McKinsey Global Institute

Discussion paper

# The China imperative for multinational companies

Reconfiguring for opportunity and risk


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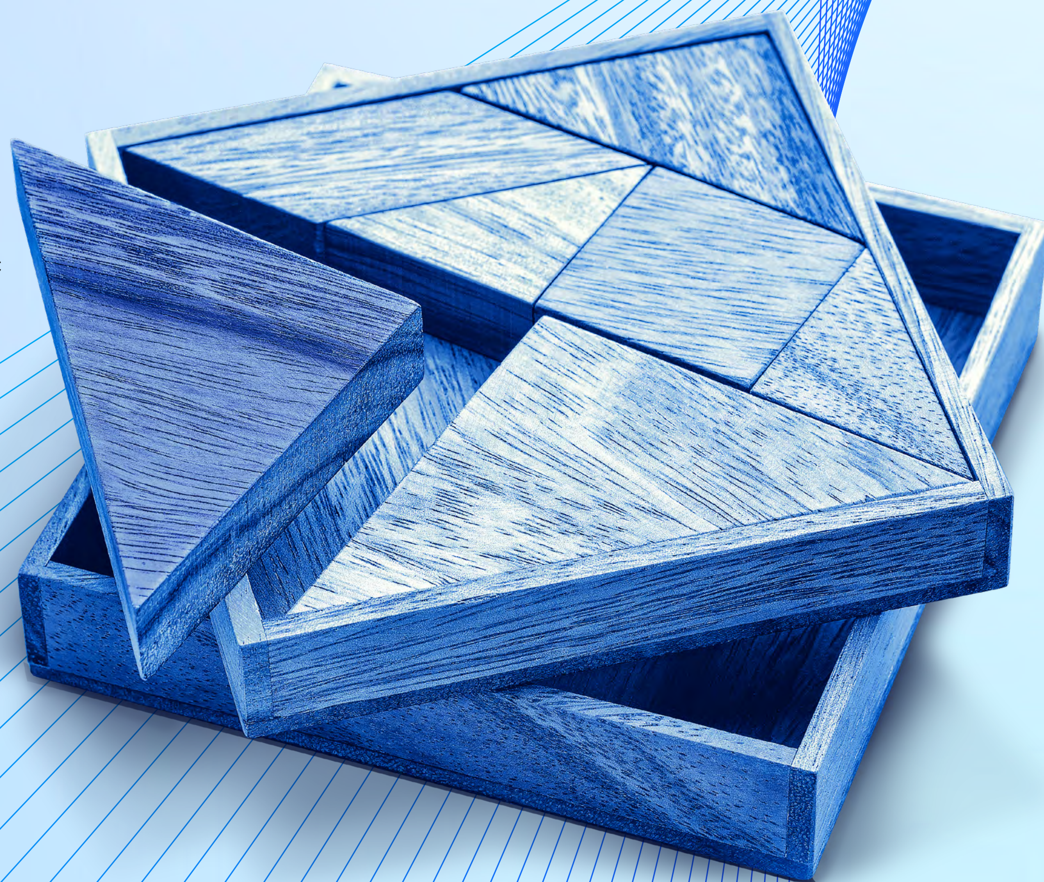

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# Summary

Over the past 30 years, multinational companies (MNCs) have enjoyed an increasingly open world. Taking advantage of a unipolar globe with relatively free flows of capital, trade, and ideas, MNCs tapped capital from wherever they chose, built businesses optimized for global supply and global demand, and served increasingly globalized customers. That may no longer be possible. In a world reshaped by the coronavirus pandemic, rising geopolitical tensions, renewed inflationary pressures, and war, MNCs must reassess, reevaluate, and reconfigure their businesses for a new era. And China is where some of the most dramatic reconfiguration may take place.

The reconfiguration will not be easy. The sheer size and complexity of the Chinese market may mean that notions of outright decoupling are simplistic; furthermore, we continue to live in a world connected by those global flows of capital, trade, and ideas. MNCs face a much more difficult imperative: maintaining access to China's upsides while managing increasingly complex risks. It is a challenge that will define the next era for MNCs, and those that solve it will be tomorrow's winners.

China and MNCs built a mutually beneficial relationship during the past few decades. Between 1990 and 2019, China's real GDP grew at an average of almost 10 percent per year, contributing more than a quarter of global GDP growth, and average household income rose from about $750 to $13,000. That dynamism was a magnet for MNCs, which flocked to China to capture part of the growth. At one point, MNCs employed 16 million people and accounted for more than half of China's exports. They also helped bring best practices to China, boosting the economy's productivity in such industries as chemicals and cosmetics.

But MNCs have started reappraising their relationship with China. A recent survey indicated that the share of US MNCs perceiving China as one of their top three investment priorities dropped from 77 percent in 2010 to 45 percent in 2022. Though many MNCs are continuing to invest in China, some are curtailing their operations there or rebalancing their investments toward other countries, and a few are pulling out of China altogether.

