partners and rivals.
<b>EXAMPLE</b> GM's relationship with Shanghai Automotive Industry Group has been key to its expansion.	<b>EXAMPLE</b> Delphi has opened a new R&D center, which will grow from 300 engineers now to 1,500 by 2010.	<b>EXAMPLE</b> Caterpillar and Anheuser-Busch are both using M&A to expand in a cost-effective way.



**PULL UP A CHAIR**  
At Haworth's furniture showroom, you can plug in and start working

As Beijing opens areas like tourism to outsiders, meanwhile, companies need more flexible business models. Parsippany (N.J.)-based Cendant Hotel Group Inc., which opened its first Ramada hotel in China in 1993, now is launching its Super 8 chain of motels, a sector Beijing is encouraging to offer more affordable rooms to tourists and business travelers and to create more jobs in services. Cendant has opened 10 motels this year, mainly in city centers, owned by Chinese franchisees. It wants around 60 within three years. "Overlay the personal income of China's growing middle class with a country with 21,000 miles of highway and big events coming up like the Beijing Olympics," says Cendant CEO Steven A. Rudnitsky, "and we are very bullish on business opportunities."

To many smaller U.S. companies, China still seems far too intimidating. But with hundreds of manufacturers succumbing each year to brutal mainland import competition, more are concluding they must take the China plunge. More than half of new American Chamber of Commerce members in China are man-

agers from small and midsize companies. Chicago-based Phoenix Electric Manufacturing Co., a 100-employee, \$20 million maker of electric motors for power tools, kitchen appliances, and other products, recently opened a second Chinese factory, in Suzhou. For Phoenix, the move was "a matter of survival because our customer base is moving here," says Chairman John S. Bank. It enabled Phoenix to keep its biggest clients, such as General Electric Co. and Emerson Electric Co., which have shifted most of their consumer-electronics production to the area.

No doubt China will keep trying the patience and pocketbooks of U.S. companies. It will be many years before China develops the intellectual-property rights protection, transparent policymaking, and level playing field that will make it anywhere as predictable as the West or Japan. But one by one, most of the obstacles that for so long made China a money pit are diminishing. So, too, is the rationale for companies who thought they could be global players without getting into China. ■

-With Pete Engardio in Beijing

**Nurture your local talent**

The caliber of China's manager class is improving rapidly, so **train** locals rather than rely on expats.

**EXAMPLE** Beijing-based Motorola University trains managers among its 9,000 China employees.

**Avoid a one-size-fits-all mentality**

Understand China's **consumers** and markets. Experiment with new China products, sales outlets, and pricing models.

**EXAMPLE** P&G offers simpler versions of popular products like Olay moisturizing cream at cheaper prices.

**Be creative in seeking opportunities**

Accept that expanding your business in China may require **new business models** or partners.

**EXAMPLE** Cendant is moving from business hotels to chains of motels in China.

# How Cummins Does It

The engine maker runs different game plans in India and China.

BY PETE ENGARDIO AND MICHAEL ARNDT



**IN AN AGE OF JUST-IN-TIME DELIV-**ery, it's probably not the best place to put an engine plant. Until recently, reaching the Dongfeng Cummins Engine Co. Ltd. complex from Wuhan, the nearest city with daily flights from Beijing, required a 5½-hour drive on a two-lane highway winding through the hills of rural Hubei Province to the dusty industrial

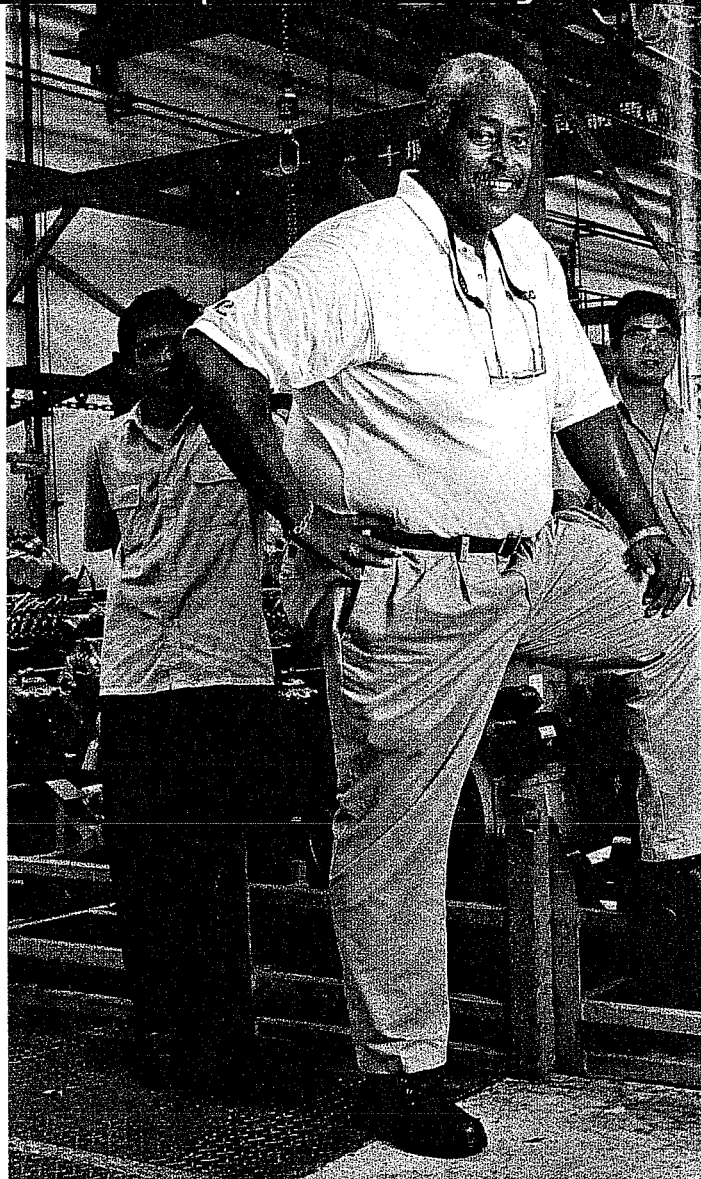
city of Xiangfan. Even today, heaps of freshly picked watermelons lie along the road into town in the summer. For plant manager Jerry Gantt, 57, Xiangfan's only African American and a former offensive lineman for the Buffalo Bills football team, the five-year assignment has meant many tough adjustments to culture, business practices, and diet. "It's been a challenge," says Gantt, a 15-year Cummins Inc. veteran. His happiest day, he jokes, was when the first McDonald's restaurant opened in Xiangfan two years ago.

