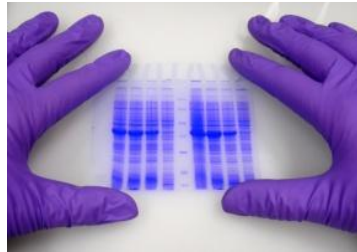


## Poisoned Chalice or Great Opportunity?

### A Report on Boston's Route 128 High Tech Companies and their Views of China

February 2010



Boston's Route 128 has a long history of technological innovation. With hundreds of small and medium enterprises (SMEs) and several Fortune 1,000 companies in towns such as Lexington, Waltham, and Woburn, it was the engine behind the "Massachusetts Miracle" of the 1980s. Though it lost the race with Silicon Valley for the hottest high tech area in the United States, it remains one of the East Coast's most dynamic regions. Raytheon and Thermo Fisher Scientific have their headquarters there, as do dozens of leading software and biotech firms. How, then, do these firms view China? Is China part of their business strategy? Why or why not?

During December 2009 and January 2010, The JLJ Group's Boston office contacted 50 of the leading high tech companies along Route 128 – in sectors ranging from lasers to software, robotics, telecom, detectors, environmental technology, and beyond. After conducting interviews with several senior executives, interesting patterns began to emerge. We report our findings below, and conclude with our own thoughts about high tech companies and the opportunities that China presents.

#### Four Approaches to China

Along Route 128, business leaders at high tech firms hold dramatically different views of China. Their opinions toward the possibilities and risks vary. For some, China is good news: an exciting, enormous new market with great potential for growth. Others wish that China had never opened up to the world. They are afraid of low-cost competitors, threats to their IP, and unreliable partners and customers. However, these basic stances alone do not determine whether or not firms engage in China. We heard from skeptical firms that nonetheless established a strong presence in China. We also heard from firms that recognize the tremendous potential of China but, resisting temptation, have preferred to stay away. How does one make sense of all this? While matters are complex, we found that most firms can ultimately be identified with one of four profiles: committed, sideliners, afraid, and pragmatic. Figure 1 summarizes our findings:

**Figure 1 Dealing with China**

		<b>STRATEGY</b>	
		<b>Active in China</b>	<b>Away from China</b>
<b>BASIC VIEW</b>	<b>China as Opportunity</b>	<b><i>Committed</i></b>	<b><i>Sideliners</i></b>
		<ul style="list-style-type: none"> <li>• Products with limited IP infringement risks</li> <li>• China revenue potential attractive</li> <li>• Tapped into foreign business networks in China</li> </ul>	<ul style="list-style-type: none"> <li>• Concerned about reliability of China customers/partners</li> <li>• Low profitability of China market</li> <li>• Strong, successful presence in non-China markets</li> </ul>
	<b>China as Threat</b>	<b><i>Pragmatics</i></b>	<b><i>Afraid</i></b>
		<ul style="list-style-type: none"> <li>• Aware that competition is present in China</li> <li>• Unclear about China market potential</li> <li>• See no option but to establish presence</li> </ul>	<ul style="list-style-type: none"> <li>• Major IP, security, reverse engineering fears</li> <li>• Unclear about China market potential</li> <li>• Pride in being US company</li> </ul>

We discuss each profile below.

### **Committed**

A fair number of firms have no hesitations about China. The revenue potential is very large, the costs of doing business comparatively low, and the ‘can-do’ attitude of Chinese managers and workers attractive. Some firms simply source from China (manpower, as in the case of software engineers, for instance, or materials). Others see China as a large and growing marketplace. Still other firms both source and sell there. Quality concerns are minimal, and fear of IP infringements exist but are not too grave. These are the committed firms.

Do these firms share certain traits? What can account for their choice? We found that these firms tend to have one or more of the following characteristics:

- Products and services with real, but limited, IP infringement potential (in the case of one company, the most proprietary products continue to be produced outside of China and are never sold there)

- Niche, high-price products: Chinese tend to copy high-volume products
- Customer base: foreign companies in China, or Chinese companies manufacturing or servicing foreign companies. These customers are more interested in quality than costs, and can therefore afford prices for US products
- Willingness to invest time and effort in building relationships, cultivating loyalty, and understanding opportunities and risks
- Committed firms are those that see a real upside to being in China and feel – because of their products and services – relatively safe operating there. These firms have accordingly proven willing to invest in understanding the complexities and nuances of doing business in China



*We appreciate the Chinese mindset: very flexible and willing to make things happen ... the quality of their work can be very good ... and we are not afraid of IP breaches – our products are niche, low volume, and hard to really figure out.*

- VP of High-Tech Manufacturing Company

## Sideliners

Sideliners are those firms that hold positive views of China but choose not to extend themselves there. They pass on the opportunity. Their choice is driven by a number of related considerations. The unreliability of partners, suppliers, and even customers is a top concern. They report hearing stories of unpaid invoices, under-performing distributors or suppliers, and unmet expectations. They are under the impression that profits would not be attractive: local competitors have far lower cost-structures.



These firms tend to share certain traits:

- Compete in fairly open and large industry sectors with relatively low barriers to entry
- Face stiff local Chinese competition
- Have real or projected difficulties in finding reliable partners, clients, and distributors
- Enjoy a well-established presence in the US and other international markets.