The reappraisal may seem surprising, given that MNCs' opportunities in China remain large. In an increasingly multipolar world, China has emerged as a major pole. Its GDP is now 18 percent of the global total—a share equal to the entire European Union's and second only to that of the United States (with 24 percent). In advanced technology, such as artificial intelligence (AI), advanced connectivity, and space technology, China is becoming a world leader. China's climate transition will require investments worth many trillions of dollars, which are likely to represent sizable business opportunities. China is also one of the world's largest producers of renewable-energy products, such as solar panels and battery components for electric vehicles (EVs).

But China also presents MNCs with unique risks. Rising tensions with the United States and Europe have the potential to disrupt global value chains, especially in critical sectors. China is aging at the fastest pace among the world's emerging economies, putting downward pressure on its labor supply. China's investment exposure to rising real estate prices is driving risk as well. The country's ratio of debt to GDP is 274 percent, a historic high.

MNCs are now seriously asking themselves if they have the right strategies to succeed in China. In fact, many are losing ground as the gap widens between the highest- and lowest-performing. For the MNCs that grew the most quickly between 2010 and 2021, revenues rose by 20 percent per year during the last two years of the period—a pickup from their 16 percent annual rate during the first nine years. At the same time, opportunities for low-performing MNCs are shrinking: those whose revenues shrank the most quickly between 2010 and 2021 saw faster revenue loss after the pandemic started (5 percent per year) than before (3 percent).

In addition, local companies in China are competing with the MNCs more fiercely for market share in many industries. For example, MNCs' share of all revenues earned in China declined from 16 percent to 10 percent from 2006 to 2020. Local companies selling some kinds of portable electronics, groceries, and fifth generation (5G) infrastructure have gained 20 to 40 percentage points of market share over the past decade. The R&D spending of China's largest public companies grew three times as quickly as that of non-Chinese Fortune 500 companies between 2017 and 2021.

In this context, MNCs are rethinking their China strategies. Their most pressing question can be put bluntly: stay or leave?

The answer depends on at least two more questions. First, what is at stake? For example, China accounts for 25 to 40 percent of the global market in some sectors, such as cars, luxury consumer goods, and industrial equipment; can companies in those sectors afford to miss out on the China market? Similarly, can companies that depend on supply chains in China or derive important contributions from R&D facilities there afford to leave? Even if they choose to leave, how will they cope with Chinese competitors in markets elsewhere?

Second, how can MNCs derisk business in China? In the following six areas, they will face a spectrum of choices that define the China imperative:

— **Capital and ownership.** Can MNCs tap into Chinese and global capital and build self-funding business models? Should they go further and spin off China subsidiaries?

— **Supply chains.** What should MNCs localize and what should they diversify? How much concentration in each step of the value chain is reasonable, not just in China but globally?

— **Innovation.** How much innovation, both in process and products, should take place within China and how much elsewhere?

— **Branding.** Can MNCs build brands appealing to local customers while taking advantage of the power of their global brand?

— **Talent.** How should MNCs hire employees from China's increasingly skilled talent pool while still benefiting from global talent flows?

— **Technology and data.** How can MNCs localize their data and technology infrastructure in accordance with evolving Chinese law while conforming with global security protocols?

The MNCs that succeed in a rapidly changing China will be those that choose wisely in those six areas. The challenge is formidable, but the opportunity is significant.

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# 1. MNCs have sizable opportunities in China—and emerging risks

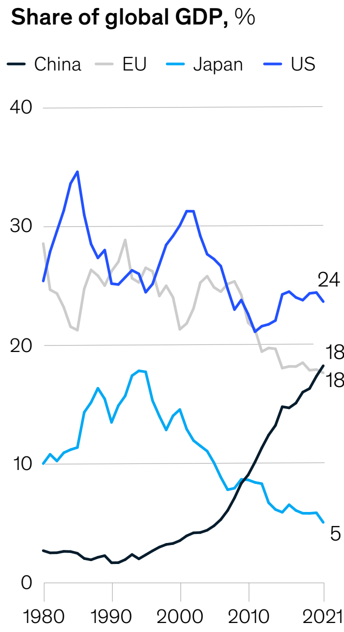
MNCs are a towering presence in China. In 2020, their total assets and their sales revenues in China each surpassed $3 trillion, an amount equivalent to about 20 percent of China's GDP. They directly employed 12 million people, or about 3 percent of the Chinese urban workforce, while paying salaries that were 40 percent higher than the national average.[1] But risks unique to China are also growing—some of them the result of the country's sheer size, others the result of its demographics, finances, and place in the world. MNCs in China are increasingly confronted with both the upsides and the downsides of operating there.