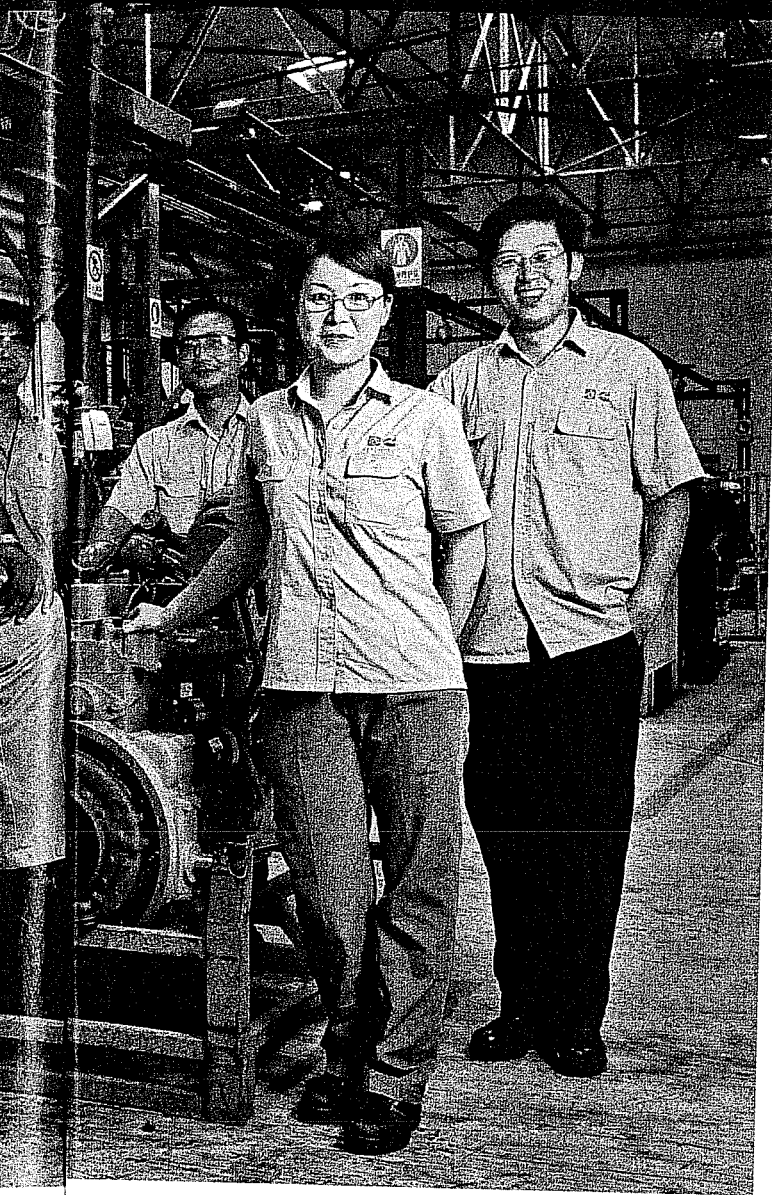
Cummins Inc. didn't have a choice where to locate the diesel-engine plant when it opened in 1995—two decades after then-Chairman J. Irwin Miller was one of the first U.S. executives to visit Beijing. That was the decision of the Chinese government and Cummins' 50-50 partner Dongfeng Motor Co., a state-owned maker of cars and trucks. But like many multinationals that decided to get into China early, Cummins has learned to play the cards it was dealt. That's been true in India, too. The Columbus (Ind.) company opened its first diesel engine venture in India in 1962. But for three decades sales were limited by bureaucratic controls on everything from pricing to product lines.

