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In China: The importance of managing relationships dynamically

By Donald N. Sull

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In China: The importance of managing relationships dynamically

By Donald N. Sull

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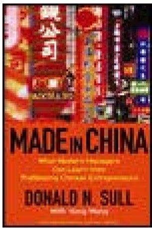

This article is based on the book, *Made in China*, which will be available in bookstores across Canada in early July. Orders can be placed now at on-line retailers. Harvard Business School Press and McGraw- Hill Ryerson have made six copies available to Ivey Business Journal. The first six readers to respond to this notice will each receive a free copy of the book. Mail your name and address to sbernhut@rogers.com.

To succeed in China, Westerners must develop and manage relationships that will enable them to seize golden opportunities and avoid or manage sudden-death threats. Government agencies, customers, technology partners, suppliers, investors, and distributors provide the resources necessary to survive and thrive in an unpredictable environment. Success, therefore, requires managers and entrepreneurs not only to select good partners and craft solid deals but also, more important, to manage these relationships as they evolve over time.

Working with partners rather than trying to do everything in-house confers several advantages in unpredictable markets: these relationships can minimize investment, parcel out risk, and allow a company to seize new opportunities and exit slowing businesses more quickly. They also have disadvantages, the most important being that dependence on these external parties can tie entrepreneurs' and managers' hands as they respond to changes in their competitive environment. The relative balance of benefits and costs shifts over time, and entrepreneurs must manage these relationships as they evolve, a challenge we refer to as managing relationships dynamically. The appliance maker Guangdong Galanz has excelled at managing relationships in a turbulent environment, and its case study illustrates the costs and benefits of relationships, how these pros and cons shift over time, and, most important, how executives can manage them effectively in a constantly shifting context.

Guangdong Galanz: From Goose Feathers to Microwaves

Guangdong Galanz has made impressive progress in the decade since it entered the white goods industry. It has carved out a commanding leadership position in the microwave oven sector. In 2003, microwave ovens accounted for only 4 percent of the total home appliance market in China. The Galanz brand dominates this niche, however, with the leading market share in every major Chinese city where it competes, outselling the second-largest brand (which varies by city) by a multiple of two to six times unit volume. In Beijing, for example, Galanz enjoyed a 61 percent share of market (by revenues) versus 11 percent for number two LG; in Shanghai, Galanz had 46 percent versus 11 percent for SMC; and in Guangzhou, 42 percent compared with number two Midea's 8 percent. By way of comparison, Haier-the number one player in the larger air conditioner segment-had a 24 percent share of total industry revenues that same year.

Galanz has successfully defended its leadership position in the domestic market despite fierce attacks from aggressive new rivals Tianjin-LG, which entered in 1996, and Midea, which began selling microwaves three years later. Today, the company has over 20,000 employees and is one of the largest home appliance manufacturers in China, with 2003 revenues of U.S. $1.3 billion.

Galanz built upon its position in China to become the global leader in unit production of microwave ovens, with annual output exceeding 16 million units in 2003. Galanz estimates that its share of global microwave oven unit production was over 40 percent in 2003, with its share in certain emerging markets in South America and Africa exceeding 70 percent of units sold. The vast majority of these units are manufactured for sale under other companies' brands. In 2001, the company diversified into air conditioner production, and within two years entered the ranks of China's top four exporters of air conditioners. Galanz executives have announced their goals of increasing annual air conditioner production volume to 7 million units in 2005 and at least 12 million units by 2008, and becoming the world's number one producer of air conditioners.

Qingde Leung and the Early Years of Guangdong Galanz

Guangdong Galanz today looks nothing like its original incarnation as the Guizhou Down Product Factory, a collective enterprise founded in 1978 to produce and supply goose down on an outsourced basis for branded clothing companies such as Yves St. Laurent. The collective enterprise was based in the Guizhou township of Shunde City in the Guangdong province, a township located at the Pearl River Delta and bordering Hong Kong. In the mid-1970s, Guangdong was considered a bit of an industrial backwater, with most of the country's heavy industry and technology concentrated farther north in the Beijing-Tianjin area and in Shanghai, among others. The provinces surrounding the Pearl River Delta, in contrast, were largely rural and lacked both up-to-date industrial equipment and the capital to acquire it.

