DYNAMIC PARTNERS

Succeeding in China's unpredictable business environment requires partnerships. But, says **Donald N Sull**, the costs and benefits of partnerships shift constantly. Making them work demands that entrepreneurs and executives must actively manage their dynamics as the case of Guangdong Galanz illustrates.

Doing business in China requires managers and entrepreneurs not only to select good partners and craft solid deals but also to manage these external relationships as they evolve. Working with partners rather than trying to do everything in-house confers several advantages in unpredictable markets: these relationships can minimise 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.

Consider the Chinese appliance maker Guangdong Galanz which has excelled at managing relationships dynamically. Although not as well known as Haier, Guangdong Galanz has carved out a commanding position in the microwave oven niche. Galanz has over 20,000 employees and is one of the largest home appliance manufacturers in China, with 2004 revenues exceeding $1 billion. Galanz is the global leader in microwave oven production, with annual output exceeding 18 million units in 2004. Galanz estimates that its share of global microwave production was over 40 per cent (and more than 70 per cent in certain emerging markets). 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 plan to increase annual air conditioner production to seven million units in 2005 and at least 12 million units by 2008 to become the world's number one producer.

The down side

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 for branded clothing companies such as Yves St. Laurent. The collective enterprise was based in the Guizhou township of Shunde City in Guangdong province. In the mid-1970s, Guangdong was an industrial backwater, with most of the country's heavy industry and technology concentrated farther north.

All this changed in 1978, when the Communist Party announced its intention to create Special Economic Zones (SEZs). Suddenly, Guangdong, with its three SEZs of Shenzhen, Zhuhai, and Shantou, was on the front line of China's integration into the global economy. One of those anxious to seize the moment was Qingde Leung.

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. In late September 1978, Leung and ten co-workers broke ground for the new factory. Most groundbreakings are ceremonial affairs, where top executives dig the first shovelful of dirt and then go back to the office. Leung kept digging. The collective enterprise had only raised one-third of the approximately $400,000 required to build the plant, and 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 around 100 workers, who washed and processed feathers by hand for sale abroad.

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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, it had revenues of approximately $19 million and was ranked among the 100 most successful township and village enterprises in China.

The golden goose

In the early 1990s, Leung anticipated that intense competition would depress profits in the textiles business. He also 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. Leung's team learned that microwaves were considered a luxury good in China, sold for $500 to $700 per unit, and that the household penetration rate was much lower than the 40 to 80 per cent typical in Japan, Europe, and the United States. Moreover, no established competitor dominated the fledgling Chinese market.

Leung was not, of course, the only entrepreneur to notice the opportunity. Between 1990 and 1998, over 100 domestic firms began producing microwave ovens. 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.

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 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 centre of the microwave factory, gathered the workers to read them aloud, and challenged them to help him remove the board. Galanz defied its critics and sold 80 per cent of its trial production run.

The tide turns

Galanz faced challenges of near biblical proportions. In June 1994, the Xijiao River experienced a flood reputed to be the largest in a century. The flood lasted two weeks, submerged the factory under eight feet of water and left more than a foot of mud. When he encountered weeping employees, Leung offered to pay the salary and traveling expenses of any employee who wanted to quit. None took him up on his offer. Instead, within three days Galanz resumed limited production, and 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 organisational challenges. In the early 1990s, Galanz was still 100 per cent owned 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.

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Leung, a senior member of the local Communist Party, initially discounted ownership restructuring as a distraction. Early in 1994, however, Leung had a change of heart and offered stock to management. Over 60 senior managers ended up with a 70 per cent stake. 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, 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 contrasted with many other ownership transitions that left a chairman owning the vast majority of a company.

In 1995, the company seized approximately 25 per cent of the domestic market and overtook then-leader SMC. Few would have predicted this turn of events, since SMC had entered into a joint venture with the global appliance heavyweight Whirlpool, then making an aggressive foray into China. The joint venture actually provided an opportunity for Galanz. Whirlpool inserted its own management team, who 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 per cent 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. Price reductions contributed to widespread consumer adoption growing the market from a few hundred thousand units per year in the early 1990s to approximately seven 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 centres in China and the United States. Although Galanz's domestic market share has eroded in recent years, it has successfully repelled attempts by other multinationals to unseat it from leadership in the Chinese market, including an 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.

Next, the world

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 were unable to compete with their Korean competitors on price and explored options to salvage their microwave business.

The European companies' sudden-death threat was Galanz's golden 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," Yaochang Yu, Galanz's deputy general manager, later recalled. Galanz executives pioneered a novel partnership agreement in which European white goods companies moved 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 utilise their state-of-the-art production equipment. Factories in France, for example, typically ran only one shift per day, four days a week, whereas Galanz ran three shifts daily seven days a week. The Europeans could also take advantage of China's low labour costs 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.

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Galanz rapidly extended its partnership model to over 200 multinational partners and expanded its microwave production from approximately one million units in 1996 to over 12 million five years later. The company subsequently extended its business model to other products, such as rice-cookers and electric magnetic ovens, and 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. 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 become taken-for-granted, and managers passively sustain them without giving them much active thought.

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.

The first step in actively managing relationships is to assess their advantages and disadvantages. A surprising number of companies trip up here. At one extreme they rush 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 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:

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. 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 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 minimise investment?
Even when companies have the resources to pursue an opportunity, 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 and used its partners' equipment to produce Galanz brand microwaves. 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 and exit?
Entrepreneurs and managers can generally secure the use of necessary resources through partnerships much faster than they can build them from scratch. Leung and his team quickly forged partnerships with regional sales agents to aggressively push Galanz products when they spotted an opportunity. 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. A networked approach, in contrast, can foster agility in getting out of established businesses. Galanz's exit from the textiles business 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 carried no finished-products inventory. 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. Partnerships can be a powerful risk management tool if the allocation of risk is clearly agreed upon and formalised 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.

Integrate and stretch

Managers and entrepreneurs cannot afford to let relationships run on autopilot. Rather, they 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 as changes in technology or macroeconomic conditions.

Galanz entered into stretch relationships with world-class partners exposing executives to best practices and forcing the company to approach this high level of performance itself. Sophisticated partners place "unreasonable" demands on the organisation 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 recognise, 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 organisations into stretch relationships, managers can pull their companies out of →

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→ second-rate practices and drag them – 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 fact, 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 it 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.

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 guanxi (connections) with powerful people – the opposite of transparency.

Understanding the political situation is critical in countries 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.

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The forces 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 naïve wishful thinking, but 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, 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 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. ■

Donald N Sull (dsull@london.edu) is Associate Professor of Management Practice at London Business School. He is the author of *Revival of the Fittest: Why good companies go bad and how great managers remake them* (Harvard Business School Press, 2005). His latest book is *Made in China* (Harvard Business School Press, 2005) from which this article is an excerpt.

London Business School

London Business School
Regent's Park
London NW1 4SA
United Kingdom
Tel +44 (0)20 7262 5050
Fax +44 (0)20 7724 7875
www.london.edu
A Graduate School of the University of London