Yet their persistence has paid off. China and India now account for \$1.9 billion of Cummins' \$8.4 billion in annual

sales—and are expected to reach \$5 billion by 2010. Dongfeng is now Cummins' No. 2 customer, after DaimlerChrysler, and has proved to be a valuable partner. The Xiangfan factory, profitable from the outset, churns out 120,000 truck engines a year. It has boosted output fourfold since 2001 while trimming the workforce by 10%, to 1,900. Meanwhile, Indian partner Tata Motors Ltd. is Cummins' No. 3 global customer, and a Cummins engineering center in Pune is becoming vital in designing engines, power generators, and components. Cummins is also winning orders in promising niches. For example, it is fitting thousands of buses in Beijing and New Delhi with hybrid engines that burn liquefied-natural gas. In both nations, Cummins is expanding aggressively in every line of business. "Both China and India are probably the largest growth opportunities for Cummins," says Chief Executive Officer Theodore M. Solso.

Cummins needs the lift. In North America its potential market for big truck engines is shrinking as customers such as DaimlerChrysler, Volvo, and Navistar shift orders to their own affiliates. In 16 months, Cummins will confront a new challenge when new U.S. emission standards kick in, which could raise costs. This makes expansion in China and India "particularly important," says Citigroup analyst David M. Raso.





**LINEMAN GANTT**  
The ex-Buffalo  
Bill manages the  
Xiangfan plant

When the Kirloskars sold much of their stake in the mid-'90s, more liberal investment rules allowed Cummins to boost its share to 51% in what now is called Cummins India Ltd. That gave Cummins clear

management control and more flexibility to invest in new opportunities. It operates a fleet of rental trucks and a truck-stop chain, and sets up and helps run power plants. It also does back-office accounting, human-resource, and info-tech support work for Cummins worldwide. It even owns a \$50 million company providing IT services to clients like Unilever and BNP Paribas.

Otherwise, Cummins is sticking with its original partners. It still shares ownership of another Indian venture formed in 1996 to make lighter truck engines with Tata Motors, India's premier maker of cars and trucks. And in China, it says it is committed to keeping its 50% stake with Dongfeng. Cummins' Fleetgard Division also has a 50-50 venture with Dongfeng in Shanghai making fuel and air filters. Plus, Cummins has a new joint venture with Shaanxi Automobile Group to make engines for heavy-duty trucks. The eagerness to share ownership is unusual. Many multinationals that Beijing pushed into marriages with state companies in the '80s and '90s have since maneuvered for full control. "Most foreign companies think it's a mistake" not to have clear control of their Chinese operations, says Steven M. Chapman, who ran Cummins' China operations for six years before recently assuming his new U.S. post as group vice-president for emerging markets. "But I really insist we be able to trust each other as absolute peers." Chapman, a Mandarin speaker, negotiated Cummins' first deal to assemble engines under license in 1985 and has worked with five Dongfeng chairmen.

There is an obvious reason to stay with Dongfeng. As China's top truckmaker, it buys 70% of the plant's engines. Dongfeng also has the funds for rapid expansion. In three years, sales at the Xiangfen venture have zoomed from \$63 million to \$554 million, yielding \$89 million in operating earnings for Cummins. Another big expansion is in the works.

In a nation where relationships are paramount, an ally like Dongfeng can be invaluable. Over the years, Cummins executives say they've developed deep connections at many levels in the company. "Our partner is very good at working through the red tape and speeding up approvals, which helps us ramp up quickly," says Cummins East Asia Managing Director John Watkins.

Dongfeng's business acumen also helps. Cummins sells an array of engines and parts to local vehicle and equipment makers. Its toughest competitors are mainland manufacturers that are improving quality and service—and undercut Cummins by up to 40%. Fleetgard competes against 1,600 other makers of filters in China. "We have the products and the technology, but we need a partner to get access to the market," says Ivan Lok, manager of the fast-expanding Fleetgard plant in Shanghai. Cummins has 100% control of its network of 200 distributors and service centers, however.

**LOCAL R&D** In China, Cummins is about to open its first development center, also a 50-50 tie-up with Dongfeng. It will focus mainly on custom-designing engines for China. There also is talk of developing emerging markets.

In India, the two-year-old Cummins Research & Technology India center in

Cummins has succeeded in nations renowned for being tough for foreign investors. It has pushed to localize manufacturing. By nurturing solid partnerships, it has minimized capital costs and gained a marketing edge. It has put a high priority on training and empowering local managers. Seven of Cummins' top 10 China managers are mainlanders. Top expatriates stay for long stints rather than use posts as two-year stepping stones. Cummins also has moved 100 Asian managers and their families to Columbus, where they are climbing the corporate ladder.

Beyond that, Cummins plays India and China differently, highlighting the two economies' diverging structures and strengths. Some major contrasts:

**PARTNERSHIPS** When Cummins entered India in 1962, it formed a venture to make heavy engines and power generators in Pune in which it owned 50%. India's Kirloskar family owned 25%, and the rest floated on the Bombay Stock Exchange.