All this changed in 1978, when the Communist Party announced its intention to create Special Economic Zones (SEZs) to experiment with free market reforms and with opening up to international markets. Suddenly, Guangdong, with its three SEZs of Shenzhen, Zhuhai, and Shantou, was on the front line of China's integration into the global economy. Qingde Leung was anxious to seize the moment. The southern entrepreneurs who pioneered capitalism are legendary in Chinese business circles, but Leung stands out even among them for his vision, diligence, and ability to survive the vicissitudes of a quarter century of turbulence.

Leung, who was born on a farm in 1937, first distinguished himself by completing high school, whereas most of his rural classmates dropped out before graduation to work the land. From 1956 to 1978, Leung enjoyed a varied career in a host of local state-owned enterprises, including the local distribution cooperative (the exclusive distribution channel under the planned economy), as well as

management positions in a workshop of a steel mill, a printing factory, and an arts and craft shop. In 1978, Leung-then a 42-year-old administrator in Guizhou township's industrial bureau-proposed that the town's party council set up a collective enterprise to wash and process goose feathers. The proposal met with stiff resistance, with one colleague vowing to crawl to the nearby Xijiao River if Leung succeeded in building the plant. Leung's proposal won approval by a narrow margin of the party council, but his colleague failed to make good on his pledge when eventually the plant was built.

In late September 1978, Leung and ten coworkers broke ground for the new factory on a deserted piece of land on the Xijiao River. Most groundbreakings are ceremonial affairs, where top executives dig the first shovelful of dirt and then go back to the office. Leung, in contrast, kept digging. The collective enterprise had only raised one-third of the approximately $400,000 required to build the plant, and the managers were forced to do the basic construction work themselves to conserve funds. With additional government bureaucrats dispatched to help, Leung completed the plant in seven months. By the summer of 1979, the facility employed approximately one hundred workers, who washed and processed feathers by hand for sale abroad.

Under Leung's leadership, the collective enterprise prospered. It backward integrated into poultry trading and expanded into related products, including woolen cloth. In 1985 it changed its name to the Guizhou Livestock Products Industrial Company to reflect its expanded business model. By 1992, the enterprise booked revenues of approximately $19 million and was ranked among the one hundred most successful township and village enterprises in China by the Ministry of Agriculture.

Golden Opportunity in the Domestic Microwave Oven Market

By the early 1990s, however, Leung anticipated that intense competition would depress profits in the textiles business, and he began actively waiting for the next golden opportunity. The local government proposed entering the synthetic fiber market, but Leung passed on the opportunity (a fortunate decision, since the business went bankrupt after the township entered later). On a business trip to Tokyo in 1991, Leung saw his first microwave oven and decided to add it to the list of possible opportunities. Although the enterprise had no expertise in white goods, the headquarters city of Shunde was rapidly emerging as China's manufacturing center for appliances and served as the headquarters for market leaders across several segments, including Rongsheng (refrigerators), Huabao (air conditioners), Aide (electric rice cookers), SMC (microwave ovens), Midea (electric fans), and a dense concentration of specialized components suppliers.

Leung sensed that domestic demand for microwaves was poised to take off. Although microwaves had been produced in China for more than a decade, most were exported. After conducting extensive research on the domestic market, Leung's team learned that microwaves were considered a luxury good, sold for $500 to $700 per unit, and that the miniscule household penetration rate in China was much lower than the 40 percent to 80 percent typical in Japan, Europe, and the United States. Moreover, no established competitor dominated the fledgling Chinese market. During this time period, many Japanese players, including Matsushita, Sharp, and Mitsubishi, started to set up joint ventures in China to produce microwave ovens for export.

Leung was not, of course, the only entrepreneur to notice the microwave oven opportunity. Between 1990 and 1998, over a hundred domestic firms began producing microwave ovens, including Haier, Sanle, Anlubao, and SMC. Other foreign electrical appliance leaders-including Whirlpool, LG, and Samsung-also entered the Chinese market through joint ventures, bringing their expertise in branding, product technology, and global manufacturing scale and processes. Leung, however, entered earlier than

most new rivals. Many of the entries occurred in the mid-1990s: in 1996 alone eighty-eight new firms entered China's domestic microwave oven market. Haier and Midea were relatively late comers, entering the market in 1995 and 1999, respectively, and Whirlpool made its big move in 1995 when it acquired 65 percent of Shunde-based SMC, which had carved out an early leadership position in the small market. Later Whirlpool acquired the remaining 35 percent and made SMC its 100 percent subsidiary.

