

# Investing in the Dragon's Belly

## Businesses considering moving to Southeast Asia should give China's inner provinces a second look

By Jack Perkowski



China's huge population and over US \$3 trillion GDP dwarfs those of other countries companies might consider as alternatives. Vietnam's population, for example, is only 85 million, and its US \$71 billion economy is a fraction the size of China's. As a result, smaller neighboring countries are much less well equipped to absorb surges in capital inflows than China is, leaving them susceptible to inflation.

ASIMCO has 17 factories located in eight different provinces throughout China. Though five of these are in Beijing and nearby Langfang, the rest are in relatively small cities in Shanxi, Hubei, Hunan, Sichuan, Anhui and Jiangsu provinces. We have found this to be a significant advantage over the years. It was not a conscious decision to locate factories in remote areas when the company was established in 1994, but it has nonetheless proven beneficial. We were seeking well-established companies that were number one or two in their product areas, and we were relatively indifferent as to location. It just so happened that many were in out of the way—and hard to get to—places.

As I began to make countless five and six-hour car trips on very poor roads to visit our newly acquired factories, I must admit that I began to question the wisdom of our location-neutral strategy. It seemed there had to be an easier way to build a business in China!

Hope came in the form of the hundreds of workers, picks and shovels in hand, that I saw on every trip. They were working on new highways that promised to shorten our trips. The improvements that the local governments made were among the several important factors that proved critical to creating the current appealing investment

Rising wage costs, a new labor law, tougher enforcement of pollution regulations and the trimming of export rebates are just some of the reasons manufacturing margins are being compressed in China. This has caused many factories, particularly those in the southern and coastal areas of the country, to close their doors or to do the unthinkable—move their production to lower labor cost countries like Vietnam.

Despite the negative recent developments, though, there is a strong case to be made that leaving China may not make sense. Companies need to avoid making knee-jerk reactions that they will regret later. One excellent alternative is to consider a move to China's inner provinces. Based on ASIMCO's experiences, I recommend that manu-

facturers look hard at China's interior before heading off to seemingly greener pastures.

China has many advantages over its competitors for investment in Southeast Asia. Take Vietnam as an example. In 2007, investment applications by foreign companies totaled US \$20 billion in the country. This came on the heels of an influx of clothing and footwear manufacturers seeking relief from rising costs in China. The result was a dramatic increase in office rents and expenses. Because of the recent investment boom, the Vietnamese economy hit the wall earlier this year. Inflation peaked at 25.2 percent in May and a proliferation of labor strikes dragged foreign manufacturers into the country's economic crisis.

It is easy to forget just how large China and its economy are and the advantages this gives to businesses.

environment in interior China. In addition to the upgraded infrastructure, other factors to consider include lower costs, enthusiastic support from local governments eager to attract investment and more stability in the management ranks.

There are, of course, some drawbacks to China's interior cities. Despite the advantages of locating in the interior, many companies may find difficulties. Outside of Beijing, Shanghai, Guangzhou and the larger coastal cities, English capability falls off dramatically and living conditions for expatriates can be more problematic. If a company relies heavily on foreign managers, it may be more challenging to move inland. However, this may simply make the case for localizing management. This in itself is a proposition with some difficulties, but it is also one that makes an interior-city strategy more practical.

In the end, every company has to evaluate its own situation. Different industries have unique considerations when deciding where to locate manufacturing bases. However, for companies thinking about leaving China due to rising costs or changes in regulations, it is important to account for all factors before heading off to Southeast Asia or other parts of the world. The country's interior provinces offer many of the advantages of China without some of the drawbacks that have emerged in some of the most developed coastal cities over the last several years.

## Advantages to China's Interior Cities

**Improved infrastructure:** Over the past 15 years, China has improved train service and built thousands of kilometers of new highways and scores of airports across the country. China's impressive investment in infrastructure has made access to every part of the country considerably easier removing one of the major obstacles to investing in the inner provinces. While getting products to port cities may add somewhat to transportation costs, these are more than offset by significant cost advantages in other areas.

**Lower costs:** Other than perhaps transportation, costs are lower in second and third-tier cities in the interior of the country. Labor, land, construction, management, supplier and overhead costs are all significantly lower than in the larger, better established cities in the coastal areas. This will likely remain so for years to come.

**Local government support:** The "big fish in a little pond" approach to site location can be a big benefit. ASIMCO's operating units are

among the largest and best companies to work for in their cities. As a result, each is very important to the local economy and receives strong support from the local government. One party secretary couldn't wait to tell me that he and his team had succeeded in obtaining a multi-million RMB tax rebate from the provincial tax authorities for our joint venture that we did not know we were even eligible for. The local government took the initiative and lobbied on our behalf, despite the fact that a portion of the rebate came from the city's own tax revenues. It is a testament to how important our company is to them.

**Less management turnover:** For the same reason that IBM located factories in small towns in upstate New York, locating plants in interior Chinese cities can help reduce management turnover. All things being equal, Chinese managers would prefer to work close to their extended families. If a company offers an attractive employment opportunity in a manager's hometown, the manager has little incentive to look elsewhere.

*Jack Perkowski is founder and chairman of ASIMCO Technologies and a Wall Street veteran. He is the author of "Managing the Dragon:*

*How I'm Building a Billion Dollar Business in China" and runs the highly acclaimed blog: [managingthedragon.com](http://managingthedragon.com)*

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Contact Catherine Shao: [Catherine@amcham-china.org.cn](mailto:Catherine@amcham-china.org.cn) Tel: 8519 1921