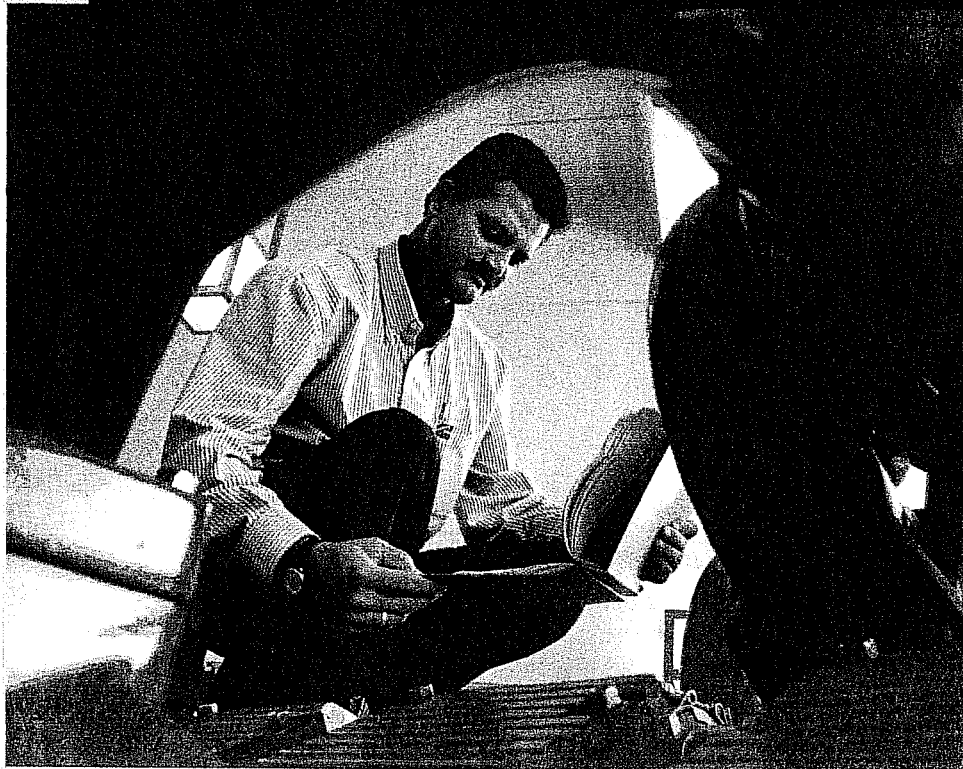
## Engines For Growth

CHINA	INDIA
CUMMINS REVENUE (U.S. \$BILLIONS)	
2004	2004
<b>\$1.1</b>	<b>\$0.8</b>
2010*	2010*
<b>\$3.0</b>	<b>\$2.0</b>

\* Estimates

Data: Cummins Inc.

# THE NEW CORPORATE MODEL



Pune is playing an important role in helping the company slash development costs and time in its bid to best such arch-rivals as Caterpillar Inc. in building a new generation of diesel engines. Cummins is tapping India's immense pool of skilled, low-cost engineers. Pune is a software and auto hotbed, where pristine industrial parks abut narrow streets jammed with cars, cattle, and rickety three-wheel taxis.

The center's 100 engineers specialize in 3-D computer modeling and simulated testing of engines and components. They collaborate with R&D teams in each of Cummins' 20 other development centers worldwide. "We're involved in just about everything Cummins is doing," says John O'Halloran, a 12-year Cummins veteran dispatched in June, 2003, to build and staff the center. In one area, a computational fluid dynamics team led by Ritesh Dugarwal, 26, an aerospace engineering graduate from the Indian Institute of Technology Bombay, simulates the combustion process inside a virtual prototype of a future engine. By mapping the movement of each fuel particle after it is ignited, they learn the size of droplets, how many are burned up, and how many are kicked out in the exhaust. Such data help determine fuel efficiency and emissions. At other pods, staff test engine components to see how they hold up to stress and whether fuel and air flow

**PUNE** The two-year-old Research & Technology Center is helping Cummins cut costs

past at optimal levels. They tweak designs, and U.S. engineers review the work overnight.

Cummins engineers in the West do similar work, of course. But because such labor is so expensive, "we had to be very selective in the past," says O'Halloran. "You can come up with hundreds of things to simulate in a computer. But we were constrained by the number of engineers, so you had to decide which tasks were most critical." Now, hundreds of parts can be modeled, tested, and perfected. That should translate into higher performance, lighter engines, and lower costs. Another benefit is that Cummins now builds half as many physical prototypes as it used to, thus cutting development time by up to two-thirds. Pune "eventually will play a significant role in developing major engine platforms," he says.

**EXPORTS** Given America's lopsided trade deficit with China, you would assume Cummins uses it as a major export base. Just the opposite. Cummins ships up to \$400 million worth of engines from the U.S. to China a year—four times more than it imports. China's booming market absorbs all of the engines it makes there.