In June 1992, the Guizhou Livestock Products Industrial Company officially changed its name to the Galanz Group of Guangdong to mark its transformation into a microwave oven company. The name Galanz is modified from a Greek word meaning "magnificence." To develop the expertise required for microwave production, Leung visited Shanghai to persuade microwave oven experts to join his new venture. He finally succeeded in recruiting a few engineers from the Shanghai Eighteenth Radio Factory to work initially on a part-time basis as consultants. Among them was Rongfa Lu, who subsequently rose to be deputy general manager of Galanz. The newly formed team licensed technology from Toshiba in 1992 to produce a trial run of 10,000 microwave ovens in 1993 under the Galanz brand.

Lacking funds for a national launch, Galanz initially focused on the Shanghai market and got its big break when the Shanghai No. 1 Department Store (then one of China's largest department stores) agreed to stock the Galanz microwave ovens on a trial basis. Galanz's senior sales executive agreed to remove the microwaves if none sold in the first three days, and parked himself in the store to personally sell the ovens. Rivals disparaged Galanz's move from livestock to electronics, predicting the company would quickly go out of business. Leung posted these remarks on a bulletin board in the center of the microwave factory, gathered the workers to read them aloud, and challenged them to help him remove the board. Leung also placed domestic microwave leader (and cross-town rival) SMC squarely in the company's cross-hairs as its focal competitor. Galanz defied its critics and the company sold 80 percent of its trial production run in Shanghai in 1993.

Galanz quickly built on its success in Shanghai to roll its products out nationally. To stimulate demand for microwaves, the company launched a national marketing campaign in 1995, placing advertisements and articles in over 150 newspapers and magazines to educate consumers on the benefits of microwave ovens; these marketing materials included practical cooking techniques and recipes. Galanz faced not only the normal setbacks encountered by any start-up, but also challenges of nearly biblical proportions. In June 1994, the Xijiao River experienced a flood reputed to be the largest in a century. The flood, which lasted two weeks, initially submerged the factory under eight feet of water; when it receded, it left more than a foot of mud in its wake. When he encountered weeping employees, Leung offered to pay the salary and traveling expenses of any employee who wanted to quit, but none took him up on his offer. Instead, Leung mobilized the remaining troops; within three days Galanz had resumed limited production, and it hit capacity three months later. Despite the flood, the company achieved sales of approximately 100,000 units and rose to second place in the domestic market for microwaves.

Galanz also had to overcome organizational challenges. In the early 1990s, Galanz was still owned 100 percent by the township government. Government policy, however, dictated that the ownership shift to a hybrid form in which the township would own approximately one-third of the enterprise (a share that would decline over time), while managers would own the remaining stake. Leung, himself a senior member of the local Communist Party, initially discounted ownership restructuring as a distraction from winning in the marketplace. Early in 1994, however, Leung had a change of heart and offered stock to management, and over sixty senior managers ended up with a 70 percent stake in the company. The outcome of Galanz's transition from goose feathers to

microwaves was far from clear at this time, and many eligible managers declined the offered shares. To demonstrate his confidence in the venture, Leung took a personal loan and acquired all the unclaimed shares. As Galanz's prospects began to look up, Leung sold his shares (at a sharp discount to their estimated value) to other managers to share the wealth. The Galanz restructuring resulted in a broad base of middle managers with a substantial stake in the company's success and stood in contrast with many other ownership transitions that left a chairman owning the vast majority of a company.