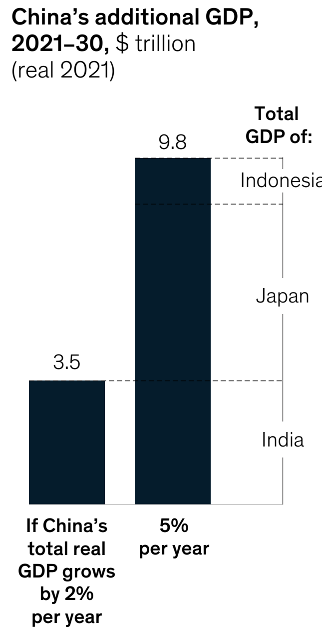
## Opportunity still knocking

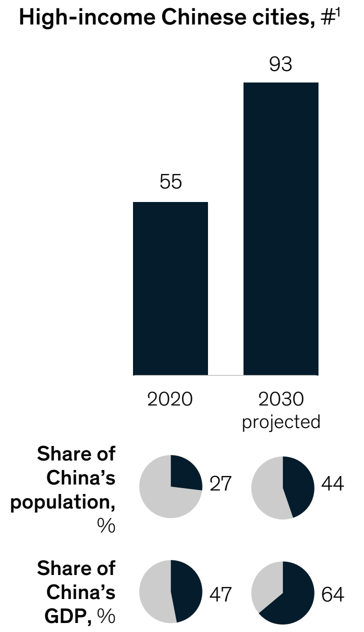
China still offers MNCs important opportunities (Exhibit 1). To begin with, China's size ensures that it retains MNCs' attention. Its GDP is now 18 percent of the global total, a share equal to the entire European Union's and second only to that of the United States (with 24 percent).[2] China's real GDP may grow between 2 and 5 percent per year over the coming decade, depending on which of various scenarios proves accurate. Even if it grows at 2 percent, the additional GDP over the 2021–30 period alone will be larger than India's total GDP in 2021. If 5 percent growth takes place, the additional GDP will be as large as the 2021 GDP of India, Indonesia, and Japan combined. China's markets will thus be too large for many MNCs to ignore. In some industries, such as cars, luxury goods, and industrial equipment, the China market already represents 25 to 40 percent of global revenues, and MNCs in those industries will have no choice but to compete there.[3]

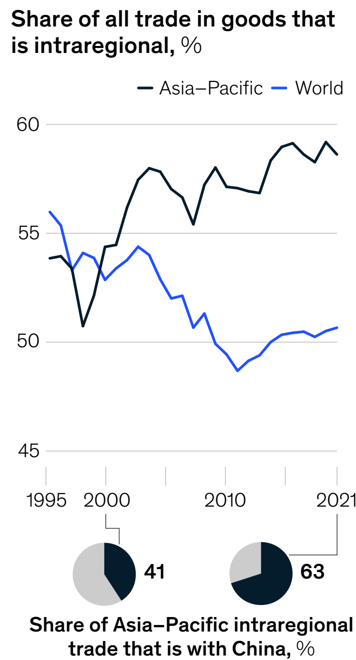
Exhibit 1

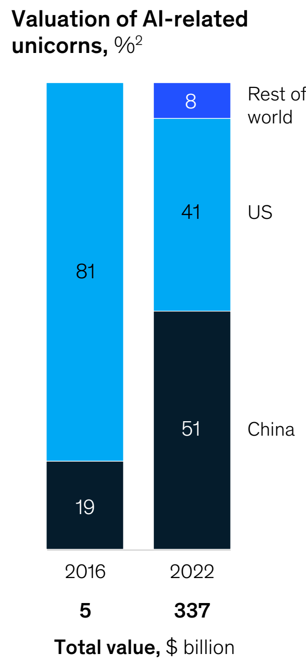
## China continues to offer multinational companies significant opportunities.

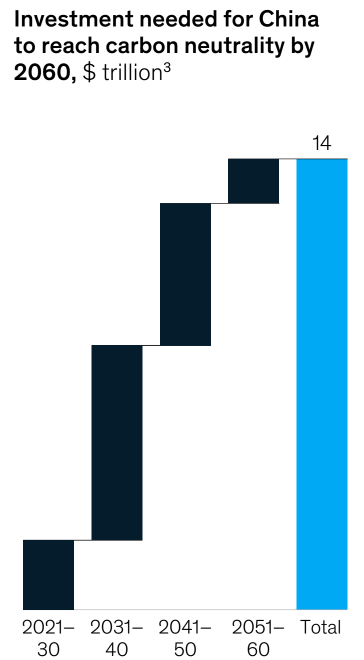



[1]Cities with per capita GDP higher than $12,695. The World Bank uses that threshold, which was last updated in July 2021, to designate a country as high income. Its measure is per capita gross national income; we used per capita GDP as a proxy for reasons related to availability of data.
[2]Unicorns are privately held companies worth more than $1 billion.
[3]Estimated investment in green infrastructure and technology in the power and transportation sectors.
Source: CB Insights; IHS Markit; International Monetary Fund; National Bureau of Statistics of China; World Bank; United Nations Comtrade; McKinsey Global Institute analysis