India, however, is a great base for exports. The Pune factory ships one-third of its generators to the U.S., Britain, China, South Africa, and other nations. It also exports engines for everything from mining equipment to marine frigates. Why use India, with its clogged roads and seaports, rather than China's superefficient industrial zones? For one, Cummins and its partners have been designing products for the price-conscious Indian market for years, providing an edge in developing nations. And while China is unbeatable in mass-volume manufacturing, India is well-suited for low-volume production of complex industrial goods. "In any component, subsystem, or piece of machinery that requires a high engineering content, India has the advantage," says Cummins India Chairman Anant Talaulicar.

Investing in local manufacturing. Grooming managers for the long term. Exporting when it makes sense, and tapping local engineering brainpower. Many multinationals are now emulating these strategies in China and India. Cummins figured it out well before the competition. ■



## CHINA WHAT'S COOL

### Peak Experience

**But don't count on the après-ski**

➤ It's cool, sub-zero, and remote. It's Yabuli, China's biggest ski resort. Nestled in the Changbai mountains 120 miles north of the city of Harbin, Yabuli is a

reach. Yet China's small, but growing, ranks of ski fanatics regularly make the trek.

Yabuli's nine lifts haul skiers up a peak that offers a respectable 3,900-ft. vertical drop. Although Yabuli was the site of the 1996 Asian Winter Games, Aspen

it's not. Hotels often lack hot water, and the nightlife is...well, there isn't any. But it is a deal. A day of skiing—including equipment rental—will set you back just \$35. At that price, even the weather isn't so hard to take.

# The Great Bank Overhaul

Can a Chinese bank be a model for heroic reform?

BY BRIAN BREMNER



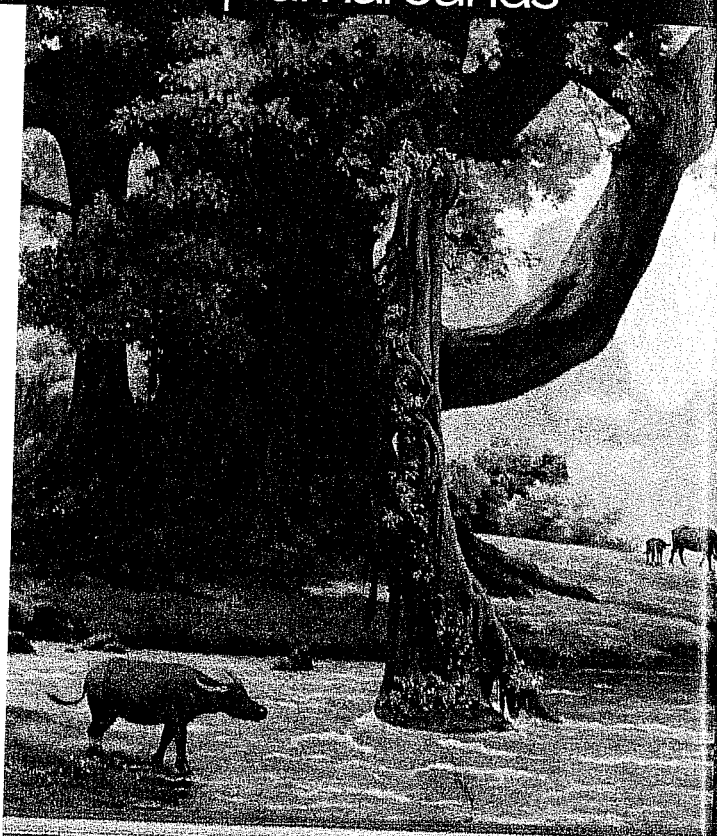
**WHEN FRANK NEWMAN PAID A** visit to Shenzhen Mayor Xu Zongheng in early June, it wasn't just to exchange pleasantries.

Newman will soon be chairman of Shenzhen Development Bank (SDB), the first foreigner ever to hold such a post, and he needed Mayor Xu's help. The private bank, which is 18% owned by Newman's other employer, Fort Worth-based private-

equity firm Newbridge Capital Group, is loaded with bad debt. Newman was there to explain his restructuring plan to the mayor and seek his help in collecting from some local deadbeats. Having seen an ornamental sword in the office of Shenzhen Vice-Mayor Chen Yingchun a week earlier, Newman said to Xu only half-jokingly, "Maybe you can use that sword on these guys." Xu smiled and assured Newman that "we will use the sword of the law."

Can China repair its mismanaged financial system—perhaps the most serious threat to sustained Chinese prosperity? Foreign investors, in hopes of finding the answer to that crucial question, are closely watching the unusual arrangement that gives Newman and his handpicked staff managerial control over SDB.

Newman, a bank turnaround artist who ran Bankers Trust Corp. in the mid-1990s, will officially become SDB's chairman later this year. But he has been scrutinizing the bank's operations for months, and he has observed plenty of the kind of trouble that is typical of Chinese banks—a backward information-technology system, a bloated staff, primitive credit controls, and a complete lack of cost consciousness. Branch managers around the country have made huge, risky loans without ever getting approval from headquarters. And there are hun-



PAUL HU/ASSIGNMENT ASIA; CHART BY ALBERTO MENA/BW



dreds of borrowers who were unable or unwilling to pay the money back. In the weeks before Newman was to take charge, the bank finally called in the Shenzhen police to speed up collection from at least one delinquent debtor.