In 1995, the company seized approximately 25 percent of the domestic market and overtook then-leader SMC. Few would have predicted this turn of events, since 1995 was the very year that SMC entered into a joint venture with the global appliance heavyweight Whirlpool, which was then making an aggressive foray into China. The joint venture initially provided an opportunity for Galanz, however, because Whirlpool inserted its own management team, that lacked local knowledge, dismantled SMC's experienced sales team, and required that major decisions be cleared first through regional headquarters in Hong Kong and then through the corporate office in Benton Harbor, Michigan. These changes slowed Whirlpool/SMC's ability to respond, and Galanz seized the initiative through a series of aggressive price cuts (of up to 40 percent each) and rapid-fire new product introductions that forced the joint venture to its knees and pushed many smaller competitors out of the industry altogether.

By 1998, Galanz had seized over half of the domestic microwave oven market. The price reductions led by Galanz lowered the average retail price of a microwave oven by nearly an order of magnitude within a few years, contributing to widespread consumer adoption that grew the market from a few hundred thousand units per year in the early 1990s to approximately 7 million units annually by the end of the decade. Galanz benefited from a virtuous circle in which higher production volume produced economies of scale, which enabled further price cuts to gain more share. The company also invested over $200 million in research and development between 2001 and 2003, after establishing microwave research centers in China and the United States in 1997. Although Galanz has seen its domestic market share erode somewhat in recent years, it has successfully repelled attempts by other multinationals to unseat it from leadership in the Chinese market, including the aggressive foray by Tianjin-LG to compete on price while leveraging LG's brand and technology. Even the overall white goods leader, Haier, has been unable to win more than a token share of the microwave market to date.

Establishing Global Market Share Leadership

After securing its leadership with the Galanz-branded microwave in the domestic market by 1995, Galanz seized a golden opportunity to expand globally. During the Asian financial crisis beginning in the summer of 1997, South Korean microwave oven manufacturers, including Samsung and LG, were accused of dumping products in Europe, and local competitors petitioned for an antidumping investigation. While the European Union inquiry dragged on, most European microwave producers found themselves unable to compete with their Korean competitors on price and the European manufacturers explored options to salvage their microwave business in the face of low-price competition from Korea.

The European companies' sudden-death threat was Galanz's golden opportunity. Yaochang Yu, Galanz's deputy general manager, later recalled how Galanz managers seized the opportunity: "We visited European manufacturers and asked how much it cost them to make a microwave oven. When they said $100, we explained that we could make them for half the cost at the same quality. And we had a deal." Galanz executives pioneered a novel partnership agreement in which European white goods companies would move their entire production lines to Shunde, where Galanz would make the

microwaves for export back to their home markets for sale under the European companies' brands.

The partnership was compelling for the Europeans because they could more fully utilize their state-of-the-art production equipment. Factories in France, for example, typically ran only one shift per day, four days a week at that time, whereas Galanz ran three shifts daily seven days a week. The Europeans could also take advantage of China's low labor cost and Galanz's established expertise at efficient manufacturing processes and supply chain management. Because Galanz limited most of its branded sales to China, it did not compete with its original equipment manufacturer (OEM) partners on their home turf. This partnership was also a great deal for Galanz, which achieved economies of scale in manufacturing and purchasing. Galanz also secured permission to use its partners' manufacturing equipment to produce its own branded products for sale in China. In contrast to Haier, Galanz avoided expensive investments in building a global brand and distribution network.

Galanz rapidly extended its partnership model to over two hundred multinational partners and expanded its microwave production from approximately 1 million units in 1996 to over 12 million five years later. The company has subsequently extended its business model to other products, such as rice-cookers and electric magnetic ovens, and has stated its ambition to move into the global air conditioner market.

Managing Relationships Dynamically

Galanz owes some of its success to Leung's sophistication in structuring deals with technology providers, distributors, and OEM customers. More important, however, was Galanz managers' ability to manage these relationships as they evolved over time. Of course, a moment's reflection clarifies that all companies must rely on relationships with stakeholders that contribute necessary resources, including capital, technology, and expertise. In stable markets, these relationships often slip into the taken-for-granted background, and managers passively sustain them without giving them much active thought. Firestone Tire & Rubber, for example, maintained tight ties with Ford Motor Company for nearly a century despite the automaker's continuous requirements for massive capital investment, hard-ball negotiations on price, and tendency to shift product liability to its tire supplier (recall the Ford Explorer recall).

