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CHINA A rising challenge

By SMRITI JACOB

Even with pitfalls, it is a land of opportunity, firms say

From uncovering fraudulent activities at a plant to extricating his firm from an onerous joint venture, Bal Dixit says his hard-knock experiences in China could fill a book. Still, the chairman and chief technology officer of Newtex Industries Inc. believes the firm's presence in the rapidly growing Chinese market offers a competitive advantage.

Continued below



AP Photo

"I've used (China) as an opportunity, because it was a threat before we moved (there)," Dixit said.

"We used to service five to six shipyards in Singapore; we lost four of them to the Chinese competition. And I said, 'If it can happen in Singapore, it can happen in other places.'"

Newtex established a presence in China a decade ago. The Victor firm—an integrated manufacturer of heat-resistant products for the industrial and safety markets—employs 75 workers in the United States and roughly 130 people at its facility in Shanghai.

"I think with the work we have done, now we can compete with anybody, including the Chinese companies, anywhere in the world," Dixit said.

Along with the competitive threat it poses, China presents a wealth of opportunities for Rochester-area manufacturers. It is a market fraught with pitfalls, but for the firms that learn to navigate around those hazards it can mean sharply reduced costs and a huge potential customer base. China also can position them for growth in other foreign markets.

A Rochester Business Journal Daily Report Snap Poll conducted in March suggests many local businesses see the upside of the

surging Chinese economy. Twenty-five percent of respondents said they viewed China as an opportunity; another 32 percent described the Asian giant as equally a threat and an opportunity.

"To stay competitive globally you need to have China as part of your strategy," said Matt Bailey, vice president of sales and marketing at Lapp Insulators LLC in LeRoy.

Lowering costs

Lower costs are part of China's allure. From saving on labor expenses to sourcing low-cost materials, China offers U.S. companies the ability to compete more effectively. Newtex's Dixit said access to cheaper raw materials and labor helped the firm reduce costs and compete better against Chinese and Eastern European rivals.

"It is a competitive advantage; none of our competitors have done what we have done there," he said. "And it is not easy to start an operation like that."

Establishing a cost-effective supply chain is another way for manufacturers to control expenses and boost profit margins. Large and small manufacturers alike see benefits to sourcing materials from China.

Gleason Corp.'s William Simpson says cost was not the main driver behind the

firm's decision to establish a Chinese presence. Nonetheless, he is looking to create a reliable supply chain there that can meet the company's quality standards.

Simpson, Gleason's vice president of global supply chain, said a critical factor to Gleason's success is its ability to develop a "high-quality, robust supply chain within (China) ... to source certain commodities that go into our products."

CAR Engineering & Manufacturing Inc. in Victor also is scouting actively for growth opportunities by selling and purchasing parts in China. The firm specializes in precision metal stamping, computer numerically controlled machining and tool making.

"I believe that there are approximately 5,000 businesses like mine in America that have closed in the last five years, and a lot of that is because of work that's gone to China, Mexico, India," said Charles Rogers, chairman and CEO of CAR Engineering. "That's a tremendous amount of good jobs that we had here in the United States that are now gone—good, solid manufacturing jobs."

"For those of us that have survived," he added, "we have to look to China for opportunities."

CAR Engineering purchases parts from

Chinese companies. It also sells goods there and plans to continue to look to that country for potential customers, Rogers said, adding that the firm's experience with China so far has been a positive one.

A vast market

The chance to build a customer base in China, an enormous market with growing needs, is what draws many firms there.

The value of U.S. exports to China reached \$55.2 billion in 2006, up from \$41.9 billion the year before. A recent U.S. Commerce Department report notes the growth of U.S. exports to China across sectors, from energy to financial services, and points to economists' prediction that China's per capita income will rise dramatically, creating a surge in middle-class consumers hungry for imported goods.

"I think the piece we're most focused on (at) Lapp and the one that others in the West are starting to catch on to is that China represents a huge market for our product," Bailey said.

"For years it was go over to China, find a source or manufacturer, then export back to your domestic market or your established market," he said. "Our strategy in China here at Lapp is that, 'Yes, we're going to do that ... but (it) also is to manufacture in China and serve the domestic market.'"

Local manufacturers' strategies for gaining a foothold in the Chinese market vary. Some have entered China via a joint venture or a wholly owned foreign enterprise; others have sold products to divisions of U.S. firms there.

Lapp Insulators' joint venture in China with Dalian Insulator Co. Ltd. is expected to expand the company's reach into the Chinese market and help ease capacity issues at its LeRoy facilities. A wholly owned venture in the Shanghai region also is in the cards, to manufacture silicon-based insulators. It would employ up to 20 workers.

Another local firm with a joint venture in China is Gleason. In 2005, Gleason formed a joint venture company, Gleason Yi Gong Cutting Tools Co. Ltd. in Harbin, China. It employs some 260 workers and produces gear-cutting tools.