The world has rightly marveled at China's dazzling growth, but the colossal waste of money involved in pushing that expansion has been less well publicized. It takes \$5 to \$7 of investment to generate a dollar's worth of gross domestic product in China, vs. \$1 to \$2 in developed regions such as North America, Japan, and Western Europe. For now, China has both the enormous profits from its export trade and the captive savings of its citizens to invest recklessly. More than \$3 trillion is stuffed inside Chinese banks, earning paltry interest, because the country's capital controls and undeveloped capital markets prevent savers from investing it elsewhere.

Unfortunately, much of that cash has been allocated so badly by China's four biggest banks and thousands of local lenders that most of them are limping financially—along with many of the state-controlled enterprises that were recipients of the banks' loans. Beijing to date has spent some \$100 billion bailing out the Big Four—the Bank of China, China Construction Bank, the Industrial & Commercial Bank of China, and the Agricultural Bank of China. Standard & Poor's estimates the four will need an additional \$190 billion later this decade to stay above water.

Why are China's banks in such terrible trouble? Because for most of their history they weren't banks in the Western sense at all; rather, they were financing arms of the Chinese government. "It used to be that local governments controlled the banks," says Fan Gang, president of the National Economic Research Institute.

## BIG STEEL, LITTLE STEEL

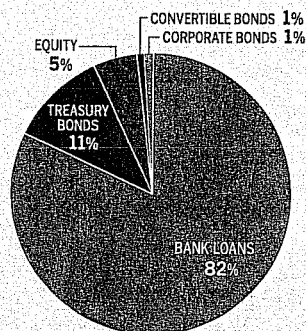
CONSIDER THE STEEL INDUSTRY. China now has more than 200 steel plants, in part because every regional government felt it needed one to feed the hot-rolled stuff to local industries. The steelmakers were all built with big bank loans. But the largest 85 of the plants produce 90% of China's steel. The rest are marginal operations that wouldn't exist without the generosity of the banking system. At the same time, China's rail network is starved for money, but its managers don't have the political connections to garner bank loans. The result is massive railyard bottlenecks. Last year 25% of those seeking to ship goods by rail were turned away, according to Andy Rothman, a strategist with investment bank CLSA Asia-Pacific Markets in Shanghai.

**BLOATED** Staff at SDB is excessive, and cost control is lackluster

China's financial managers know the country's growth engine is at risk if it can't allocate capital more shrewdly. That's why they've developed a plan for each of the Big Four—which together