In unpredictable markets, entrepreneurs and executives cannot afford to take long-standing partnerships for granted, but must consciously reevaluate their shifting benefits and costs and actively manage them in light of shifting circumstances. An ancient Chinese proverb states that "there are no eternal friends and no eternal enemies, only interests." In an unpredictable market, moreover, these interests can shift substantially, often in a relatively short period of time. The absence of eternal friends and eternal enemies is important to remember in a fast-changing environment. Galanz stands out among its Chinese peers in managing relationships. It is important to note that Western managers have not cracked the code for managing dynamic relationships systematically. Companies in unpredictable markets such as information technology, medical devices, and telecommunications equipment are currently struggling to manage their relationships more effectively. The nascent business development function, for example, hardly existed a decade ago but now represents a prominent way that companies in unpredictable industries attempt to manage their partnerships more systematically. The following sections provide some practical tips for managing relationships in dynamic markets.

Clarify the Costs and Benefits of Relationships

The first step in actively managing relationships is to assess their advantages and disadvantages. This may sound like Business 101, but a surprising number of companies trip up here. At one extreme they rush

willy-nilly into countless deals with anyone that will say yes, and then lack the resources to make any of these deals work. The resulting partnership ends up as little more than a press release and a puff of smoke. At the other extreme, many Chinese companies try to do everything themselves, relying only on the local government for help. This do-it-yourself approach limits their options while spreading capital and management attention too thinly across multiple activities. Managers should clearly understand the pros and cons of key relationships.

Some questions for assessing relationships are as follows:

- **Which specific resources does this relationship provide to pursue an opportunity?** Often, individual entrepreneurs identify an opportunity but lack any resources to pursue it, or a resource-rich company spots a market gap but lacks the specific resources required to fill the gap. For example, Galanz's experience in textiles provided no advantage in the microwave oven market other than the cash reserves it had accumulated. Instead, Leung and his executives had to assemble the required resources from scratch. They identified precisely which resources they needed and systematically searched for them: Leung targeted Shanghai's Eighteenth Radio Factory for technical and sales executives, Toshiba for product technology and manufacturing equipment, and Shanghai's leading department store for shelf space.
- **Does this partnership minimize investment?** Even when companies have the resources to pursue an opportunity on their own, it is not always in their best interests to put all of their eggs in that basket. Using partners' resources allows a company to preserve its capital. Galanz, for example, avoided capital expenditure to serve its OEM customers by using their equipment. The company went one step further, however, and also used its partners' equipment to produce Galanz brand microwaves. Making these smaller bets frees chips to spread across multiple experiments. Galanz used a portion of the money it saved on microwave oven production equipment to enter the air conditioner market.
- **Can this partnership accelerate entry?** Entrepreneurs and managers can generally secure the use of necessary resources through partnerships much faster than they can build them from scratch. When microwave market leader SMC entered into a joint venture with Whirlpool in 1995, Leung recognized that management turmoil at SMC/Whirlpool would not last forever. He and his team quickly forged partnerships with regional sales agents to aggressively push Galanz products through the window of opportunity before it shut as Whirlpool/SMC put their house in order.
- **Can this partnership accelerate exit (if necessary)?** External networks can not only speed entry, but also exit. Executives too often view internally developed projects as sacred cows that can never be slaughtered because the company has invested so much in them. A networked approach, in contrast, can foster agility in getting out of established businesses. Galanz's exit from the textiles business, for example, was accelerated by its reliance on a network of subcontractors and suppliers; ceasing operations did not entail major internal disruption but rather letting contracts with partners expire.
- **What risks does this partner share?** One of the main advantages of partnering is the ability to carve up risk and transfer it to the party best able to bear it. Historically Galanz,

for example, has carried no finished-products inventory on its books. The company required dealers to pay cash on delivery for products and bear the inventory and accounts receivable risk. But it is critical to clearly specify the risks borne by each party. For example, when Galanz made a series of deep price cuts to stimulate consumer adoption, it risked hurting its distributors. Distributors might buy microwaves at a wholesale price of $100, for instance, and then end up carrying expensive inventory if Galanz cut prices to $60 later that week. Galanz mitigated this risk by agreeing to reimburse distributors for any loss in inventory value that resulted from a Galanz price cut. Partnerships can be a powerful risk management tool if the allocation of risk is clearly agreed upon and formalized between the parties.