In addition, the Rochester manufacturer recently established its first wholly owned manufacturing facility, Gleason Gear Technology (Suzhou) Co. Ltd., a 22,600-square-foot plant in Suzhou, Jiangsu Province. The site assembles gear-manufacturing equipment for the Chinese market.

"China remains the largest consumer of machine tools in the world and has been for the last several years," Simpson said, "so we view it as a significant opportunity for both our machines and the tooling that accompanies our machines."

Bausch & Lomb Inc.'s acquisition of a controlling interest in China's Shandong

Chia Tai Freda Pharmaceutical Group from Sino Biopharmaceutical Ltd. for \$200 million in cash two years ago provided a deeper entry into the Chinese market. The eye-care company has been selling products in China for the last two decades. The Freda deal offered Bausch & Lomb access to a national network of pharmaceutical sales representatives and distributors and strong domestic brands, among other benefits.

Chairman and CEO Ronald Zarrella at that time called the acquisition "a springboard for future growth in this strategically important market." Analysts applauded the move.

U.S. companies with Chinese operations represent another potential market for local firms. The needs of Gorbel Inc.'s North American customer base prompted the company to investigate China. President Brian Reh said customers building plants in that country need Gorbel products, and his firm cannot service them efficiently and cost-effectively from the United States.

"Now that we are in China we hope to capitalize on many other opportunities like selling to other multinationals, Chinese state-owned companies and other surrounding Asian countries," Reh said.

Gorbel—a maker of jibs, cranes and ergonomically designed lifts used by manufacturers to move products—opened a manufacturing facility in Tainjin, a two-hour drive east of Beijing. As of March, it employed 25 staffers there.

A global springboard

Gorbel is only one example of a firm that has gone to China also with an eye on markets beyond its borders. A presence in China means proximity to other regions in Asia and also enables firms to supply sites and prospective customers in Europe and the Middle East.

"(Operating in China) was really more (a case of) establishing a strategic beachhead, if you will, in the country, closer to our customers," Simpson said. "The technology that Gleason brings there is unparalleled in the marketplace and we are establishing this presence and our competitors are not."

"So we see it as a strategic opportunity for our company because we do bring the best technology, the world's leading technology in the field that we're in."

Gorbel's Reh sees its move into China as "solidifying our health in the USA by diversifying our customer base to other parts of the world."

Newtex uses its operation in China as a base to export to Singapore, the Middle East and even Europe.

"We would not be able to get a major portion of our Middle East business without our Chinese factory," Dixit said.

Lapp Insulators is approaching China from various angles. Its strategy is akin to a three-legged stool: making product in

that country to serve the Chinese market; finding low-cost suppliers to feed its factories in Germany and the United States; and using China as a manufacturing hub to serve areas in Southeast Asia.

"I would certainly be in the camp of viewing (China) is an opportunity, but it is with a challenge, no question," Bailey said. "There is a whole set of rules and culture differences that you need to understand and incorporate into your strategy."

Cautionary tales

Mere presence in China does not guarantee success, experienced executives warn. Proper planning and research are crucial.

"You need to go to China not just because everybody else is doing it but because you have a bonafide business opportunity and it fits in with your strategic plan," Simpson said. "Going to China for the sake of going to China is a fool's game. You'll fail."

Experts say China's rapid growth requires companies to be nimble; not all firms properly anticipate future demand and staff up accordingly.

Finding staffers there with needed skills

Verbatim

"To stay competitive globally you need to have China as part of your strategy."

—Matt Bailey, vice president of sales and marketing at Lapp Insulators LLC

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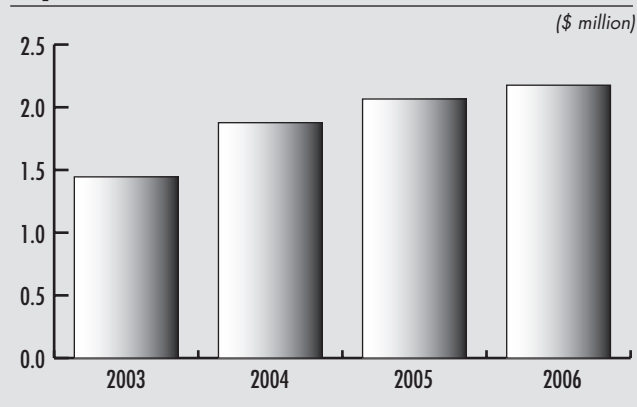
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Exports to China from New York State



can be difficult. Gorbels' Reh said it is tough to find high-quality salespeople.

"Due to a government run by central planning for the last generation, this skill is relatively new to China," he said.

The language barrier also is very real, China pros say, making negotiations and other business transactions difficult.

"Entire (generations) did not go to college so it is hard to find talented people who can speak English," Dixit said.