## In China, Banks Rule

SOURCES OF FINANCING FOR CHINESE CORPORATE/GOVERNMENT PROJECTS



Data: People's Bank of China

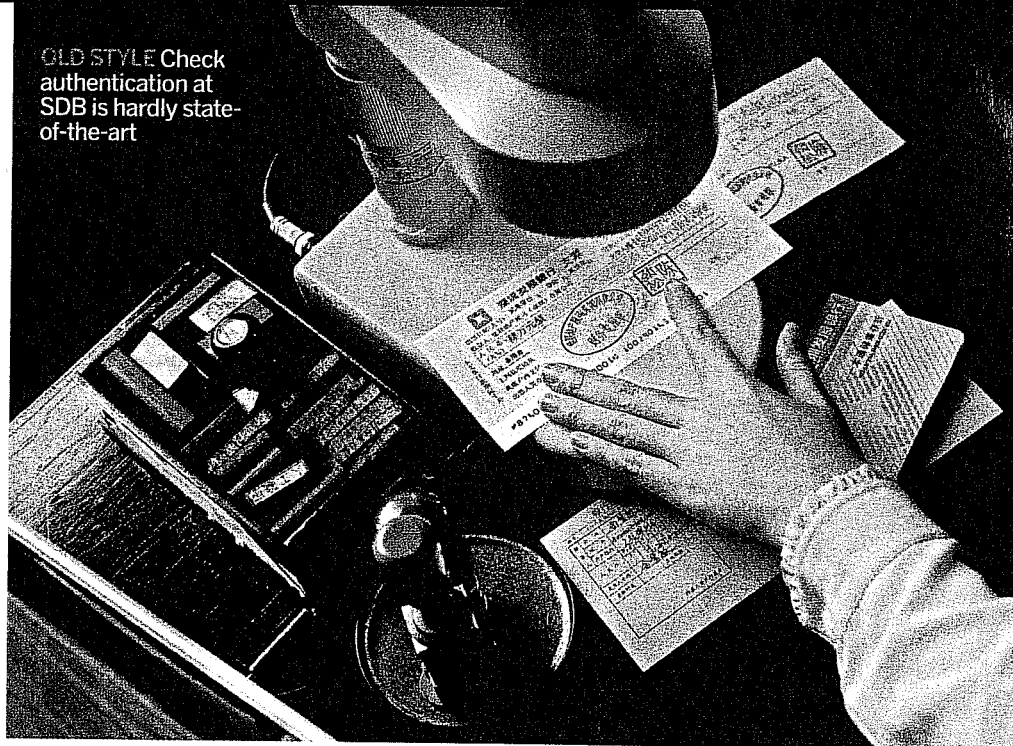
# THE NEW CORPORATE MODEL

make 57% of all corporate loans—to link up with one or more foreign banks between now and the end of 2006, when the banking system will be fully open to foreign investors. The idea is that the foreign stakeholders will lend their expertise and, among other reforms, help straighten out the big Chinese banks' loan books. Bank of America Corp. bought a 9% stake in China Construction Bank for \$3 billion, and on June 23, Switzerland's UBS announced it was in negotiations to make up to a \$500 million investment in Bank of China.

Analysts note, however, that the Big Four and their government overseers are unlikely to let foreign partners have much real control over management. That's why Newbridge Capital's effective takeover of SDB is so important. SDB is one of a half-dozen younger, privately owned banks created in the late 1980s. These smaller banks are much more malleable reform vehicles, although Newbridge's Hong Kong-based managing partner, Weijian Shan, notes that, even in those banks, "you really need an experienced management team" willing to shake things up. Several of these "shareholding" banks have important foreign partners. Shanghai Pudong Development Bank is 5% owned by Citigroup, while Tianjin-based Bohai Bank is expected to get regulatory approval to sell a 20% stake to London-based Standard Chartered Bank later this year.

Newbridge's investment in SDB, a commercial bank with \$25 billion in assets, took two years to negotiate. The talks were led by 51-year-old Shan, a Beijing native whose family was relocated to the Gobi desert during the Cultural Revolution and who later went on to earn a doctorate in business at the Uni-

OLD STYLE Check authentication at SDB is hardly state-of-the-art



versity of California at Berkeley. The key sticking points were share price and managerial control. In the end, Newbridge paid \$145 million for its 18% stake in the bank, making it the biggest single shareholder. It bought the shares from Chinese companies with the consent of the government. As part of the deal, Newman was appointed chairman. He has recruited other outsiders for top bank posts.

## 'A BANKER'S BANKER'

NEWMAN IS NO STRANGER to salvage jobs. As chief financial officer of Bank of America in the late 1980s, he plugged gaping holes that appeared in the bank's balance sheet after a wave of credit-card and consumer-loan defaults. In 1996 he took the top job at Bankers Trust after a scandal involving derivative contracts drove out a big chunk of senior management and sullied the bank's reputation. Newman "is a banker's banker," says friend Timothy C. Collins, CEO of Ripplewood Holdings LLC, the New York private-equity firm that acquired and turned around Shinsei Bank Ltd. in Japan.

Those turnaround skills will be sorely needed at SDB, where Newman has found that normal budget control mechanisms don't exist, and there is no system to measure which bank products are selling. When he arrived, Newman was shocked to find that loan officers didn't generate regular reports detailing which loans were being paid off and which were not. That matters greatly, since last year the bank doubled its provisions for bad loans, which pushed SDB's profits down 21%, to \$39.4 million, on \$1.08 billion in revenues. Bad loans

## A Bird's-Eye View of China's Banking Sector \*

### THE BIG FOUR

Bank of China, China Construction Bank, Industrial and Commercial Bank of China, and Agricultural Bank of China make 57% of all corporate loans, mostly to state enterprises. They hold \$1.8 trillion in deposits. Bad loans: \$122 billion, or 10.1% of total loans.

### SHAREHOLDING BANKS

A dozen privately owned national banks, including Shenzhen Development Bank, are concentrated in affluent coastal cities. They're considered more malleable reform vehicles. Bad loans: \$18 billion, or 4.6% of total loans.

### CITY COMMERCIAL BANKS

China's 100-plus commercial banks were set up by local governments to fund favored projects. Five of them, including Bank of Shanghai, have foreign stakeholders. Bad loans: \$12.4 billion, or 10.4% of total loans.

### RURAL BANKS

Most of these 32,000 credit cooperatives and small commercial banks have strayed from their original focus on farm loans and are poorly capitalized. This group is in desperate need of consolidation. Bad loans: \$542 million, or 6.4% of total loans.

Data: China Banking Regulatory Commission, Moody's Investors Service

\*Note: Government bad loan figures are lower than overall Western estimates

# THE NEW CORPORATE MODEL

now account for 11% of the bank's loan book. Also worrisome is SDB's capital adequacy ratio, which is 2.8%, well below the 4% mandated by Chinese regulators.