- **Has this relationship become a shackle?** For all their benefits, relationships with external partners impose costs as well. Companies come to depend upon their partners for resources. This dependence, in turn, can put them at the mercy of their partners. Dependency is fine as long as partners' interests are aligned. Interests, however, tend to diverge over time, and these shifts can take place quite abruptly in a volatile environment. To paraphrase a Chinese proverb, a couple can share the same bed and same dreams when they fall asleep, but their dreams may diverge as the night wears on. In these situations, a powerful resource provider can prevent a company from responding effectively to shifts in the market. Recall the case of Great Wall-the early leader in personal computers that lost out to Legend. Initially, Great Wall's close relationship with the Ministry of Electronic Industries (MEI) provided production licenses, funding, and access to technology. Over time, however, the MEI's demand for domestic content forced Great Wall to use substandard components, which hurt the company's reputation for quality.

Integrate Relationships into the SAPE Cycle

Given how the benefits and costs of relationships shift over time, managers cannot afford to let relationships run on autopilot. Rather, managers should monitor key partnerships, anticipate how the mix of costs and benefits is likely to evolve, shift priorities to ensure that benefits continue to outweigh costs, and execute quickly and effectively against concrete objectives for the partnerships. External relationships, in other words, are every bit as important in the SAPE cycle as changes in technology or macroeconomic conditions.

The evolution of Galanz's relationship with its distributors illustrates the power of integrating partnerships into the SAPE cycle. In the early 1990s, Galanz had multiple distributors in each region. These distributors specialized by product lines, with one dealer selling top-of-the-line microwaves in Qingdao, another distributor of mid-range products in the same city, and a third moving inexpensive units. This distribution structure served Galanz well during its period of rapid growth because the extensive dealer network served first and foremost as a channel to get products into retailers' hands. While their wholesalers oversaw distribution and inventory management, Galanz executives were free to focus their efforts on advertising, brand building, and educating customers about the wonders of microwave ovens.

The situation shifted, however, a few years later, as the explosive growth in consumer adoption began to level off and Galanz was emerging as the market share leader. At this point, Galanz managers anticipated that the distinctions between high-, mid-, and low-end products would blur and that distributors in the same city would enter into cut-throat competition across the product tiers. Moreover, Galanz executives anticipated a more active role for distributors in marketing the products

locally and providing value-added services to retailers to differentiate Galanz products with enhanced service. In response to these shifts, Galanz made restructuring its distribution network a top priority for the company. Galanz cut the total number of distributors to facilitate closer cooperation on local marketing and service to retailers, and assigned an exclusive geographic license to one dealer per region to sell products across the tiers. Dealers were selected from many applicants based on their willingness to collaborate with Galanz in joint marketing and service provision.

Commit to Stretch Relationships

Galanz, like most of the successful companies we studied, entered into stretch relationships, or links with world-class partners that expose executives to best practices and force a company to approach this high level of performance itself. Sophisticated partners place "unreasonable" demands on the organization and are generally a pain in the neck to deal with. They demand data and transparency, impose high standards, and push for constant improvement. It is much easier to settle for working with less demanding-often local-collaborators. What executives fail to recognize, however, is that these unreasonable demands are actually stretch partners' most valuable contribution to the firm's development. By actively seeking out and locking their organizations into stretch relationships, managers can pull their companies out of second-rate practices and drag their organizations-often kicking and screaming-to world-class practices and performance levels.

Although stretch relationships are sometimes painful, they can help companies close the gap with global leaders in their industry. In fact, we believe the Chinese companies that are most likely to emerge as formidable global competitors will generally not be state-owned enterprises that struggle to maintain cozy relationships with government ministries. Rather, the most successful firms will be those, like Galanz, that enter into and successfully manage partnerships with sophisticated investors, customers, and technology suppliers. When Leung decided to pursue the microwave oven opportunity, he did not select the most approachable competitor for technology. Rather, Galanz selected Toshiba as a partner because that Japanese company offered cutting-edge product and process technology. Subsequently, Galanz has moved to the frontier of the microwave oven technology globally through its stretch relationships with high-end original equipment manufacturers in the world's most demanding markets, including Japan, Europe, and the United States.