Lack of scruples is another risk factor. Newtex a few years ago discovered its senior manager in Singapore in 2001 had formed another firm, based in Shanghai, to compete with the Victor-based company.

"We were sourcing some materials in China, so they would have this material brought through this company they had formed," Dixit explained. "We lost \$1.1 million worth of goods that came through this company as a middleman.

"That was a serious conflict-of-interest situation and those increased costs were passed on to us because they made money on that transaction."

Newtex hired a private investigator and a consultant to unravel the fraud. The company ultimately replaced its management teams in Singapore and Shanghai.

"Now that the operations (have) settled down, it's moving very nicely and both are making money now," Dixit said.

Newtex's experience on a smaller scale mirrors what happened with Groupe Danone SA. In published reports, the French company recently said its joint venture partner in China for the past decade had cut it out of more than \$100 million in revenues, through a network of bottling plants and wholesalers that manufacture the same soft drinks that the partners have produced under the name Wahaha.

While conceding that joint ventures are an easy way to enter China, Dixit cautions against them, pointing to ethical and trust issues. Newtex first established a joint venture roughly a decade ago. Faced with the need

to obtain capital from his Chinese partners, Dixit soon discovered a pitfall: The laws in China favor Chinese minority investors.

"(This) joint venture that we acquired was in such an awful shape ... we knew we needed a lot of capital to bring it up to the standard we'd like to see," he said.

But when Newtex approached its minority partners to request their portion of investment to

spruce up the operation, the Chinese refused.

"They just flatly turned us down. They said they had no interest—'But you can go ahead and spend your money if you want to,'" Dixit recalled. "I just didn't like that setup that was there. I think even if they own one share of stock they have a lot of rights. (That) can make life difficult particularly for foreign investors."

Newtex eventually bought out its partners. It also acquired a Chinese company's assets, starting Newtex Shanghai. In 2001, the company combined the operations.

China veterans also point to the lack of proper enforcement of intellectual property rights.

"There is not always a level playing field for the way that the Chinese operate," Bailey said. "They are part of the (World Trade Organization), no question, but in some ways—intellectual property is a perfect example—the Chinese say one thing and do another."

Lapp Insulators, he added, works to keep a "tight lid" on trade secrets.

Perhaps the most common obstacle that confronts many U.S. companies in China is the tangle of red tape.

"Anyone considering an undertaking such as beginning an operation in China should never underestimate the complexity of the task," Gleason's Simpson said. "There is a significant amount of bureaucracy that must be gone through, and it takes time and it takes patience. ... It is not a matter of picking up an operation and plopping it down in some city in China."

Reh agreed: "It takes a big leap of faith and more capital than most Americans are willing to put at risk. My feeling is if you commit to China, then you have to back up that commitment with energy."

Finding the right contacts and establishing strong relationships are keys to doing business in China, Lapp Insulators' Bailey said.

"I think the biggest asset that a company can have in China is the technology, the processes, but right behind that would be

relationships," he noted. "It's not what you know but who you know—that old adage is very, very appropriate in China."

An altered landscape

The challenge posed by China's emergence as a global economic powerhouse is not really new, some experts say.

If China did not exist, companies still would face a threat of losing market share—it is the nature of free enterprise, said Daniel Rosen, principal of New York City-based China Strategic Advisory LLC.

Cutting costs, improving quality and value propositions—"that has been happening in America forever," he said.

Rosen concedes that the process of adjusting to Chinese competition is a painful one, but he added that China's obvious strengths are offset by some glaring weaknesses. He cited the lack of brand expertise as an example.

"For all the talk about China, how many people can name three Chinese brands which are powerful brands like Buick would be?" Rosen said. "It's great to be able to manufacture something for somebody else and put their brand name on it and sell it at Wal-Mart for \$10, but the Chinese manufacturer is only making 50 cents on that.

"If you don't have a brand," he added, "you can't do retail downstream closer to the consumer (and) then you don't get to enjoy much of the profit anymore."

Yet few observers discount China's rising clout and the fact it is reshaping the competitive landscape.

"As they begin to establish themselves in our markets they will gradually learn and adjust in the following years and will be better and better in what they do," said Richard Rosenbloom, president and CEO of Ameritherm Inc. "So the opportunity for us is to understand the threat and respond to it."

Ameritherm, which specializes in precision heating solutions, currently is focusing on Europe, India, South Africa and Australia, before it enters China and Japan.

"China's capabilities are increasing every day," Reh said. "The time is now to get on board. Because tomorrow may be too late and the best opportunities for your business might forever belong to someone else."

Added Rosenbloom: "I think if anyone ignores China they're going to be in deep trouble. I think anybody who is foolish enough to sit there and wait for China to collapse before they respond to it (is) very short-sighted—it's called wishful thinking."

sjacob@rbj.net / 585-546-8303

About this series

This is the first article in a two-part series on China that examines the opportunities and threats it presents for local manufacturers. This week's focus: the threats.