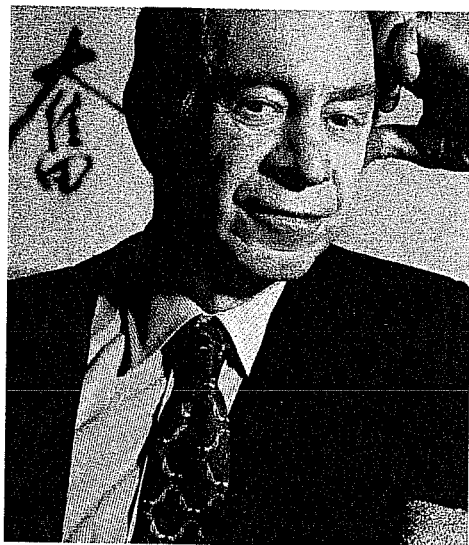
Newman, who doesn't speak Mandarin, is working with a team of experienced players who do. SDB President Jeffrey Williams is the former CEO of Standard Chartered Bank in Taiwan. Twenty years ago he opened Citibank's first mainland branch in Shenzhen. Other key players include Liu Baorui, head of retail banking, and NPL workout czar Wang Ji, both recruited from other Chinese banks. SDB's chief technology officer, mainlander Bruce Sun, is a former chairman of the Department of Information Systems at California State University. He worked for one of China's major banks before joining SDB.

Job No. 1 at SDB is to gain effective control over the bank's

such as credit-card and mortgage lending—a high priority for Newbridge. Newman says the bank likely will raise the cash it needs via a stock offering on the Shenzhen exchange, where it is already listed, perhaps in combination with a private placement of shares with another strategic foreign investor.

That's a tough strategy for the time being. China's markets are at an eight-year low, and stock prices will be held down for the foreseeable future by the government's promise to sell off a big portion of its shares in listed companies. SDB likely will try to raise \$483 million this year, according to Hong Kong-based ABN-AMRO analyst Simon Ho, who is advising his clients to steer clear of the stock. Newman, however, is convinced he can put together a plan to raise the money he needs.

If he does, and if there isn't a huge increase in bad loans, SDB



## Fixing a Broken Bank

Newbridge Capital's Frank Newman, named chairman of Shenzhen Development Bank after the buyout firm took an 18% stake, faces a host of challenges:

### A CAPITAL SHORTAGE

The bank's capital adequacy ratio is 2.8%, well below the 4% required in China. Shenzhen could try to raise cash in a stock offering or private placement, but China's stock markets are depressed.

### A ROTTEN LOAN BOOK

Some 11% of the bank's loans are bad. Newman has assembled a team of collection specialists, who are aggressively pursuing deadbeats with help from local government. But progress is slow, and additional loans could turn sour.

### A NEED FOR GROWTH

Newman wants to build out the consumer finance side of SDB's operations, including credit cards. He may also put more emphasis on trade finance, which would play to China's vibrant export sector.

230-odd branches in 18 major cities, including Shanghai, Beijing, and Chongqing. Newman says the branches have operated like "fiefdoms with their own emperors." And the little emperors have made bad loan decisions—for instance, lending millions of dollars to build little-used toll roads connecting coastal cities. Now all major branch loan officers report to headquarters, and a central credit committee clears major lending decisions. "You try to turn off the spigot," Newman says.

## 'DETECTIVE WORK'

A PRIORITY IS DOING triage on the bank's loan portfolio to decide which nonperforming loans it should attempt to collect. Newman says he has been surprised at the number of defaulted borrowers who suddenly come up with the money they owe when pressure is put on them. To go after the tougher cases, SDB has assembled a 130-person, specially trained loan collection department. "Collection has its own special set of techniques," says Newman. "You have to know how to work with lawyers, sometimes the local government, and sometimes you need to do a little detective work to see where people have assets hidden."

Another pressing issue is how SDB will raise the capital it needs to meet minimum capital requirements and upgrade its decrepit IT systems. Unless it can do that, senior executives won't be able to track costs and earnings in real time or invest in new businesses

may have some interesting growth areas to exploit. First, Shenzhen (population: 10 million) is a major technology center, home to 100-plus major tech companies, including telecom networking equipment makers Huawei Technologies Co. and ZTE Corp. Newman wants to build up the bank's expertise in lending to them. He also intends to get into trade finance, raising and lending money in multiple currencies for the nation's exporters.

Then there's consumer lending. It represents only 11% of all loan assets in China, but it has doubled since 2000 as a middle class has emerged in the affluent coastal cities where the bank does most of its business. SDB has just a few hundred thousand credit-card accounts at a time when 98 million cards are in circulation in China. Lending rates on cards are capped at 18%, but the cost of funding is only 3.6% or so. The risk is that China doesn't really have a system of independent credit bureaus that can help banks assess risk.

Just how long will it take to get SDB back on its feet? Well, Newbridge has made a commitment to hold its stake in the bank through the end of 2009. After that, it will probably sell to the highest bidder—and maybe make a bundle on the way out, as it did early this year when it sold its stake in Korea First Bank to Standard Chartered. But there's more to this saga. If Newman & Co. can re-fashion SDB into a bank with a real credit culture, its success could have a ripple effect throughout the Chinese money system. For an old banking hand from the States, that would be quite a legacy. ■

■ **MANY DEFAULTED BORROWERS CAN COME UP WITH THE MONEY WHEN PRESSURE IS APPLIED**