Many Chinese companies fall short, however, in forging stretch relationships with sophisticated capital providers, and it is worth pausing to explore this failure in more detail. Most Chinese entrepreneurs we spoke to saw global investors or banks as either sources of easy money in periods of irrational exuberance or troublemakers to avoid at all costs. In general, these managers preferred to raise capital from the easiest source they could-retained earnings and informal capital cooperatives, as well as Chinese banks and local stock markets. Like South Korean chaebol and Japanese keiretsu businesses before them, many Chinese companies, especially state-owned ones, have obtained these loans through a process that was as political as it was economic.

But stretch relationships with sophisticated capital providers can offer important advantages. The exceptional companies we studied that did seek out global capital providers, such as Sina or UTStarcom, illustrate these advantages. The obvious benefit, of course, is access to lower-cost capital. But there are less apparent benefits as well. Sophisticated venture capitalists, private equity firms, multinational banks, or institutional investors provide an external perspective on how the company is doing that serves as an excellent check and balance on management's internal assessment. Changes in credit ratings and shifts in stock prices, for example, provide early warning signs of potential threats or opportunities

as perceived by people with their money at risk. Stretch relationships with sophisticated capital providers can also provide external pressure for change and guidance on how to make those changes. Recall, for instance, how Sina's Zhidong Wang relied on venture capitalists to help identify constraints on scaling the company and also for guidance on overcoming these constraints.

Commit to Transparency

Forging and maintaining stretch relationships often requires an increased level of transparency. Managers must entice stretch partners to work with them, and one powerful means of doing so is to increase their level of transparency. Indeed, companies that aspire to emulate Galanz and partner with world-class firms generally have no choice but to become more transparent. This assertion may surprise some readers, both Chinese and Western, who believe that success in China's market depends on access to privileged information and guaxni (connections) with powerful people-the opposite of transparency.

Understanding the political situation is critical in countries such as China (or India, Russia, or Brazil, for that matter) that are undergoing fundamental political changes as they integrate into the global economy. Connections to policy makers matter in China, particularly to the extent they provide early warning of likely regulatory changes or, better yet, solicit executives' input in helping to shape these emerging policies. Of course, that is equally true in any other country in the world where government policy influences an industry. (If you doubt that, try landing a defense contract in the United States or running a large bank in France without political connections.)

The forces that are inexorably forcing global competitiveness are also pushing for greater transparency. The argument is simple. Entering into stretch relationships with customers, technology partners, investors, and suppliers enhances Chinese firms' ability to survive and thrive in turbulent markets. But these sophisticated partners often demand a high level of transparency before they will do business: Venture capitalists or global banks demand to see the financials before (and after) investing. Customers such as Ford or BMW insist on monitoring their suppliers' quality, production costs, and inventory to manage their own supply chain. Technology leaders such as Cisco or IBM demand visibility into their partners' development plans and performance in exchange for paying development costs or transferring technologies. Professional managers are more likely to leave a multinational to join a transparent Chinese company than an opaque one.

The argument that "it pays to be transparent," is not an expression of naïve wishful thinking but rather a cold, hard reality as global competition imposes transparency on companies. To compete globally, Chinese companies must increasingly yield to this pressure. When it comes to transparency, firms like Galanz represent the exception, creating an island of transparency in a sea of opacity. Chinese business as a whole has significant room to improve in terms of transparency. In a recent global survey conducted by the accounting firm PricewaterhouseCoopers, China scored second to last in terms of transparency, ahead of only Russia among the world's major economies. Galanz was not the only transparent company in our sample, and the NASDAQ-listed companies (i.e., UTStarcom, AsiaInfo, and Sina) were forced to be transparent by investors and regulators as well. Other companies, such as Haier, were more of a mixed bag-internally transparent (recall the management rankings posted near the cafeteria door) but opaque in their reporting to financial markets.

How can companies become more transparent in a low-transparency country? Here managers in China (and elsewhere) have much to learn from best practices in Brazil, where a few outstanding companies have created islands of transparency in a sea of opacity (see sidebar)

This article has discussed concrete actions that entrepreneurs and executives take to manage relationships dynamically in China.

