Building a Sustainable Business in China

When I go to China to meet potentially attractive investment opportunities one of the questions I keep pondering about is:

What is the SUSTAINABILITY of a company’s business model and financial performance?

Collapsing growth rates and margins and - along with this - a decline in the multiples investors are prepared to pay for a business can quickly wipe out a large part of the market capitalisation of a stock. On the other hand, companies that have taken the right measures and are on track to build a sustainable business can have a substantial value upside driven by a solid earnings growth and a medium-term rerating of multiples. This mechanism naturally applies to both mature and emerging markets, but the starting points and foundations for sustainability are very different: In China, many private (i.e. not state-owned) companies are 10 to 15 years old, have high growth rates and are still in the early stages of their life-cycle. Many western companies, on the other hand, are mature low growth businesses which have been around for many decades.

Plastic injection moulding machine (PIMM)

In China, technology leadership or strong brands, which are important foundations for a sustainable business, are starting to emerge but are still much less frequent than in mature markets. Scale and cost advantages, which Chinese companies frequently claim to have, are often not sustainable because labour and raw material cost are rising and competitors have access to cheap capital to scale-up, too. Even more unsustainable are margins and returns bloated by temporarily low raw material cost or a temporary undersupply situation which will almost certainly result in overcapacities later on.
Sustainability in China often relies on less tangible and more difficult to assess factors such as:

- A well-functioning nationwide distribution system;
- Special none-exchangeable customer relationships;
- The ability to operate in a just-in-time-network at Western quality and precision levels;
- Control over input cost and/or the sales price;
- A founder’s ability to build and empower a high quality well incentivized management team.

A good example for what it can mean for a Chinese company to build a sustainable business is Haitian. Haitian is the world’s largest manufacturer of plastic injection moulding machines (PIMMs) by volume. Although sustainability has many dimensions I will only focus on the following three areas to illustrate the challenges of a company like Haitian: Management, research and development, and brand and product strategy.¹

**Management:** A turning point for Haitian was the year 2007 when the Zhang Family, the controlling shareholder of Haitian, convinced Helmar Franz to join Haitian’s Board and to take on responsibility for strategic planning. Franz, an engineer by training, previously was the CEO of Mannesmann Plastic Machineries (MPM), a leading PIMMs manufacturer at that time, and had more than 30 years of experience in the plastic processing machinery industry. The Zhang Family and Franz got to know each other in the years 1998-2005 when Haitian and MPM had a PIMMs joint venture in China.

So, when Franz joined Haitian a trustful relationship was already in place. Franz’s time with Haitian has turned out to be highly effective because Franz committed himself to really get involved – Franz fully relocated to Ningbo where Haitian’s headquarters and its main R&D and manufacturing facilities are located. And, equally important, the Zhang Family was prepared to listen to Franz’s suggestions, empowered him to change the way Haitian operated, and incentivized him adequately (per public company filings Franz holds a 0.5% stake in Haitian). For Haitian this was a unique opportunity to gain access to first class Western engineering and management know-how and to accelerate its development path by many years.

¹ Other equally important aspects are business organisation, manufacturing know-how, quality assurance, controlling, IT systems, robust internal processes and procedures, and governance.
**Research and development:** The Zhang Family and Franz were well aware that a successful machine-builder requires genuine proprietary technology and innovation. They agreed that copying European and Japanese imports is not a viable strategy. Copying ultimately means being a second class follower. The Zhang Family and in particular Franz were also conscious of the fact that building world class machines requires a research and development hub either in Japan or in Europe for the following reasons:²

a) The development of a competitive PIMM for premium markets requires European or Japanese standards;

b) A premium PIMM requires the most innovative components from leading edge suppliers which are not available in China (in fact, top notch machine-builders need to be so close to their key component suppliers that they are aware of the next generation of components which are currently being developed); and

c) The development of a premium machine cannot be accomplished without first rate engineering services which are currently also not available in China.

For these reasons, Haitian acquired an R&D hub in Germany in 2007 which was given the task to develop high-end all-electric injection moulding machines. Running such a hub and ensuring a seamless flow of information and know-how is a formidable challenge. In the case of Haitian, the German subsidiary is run by Franz’s son, who also holds an engineering degree and has a PIMMs background. Close personal ties between senior personnel in China and in German are a precondition for an effective cooperation.

**Brand and Product Strategy:** Under the leadership of Franz Haitian developed a multi-brand strategy. The main reason for this was that covering the full spectrum of PIMMs applications under one brand would overstretch and debase the core Haitian brand. Haitian rather decided that the core HAITIAN brand should focus on hydraulic machines and cover the middle and upper middle standard segment. ZHAFIR Plastics Machinery based in Germany became the brand for mid to high end all-electric injection moulding machines for dynamically growing high tech markets. The TIANJIAN brand was established to cover the lower end mass market in China, India and other emerging Asian countries. Haitian’s brand strategy also influenced its organizational structure as each brand has its own dedicated resources (management, R&D, manufacturing, marketing and sales).

Time will tell whether Haitian will succeed in becoming a company that can generate value for shareholders in a sustainable way. Formidable challenges lie ahead. Just to name two of them: Building a distribution network in mature markets such as Western Europe or Japan with strong local incumbents is highly challenging. Besides this, Haitian’s competitors are fighting back: Western PIMMs manufacturers have successfully built up manufacturing hubs in China to reduce cost and stay competitive (a good example is Engel, a leading Western PIMMs manufacturer; reports about its China activities are published on its website [www.engelglobal.com](http://www.engelglobal.com)).

However, I believe the odds are good that Haitian will succeed. Generally speaking, Chinese companies have a good chance to succeed in relatively mature technologies (such as PIMMs) where Western companies increasingly struggle to maintain substantial technology advantages. Supported by scale effects and lower factor cost, Chinese manufacturers are well positioned to gain market share in particular in standard applications. Western manufacturers, on the other hand, face the risk of getting stuck in low volume niches which erodes their ability to support a high cost base and high R&D cost.

Haitian’s financial performance also suggests that its strategy has so far been successful. Between 2005 and 2011 sales grew at a CAGR of 18%, partly due to steady market share gains. Although up to date market share data are not available, comparing Haitian to its peers suggests that Haitian has continued to gain market share in China in 2010 and 2011 (both from the substitution of imported machines as well as from local competitors).3

And finally a health warning: The above comments on Haitian are not meant to promote Haitian as an investment opportunity but to illustrate the challenges of Chinese companies to build a viable and sustainable business. Haitian operates in a highly cyclical industry and is a late cycle company. And although I believe that the quality of Haitian’s business model is well above average, the success of an investment is also very much linked to the right entry price.

3 Chen Hsong is China’s No. 2 PIMM manufacturer. Chen Hsong’s 2011/12 revenues (financial year end March) are expected to decline by 25% yoy.
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