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BY JOSHUA KURLANTZICK

Robert Kushner, founder and managing director of Pacific China Industries Ltd., a 15-person company that develops and manufactures novelties in China, hardly seems like a typical American businessperson prospecting for gold in the Middle Kingdom. His Hong Kong office is crammed full of tchotchke products—dancing rock stars to mount on dashboards, collapsible corkscrews, sunglasses holders—that seem far from the high-tech exports increasingly flowing out of Chinese factories. He is not part of a massive corporation like GM or Wal-Mart, multinationals that claim to be best positioned to take

other major auto manufacturers are drastically expanding their operations in China—smaller companies like Kushner's actually have proven among the most successful foreign operators. In fact, some entrepreneurs' businesses in China have become so profitable that large corporations have begun copying their strategies.

Rough Road

Over the past two decades, as China has liberalized its economy, several large companies have prospered by moving manufacturing into China or, more rarely, by producing goods for the Chinese consumer market. KFC, one of the first fast-food chains to peddle its wares in the Middle Kingdom, now has branches in every province and an outlet in Tiananmen Square, near a massive portrait of Mao Tse-tung. Carrefour, the French supermarket chain, has gained a loyal base of

Chinese shoppers.

Yet more often than not, major multinationals have found making money in China considerably harder than they expected. "China tempts people because it has a billion potential consumers, but I can count on two hands the number of big companies that have proven profitable selling to China," says Joe Studwell, author of *The China Dream: The Quest for the Last Great Untapped Market on Earth* (Grove Press), a comprehensive book on companies' attempts to penetrate the Middle Kingdom.

Some big companies misjudged the market. British brewer Bass overestimated the number of Chinese people able to pay big money for its premium lagers and stupified potential Chinese customers with

promotions featuring dancing Scotsmen dressed in kilts. Other giants have had their ideas expropriated, with little recourse. Pepsi has sold its drinks in China for 20 years but admits it has yet to make a profit; now it's accusing its Chinese joint-venture partner of infringing on its intellectual property rights.

Smaller companies face difficulties in China, but they possess several advantages, says Ming-Jer Chen, an expert on Chinese business at the University of Virginia in Charlottesville. "Small companies operate below the radar of government officials—certainly below the radar of central officials in Beijing, and they less often go head-to-head with big Chinese companies favored by the state," Chen says. "So while a Disney or a Microsoft might

dealing with the government in any country, but we have as much freedom to compete as we would in the U.S.," says the 48-year-old co-founder of NewTone Communications Corp., a \$6 million software company with 140 employees, an office in Shanghai and a virtual office in Silicon Valley.

Derek Sulger, co-founder and CFO of Intrinsic Technology, a Shanghai mobile telecom service provider founded in 1999, agrees: "For a small private company, China is quite an open place."

Because smaller firms also have fewer resources and less ability to absorb losses, they tend to focus more on short-term profitability in China. "Companies like Anheuser-Busch or GM always talk about how

NOT TOYING AROUND: Like many owners of small companies doing business in China, Robert Kushner says success comes from focusing on short-term goals.



have to spend huge amounts handing out favors, smaller companies do not have to do so much wining and dining."

Since entrepreneurs usually escape the government's notice, they are less obligated to locate offices and factories in areas favored by Beijing. When Honda decided to build a new auto plant in China in 2002, it allegedly came under intense pressure to erect the factory in Guangdong, a southern province that the government wanted to develop. The area is far from a port that could handle car shipments, automobile industry experts say, but Honda shouldered the increased cost and set up shop there.

Bruce Wang tells a different story. "There's always some element of

they're losing money now because they want to be heavily invested in China for the long run, so when the market grows they will have established their brand," says Kathleen Ng, an expert on business practices in China who works in Hong Kong. "But that market could be 20 years from now, and by then, local companies might be more powerful, or the shape of the industry might be totally different."

Conversely, says Johnson Shen, founder of Chic Logistics, a \$4.6 million Shanghai-based transportation company with funding from American VCs: "We were profitable last quarter, only three years after we started up, because we don't have the

luxury of not being profitable once our VC funding runs out."

"I stick to the basics of business," says Kushner. "I expand when it's financially possible, and I make a profit on my orders because I can't afford to have a grand China plan for making money in 2020."

Most smaller companies also keep their overhead costs lower by minimizing the number of expatriate staff, who usually require "expat packages" that can include company-provided housing and even a driver so they do not have to navigate China's chaotic streets themselves. "We thought about bringing in more expatriates, maybe a CEO-type with experience running young telecom companies," says NewTone Communications co-founder and CEO Howard Li, 49. "But it wasn't worth setting someone up with expatriate perks, because they wouldn't necessarily have more knowledge than local staff who know how to operate on the ground, which is crucial in China." And local talent is cheap, though it can be hard to retain Chinese managers: Wages for local professionals are roughly 20 percent less in China than in India, China's major competitor for foreign investment. (See "Trekking Into New Territory" on page 69.)

Keeping salaries down allows smaller firms to operate more flexibly, a key to surviving in a place where long-term contracts are rare, deals are sealed with a handshake, and Chinese factories seem to open up or close down overnight. "You have to have more trust in your local partner here because you cannot rely on the courts, and you have to be able to change your plans incredibly quickly," says George Man, vice president and general manager of sales for the Asia-Pacific region for Phoenix Technologies Ltd., a San Jose, California-based software provider with 30 employees in China.

"You must become part of the local ecosystem in whatever city you are in [in] China," says Albert E. Sisto, Phoenix's CEO, chairman and president. "You have to be seen as close to local partners and knowledgeable about local trends—otherwise you will not get respect, and you're more likely to have your products copied."

