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Before Heading to China...

...Make sure you know what you're trying to do there

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If you're an executive under pressure to move business to China, think carefully before committing to a strategy.

Considering that China has undergone rapid and sustained economic growth over the past 30 years and today is the largest recipient of foreign direct investment in the world, it isn't surprising that many companies feel the need not only to respond to competition from Chinese-made products but also to enter and compete in the Chinese market itself.

The problem is, some businesses are rushing in without a realistic understanding of the opportunities presented by China and the trade-offs inherent in pursuing them.

While China has many strengths, its economic picture isn't as rosy as some might believe. For example, China may be one of the world's largest economies, but it remains a poor, developing nation in terms of per-capita income, ranked around 100th globally last year.

The high-value exports coming from China are typically manufactured by Western-owned factories, not Chinese organizations, and the low labor costs that have driven much of China's economic growth are rising steadily amid labor shortages in the country's developed coastal region.

For these and other reasons, companies need to consider carefully what they hope to accomplish in China before making a big investment. Is the strategic goal to gain a competitive advantage by using China's low-cost labor to reduce expenses, or is the goal to be closer to multinational customers operating in Asia? Is the main priority to compete in China's domestic market or simply to source finished products from China?

To help companies think about a possible move into China, here is a closer look at four potential strategies.

Establish a Presence in China to Improve Supply-Chain Performance

Some companies want to incorporate China into their manufacturing and sourcing platforms to improve the performance of their global supply chains.

These companies are drawn to China not chiefly by its lower labor costs or the opportunity to compete in the local market. Rather, they hope to benefit mainly by delivering products faster to Western customers operating nearby or by reaching a size in the region that allows them to achieve economies of scale. These companies aren't typically committed to remaining in China: If their customers locate to another geographic region, they will, too.

The vast majority of China's export manufacturing comes from its coastal region of the Pearl River Delta (including Hong Kong), the Yangtze River Delta (Shanghai area), and Zhe Jiang province and the Bohai region (Tianjin and Beijing area). Western managers should be aware that locating operations outside these regions could raise their costs—because transportation expenses remain high in China—and require far greater training of staff.

Move Manufacturing to China to Take Advantage of Lower Labor Costs

Some companies are driven to establish manufacturing plants in China because they want to take advantage of the country's cheap labor and duty-free zones. The minimum wage in China is less than $1 an hour, compared with $7.25 an hour in the U.S. This strategy may be of particular interest during an economic slump when businesses are being pushed to cut spending. Like the first strategy, the companies taking this approach seek only to source products from China, not to compete in the local market itself. Many U.S. and European furniture makers have pursued this strategy to keep their costs low.

There is a trade-off, however, between employee skills and lower wages. A university degree doesn't necessarily mean the same thing in China as it does in the U.S. For example, while China graduates more than 300,000 engineers a year, less than 10% are able to work at international engineering standards. Thus, while salary costs in China often are lower, the skill level and the resulting quality and productivity levels are likely to be considerably lower for many vocations as well.

Compete in Local Chinese Market Based on the Strength of Brand

Some international companies see great long-term potential in China and want to compete in the domestic market. They decide to rely on their global network—often the power of their brand—to gain a competitive edge rather than competing on price. Take Procter & Gamble Co., a major supplier of consumer goods in China. P&G relies on the fact that Chinese consumers perceive its products to be high quality, and thus value for the money. In general, international brands are welcomed by Chinese consumers because of their reliability.

However, Chinese consumers have lower incomes and live in tighter living spaces, so Western companies may need to reduce the size of the products they sell there. Moreover, China's local markets are diverse in lifestyle, regulation and infrastructure. For this reason, Western companies selling goods or services in China may need to develop multiple marketing and distribution strategies, one for each region of the country they enter.

Compete in Local Chinese Market Based on Strength of Cheap Labor

Some companies seek to both make and sell products in China, using the country's cheap labor as a source of competitive advantage. These companies tend to become insiders in the Chinese market, designing products and services specifically for Chinese locals. Yum! Brands Inc., for example, sells unique dishes such as snails that appeal to local tastes.

Managers pursuing this strategy should be aware that competition is intense in most local Chinese markets. Heavy government involvement in the economy has resulted in overinvestment and overcapacity in some industries. At the same time, Chinese companies tend to overdiversify, meaning they will often keep a given business unit going rather than restructuring it. All of this leads to many industries having product prices below what seems reasonable.

The bottom line is that multinational companies need to take a more nuanced view of China before determining whether and how to exploit the opportunities available there. Optimism is a good thing, but making decisions based on realistic information is better.

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