- Dynamic relationships are the shifting balance of costs and benefits that characterize partnerships in unpredictable markets where interests among partners can shift dramatically and quickly. Benefits of such relationships include access to resources, reduction in investment, accelerated entry and exit, and risk sharing. However, relationships can also become shackles that limit a company's degrees of freedom.
- Stretch relationships are links with world-class partners that expose executives to best practices and force a company to approach this high level of performance itself. By actively seeking out and locking their organizations into stretch relationships, managers can pull their companies out of second-rate practices and help close the gap with global leaders in their industry.
- Increased transparency allows companies to attract and retain stretch partners. Executives in opaque markets such as China can make credible commitments to increase their firm's transparency, including opening their books, reporting more information than required, and instituting a clear governance structure.

Please see the sidebar on the following page

Going the extra mile to increase transparency

When Chinese managers look for best practices, they typically turn to the United States, Japan, or Western Europe. To understand how to become more transparent in an opaque environment, however, it is more instructive to study how companies achieved this goal in other low-transparency countries. A study of successful Brazilian firms identified a series of innovative steps that firms used to increase transparency beyond the legal requirements or norms of their local peers.

Open Up the Books

From its inception, the Brazilian construction engineering firm Promon was employee owned. This choice of organizational form required Promon to disclose all of its transactions to its shareholders, more than five hundred partners in total. Many executives might see this requirement as a burden, but Promon's senior partners actually saw it as a source of competitive advantage. Promon's partnership structure allowed the company to insulate itself from government corruption. One senior Promon executive recalled:

> *"I remember a time when we received a visit from a distinguished gentleman who represented a senior government official. He asked us to please contribute 10 percent of all the work we were doing for the government to a special secret fund. I told him that we simply could not. Being an employee-owned company we would be unable to hide such a transaction. To my surprise, he understood and even sympathized with our values. Not only did we not lose any government contracts after that event, but this same gentleman referred business to us because we were trustworthy."*

Promon's reputation for professionalism and honesty consistently attracted customers and partners. In 1993, for example, when Northern Telecom (Nortel) was looking for a local partner, it came directly to Promon because it had been burnt by a previous relationship with a Brazilian company and was looking for a company it could trust.

Report More Information Than the Capital Markets Require

Brazilian banking leader Itau has benefited from its commitment to transparency in the capital markets. In 2001, Itau voluntarily joined Level 1 reporting in the São Paulo Stock Exchange Governance Index, thereby committing to greater reporting than it was required to do by law. That same year, it began trading its American depository receipts on the New York Stock Exchange. The company has won a series of awards for its reporting and investor relations, including one from the Board of Governors of the U.S. Federal Reserve Bank. The investments Itau made in disclosure and fair treatment of minority investors paid off handsomely: the company's stock price easily outperformed its peers, and it has been able to tap the Eurobond market to greatly reduce its overall cost of capital.

Commit to a Clear Governance Structure

In 2001, the family-run conglomerate Votorantim Group issued an annual report for the group as a whole. It established a new governance structure with a separate family council to deal with family-specific issues, leaving professional managers to run the businesses. Family transitions are delicate and can lead to internal problems that threaten the business. To avoid such problems, Votorantim is implementing a transition plan gradually and communicating the transition process broadly.

Make Transparency the Core of Your Organization

The Brazilian cosmetics company Natura made transparency the core of the entire organization as it transformed itself to compete in the 1990s. Facing the nationwide economic crisis in 1989 and the opening of the Brazilian economy a year later, Natura's three founders decided to anchor the company's transformation on the value of transparency. Management committed to a series of actions that were consistent with transparency. Seven branch offices were consolidated into one headquarters without walls, where everyone sat in cubicles and ate in the same cafeteria. The company focused its entire marketing campaign on transparency, under the motto "Truth in Cosmetics." For example, in marketing its Chronos line of antiwrinkle cream, the company used models who were older than thirty as well as real consumers. According to one cofounder: "We will not lie to you and tell you that you are going to look like Claudia Schiffer if you buy our products, but our ads tell you that you will still be beautiful."