In fact, even bigger firms are considering using local staff more and emphasizing flexibility. "The multinationals investing in China the right way are using hungry local guys or

expatriates who are comfortable in China and can live without some of the special benefits," says Roy Bagattini, managing director of SABMiller China, considered the most successful major foreign brewer in the country. "We don't want everything dominated out of our headquarters in Beijing—we want to have a few expatriates out in the field at our brewery sites and competent local managers."

Uneasy Success

Using many of these strategies, entrepreneurs have racked up numerous victories in China. Kushner says his company has been profitable every year since 1997. NewTone Communications expects to be profitable by the beginning of 2003, less than five years after the company was founded; by comparison, nearly all U.S.-focused communications companies that got their start in the late 1990s have gone bankrupt or continue to struggle. Chic Logistics has reached profitability and expects to become the major national logistics provider by 2005: The company has already beaten out international logistics players like Maersk for several contracts in China. Phoenix Technologies has signed major deals with several of the largest Chinese computer firms, including Legend Computer, and expects China to become one of its two main sources of profits within five years.

Despite successes, smaller companies are not breathing easy. "When I first [began] going to the mainland 20 years ago, people would come up to you and touch your skin to see if you were real," says Peter A.J. Gardiner, executive chairman of the board of directors at Zindart Ltd., a Hong Kong-based toy manufacturer. "Now, Chinese [people] in most cities are more comfortable dealing with foreigners and have brought some private businesses up to foreign standards." Indeed, the number of private local companies in China rose by 15 percent in 2001, and these firms will increasingly dominate the economy as the hulking state enterprises—vestiges of Mao's era—are downsized and eliminated. In November 2003, the Chinese government announced that it was accelerating the privatization of thousands of state-owned businesses.

Adding to small companies' worries has been the SARS virus that hit China over the past year. Although there's little evidence that SARS has made it harder for companies to recruit employees or

TREKKING INTO NEW TERRITORY

If you're considering taking your business to China, here are some strategies to help ensure your success:

1. WEAR OUT YOUR SHOE LEATHER.

Entrepreneurs say the only way to decide whether you should move some production to China, target the Chinese market, or even transfer your whole operation is to make a lengthy visit—at least one month long—to areas where you hope to locate. It is very difficult to schedule appointments in China more than a few days in advance, so be prepared to land in a city and wait until the people you need to meet are available. "You have to get on the ground, meet potential partners and check out factories to see for yourself whether everything is right for you," says Robert Kushner, founder and managing director of Pacific China Industries Ltd., a Hong Kong company that manufactures novelty items. "Business in China is about building relationships, and you have to see whether there's potential for good relationships."

2. LEARN THE LINGO.

Outside of Hong Kong and a few areas of Shanghai and Beijing, few people in China are proficient in English. Learning at least rudimentary Mandarin Chinese is essential for entrepreneurs who cannot afford the retinue of translators and personal assistants the multinationals employ. Even if you have the capital to afford a full-time translator (quality Chinese-English translators are expensive), using a translator exclusively will make it harder for you to build relationships with local Chinese partners. Many universities and private language schools in the United States offer courses in Chinese, and most major Chinese cities have language schools for foreign businesspeople.

3. PAY MANAGERS A HIGH WAGE.

Though the low cost of labor is one of China's most important comparative advantages and a major reason why foreign companies locate in China, experts say one of the biggest mistakes foreigners make is to pay local managers too little. "For Chinese managers with a college degree and some English skills, the job market is great," says George Man, Asia-Pacific general manager of Phoenix Technologies Ltd. "Pay them an above-market wage, or you will constantly have managers jumping to other foreign firms or big local companies, and your costs will go through the roof."

Kushner agrees, saying: "You have to pay managers top dollar, and you also should pay the inspectors at your plants well; otherwise you'll wind up with too much of your product going out the back door, and one day, you'll see your items for sale in the local markets."

to manufacture and ship goods for export, several economic studies have estimated that, by scaring consumers, SARS will shave at least one percentage point off China's annual growth, potentially depressing the market for many goods.

Meanwhile, the prolonged boom in China, which has posted economic growth rates of more than 7 percent per year for more than a decade, draws more foreign competitors into entrepreneurs' industries. Since China entered the World Trade Organization in 2001, committing itself to further liberalizing its economy, investment into the country—already the second-largest recipient of foreign capital in the world—has actually increased. Nomura Securities, a Japanese research firm focusing on Asia, has predicted that foreign trade with China will double by 2006.

And entrepreneurs, who typically have fewer resources with which to defend themselves, are not immune to piracy and graft. A 2000 PricewaterhouseCoopers survey of 35 countries found that only Indonesia and Russia

boasted more corrupt government officials than China. Even Chinese leaders recognize the extent of the problem. Huang Jianping, a former top official at the Ministry of Foreign Trade and Economic Co-operation, admitted that it is cheaper to pay off bureaucrats in China than to spend money on law and accounting firms that would enforce trademarks and rigorously audit operations and balance sheets.

"If some kind of [intellectual property] theft happens, what are you going to do?" says Gardiner. "The court system is improving, but you are still not going to go there with a serious intellectual property claim."

Kushner agrees: "My products usually get knocked off by local competitors in about two months—three months, tops." Despite the potential hazards, though, China still promises to be fertile ground for entrepreneurs in search of new opportunities in an untapped market.

JOSHUA KURLANTZICK is a writer in Washington, DC.