*We wish we could do business in China, but we do not trust the way the Chinese do things. An interesting market, but the local competition is tough and we just do not know how to find the right way in.*

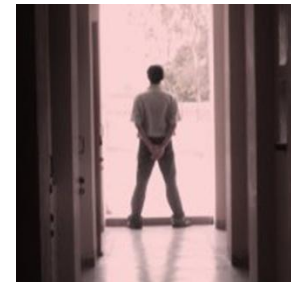
- Director of Software Company

It remains unclear how accurate the perceptions of China held by these firms might be. Some may be based on solid research and experience. Some may be a function of hearsay.

## Afraid

For some firms China primarily spells trouble. Whether operating in the B2B or B2C space, these firms tend to offer services and products with either limited or unclear applications in China, and with a real vulnerability to IP protection infringements and reverse engineering. The sense of vulnerability is heightened if competitors already exist in China and have an interest in copying more advanced and sophisticated technology. Lack of faith in IP law enforcement processes and in their own ability to track the fate of their products complicates matters further. These firms are afraid of China.

A software executive thus had no problem listing for us a few possible clients in China: government offices, law enforcement agencies, and border control units. There is some potential, he noted, but “the risks far outweigh the possible benefits.” The possibility of some extra revenue did not compensate for the enormous risks of losing control over their IP. The company sells all over the world, and a little bit in China. For the most part, however, for companies like this, China is a threat: a place that could cause enormous losses down the road. As an executive in another software firm put it, “sure, there might be an opportunity there, but we are very scared by the danger. We have heard so many horror stories. Selling in China could turn against us very quickly.”



Afraid firms tend to share certain characteristics:

- Offer products and services that currently have no obvious application in China
- Rely on IP that is either vulnerable to infringements or appears to be so

*We do not want to have anything to do with China. We have enough trouble with our US customers ... besides, our services would not be easily transported over there.*

- Executive at Telecom Firm

Are generally satisfied with their current client base and markets, and therefore do not feel the need to become active in China.

## Pragmatics

The pragmatics appear to be the minority. These are firms that perceive China in a rather negative light – as a dangerous and unreliable place to do business – but have come think that they cannot afford not to be in China. In their view, China is a gamble that they must make. The logic is that the competition is already in China – either selling or sourcing from there. To remain competitive, they too must establish a presence there. Given that China does not represent great potential in their view, investments are tailored to size and plans are modest. The objective is not to capitalize on a golden opportunity but to carefully extract from China what must be extracted.



These high tech firms share certain traits:

- Believe that China is a dynamic market for key products and services
- Their competition is already present in China
- Concern with safety and reliability of the China market
- View no option but to become active in China

*We sell what the Chinese really need and are careful about how we do it. Our international competition is in China already, and the market is sizeable ... we cannot ignore it.*

- Director of Software/Manufacturing Company

## JLJ's Perspectives

At JLJ, we have always been of the opinion that China holds great promise for companies in most industries. It offers a huge market and generally unmatched growth rates. We have also stressed, however, that not every company should be in China and that success does not come effortlessly or easily: investment of time and resources, research, reliable data, and more are needed. To succeed, companies must be knowledgeable about China. The two concepts of 'opportunity' and 'knowledge' are therefore related. Consider the following data points:

1. The Chinese government set aside RMB 32.8 billion and RMB 30 billion for 2009 and 2010 respectively for projects promoting the development of new energy sources, 3G telecommunications, aircraft and moon-landing capabilities, new medicines, and water conservation initiatives
2. In response to the global financial crisis, the government has earmarked RMB 370 billion for investment in high and new technology enterprises (HNTE), as well as for technology upgrades in traditional industries
3. In June 2009, China's Ministry of Science and Technology initiated a plan to provide financing, in the form of subsidized loans, for initial public offerings (IPOs) of small and medium-sized HNTEs in the construction of national-level high and new technology parks
4. To court investment, high tech firms in certain sectors can benefit from aggressive corporate income tax credits (lowering the rate from 25% to 15%). This is independent of location or type of investment vehicle (JVs, wholly foreign-owned enterprise, etc.)
5. Local government subsidies, loans, and other forms of preferential treatment are available to high tech companies in different parts of China.

There are real opportunities in China, but these must be carefully understood and researched. The market potential itself is enormous, but important variations exist across industry sectors. Our view is that some firms along Boston Route 128 have a China strategy that is driven by solid data and insights. Many firms, however, appear not to be capitalizing in full on the opportunities that China presents to them. This results in part from poor understanding of the following:

1. Potential of China as either a sourcing point or market
2. Options available for engaging in China
3. IP risks and realistic ways to protect valuable assets

4. Ongoing competitive dynamics in China, including the short and long term evolution of their industries
5. Existing regulatory and financial incentives for high-tech and other industries.

In particular, we believe that with more solid information at hand, most of the firms along Route 128 would actually change their strategic outlook on China. Some sideliners would recognize, for instance, that some of the perceived factors preventing entry (such as low profitability) may be addressed with creative changes in their supply chain. Some companies afraid of China would be surprised to know the size (present and future) of the market for their products and services, and recognize that there are creative ways of protecting their IP. Finally, some of the pragmatists would find strong reasons to expand their operations in China.

*With offices in Boston, Shanghai, and Beijing, The JLJ Group provides solutions to international companies entering or growing in China. Our wide range of in-house services has helped more than 400 clients – many in high tech industries – from over 30 countries gain competitiveness in China's challenging market. For more on JLJ, please visit <http://www.jljgroup.com/us>.*

*For questions about this report, contact JLJ's North America Director Francesco Duina at [Francesco.Duina@jljgroup.com](mailto:Francesco.Duina@jljgroup.com) or at 857-636-2596.*