Furthermore, continued urbanization and the growth of the middle class are making China's big consumer base even bigger, which will power demand in a broad range of industries, including biopharmaceuticals, consumer health, and entertainment. Today, roughly 65 percent of the country's population lives in cities, a share that is projected to grow to 71 percent by 2030 and to 80 percent by 2050.[4] That urbanization will help lift more of the population into the middle class. In 2020, 55 cities in China had per capita GDP higher than $12,695 (a level that the World Bank uses to designate a country as high income), and they represented 27 percent of the country's population.[5] By 2030, according to our analysis, there may be more than 90 cities in the high-income category, representing 40 to 50 percent of China's population.

China is an attractive opportunity for MNCs serving emerging markets in Asia. Its trading relationships with regional partners are strong; for example, it has been the top trading partner with the countries of the Association of Southeast Asian Nations (ASEAN) since 2009, and as of 2021, it was contributing 20 percent of all trade with those countries, up from 12 percent in 2010.[6] The reverse is true as well: the ASEAN countries have become China's leading trading partner, having seen their share of China's trade rise from 10 percent in 2010 to 15 percent in 2022.

**40–50%**

Share of China's population living in high-income cities by 2030

As those facts suggest, the Asia–Pacific region, already the largest regional economy in the world, is becoming increasingly interdependent. Between 2000 and 2021, the share of all trade in goods that is intraregional grew from 54 percent to 59 percent in that region, whereas in the world as a whole, the share that is intraregional declined from 53 percent to 51 percent.[7] And of intraregional trade in the Asia–Pacific region, the share involving China grew from 41 percent to 63 percent over the same period.

MNCs evaluating their opportunities in China may also notice that it is becoming a global leader in innovation. It has already built a strong digital economy, especially in consumer-facing sectors, and now it is turning to strengthening its presence in AI and other "deep tech." In AI, China's progress in the R&D stage is suggested by the fact that in 2021, Chinese researchers published 60,000 articles about AI in scholarly journals—by far the most in the world, ahead of 26,000 for the United States and 9,000 for the United Kingdom.[8] A sign that China is also a leader in the commercialization stage is that among AI-related unicorns (privately held companies worth more than $1 billion), companies in China currently account for 51 percent of total global valuation, a rapid increase from 19 percent in 2016, according to our analysis.[9] China is also actively pursuing other advanced technologies, such as advanced connectivity and space technology. Of 14 technologies that McKinsey has designated some of the most significant trends unfolding today, China has identified all of them as strategic focus areas—11 at the country level and the other three at the sector level—in national guidance or legislation (such as its 14th Five-Year Plan).[10]

China's climate transition will present MNCs (as well as local companies) with further opportunities. In 2021, China declared the goals of hitting peak $CO_2$ emissions before 2030 and achieving carbon neutrality before 2060.[11] Those goals will require massive investment. A World Bank model indicates that to reach the 2060 goal, China would need to invest an additional $14 trillion in the power and transportation sectors alone.[12] The opportunities for MNCs that could participate in decarbonization in key carbon-heavy sectors—such as power, industry, agriculture, transportation, and construction—are clear.

Finally, China refines many resources that are critical to the production of EV batteries, such as natural graphite (of which it refines 100 percent of the world's supply), lithium (70 percent), and cobalt (68 percent). China is also the world's largest producer of EV battery components, responsible for 74 percent of the world's total production capacity in 2021, according to estimates by McKinsey. And it produces more than 80 percent of solar panels and their components.[13] Those are all significant business opportunities, though their concentration in one country also poses risks.

## Unique risks on the rise

Though MNCs have no shortage of opportunities, they are beginning to realize that they face risks as well, some of them unique to China (Exhibit 2). In an annual survey conducted by the American Chamber of Commerce in China, the share of MNCs perceiving China as one of their top three investment priorities dropped from 77 percent in 2010 to 45 percent in 2022.[14] In a survey conducted by the European Union Chamber of Commerce in China, the share of respondents viewing China as a top three investment priority did not change much during that period, but the share seeing it as *the* top priority declined from 30 percent to 23 percent.[15]

One risk is that as China's influence has grown, others have increasingly seen it as a rival. In a resolution passed in 2021, the European Parliament said that China was "asserting a stronger global role both as an economic power and as foreign policy actor, which poses serious political, economic, security and technological challenges to the EU."[16] In 2022, the US government called China "the only competitor with both the intent to reshape the international order and, increasingly, the economic, diplomatic, military, and technological power to do it."[17]

A related risk is that public sentiment toward China is changing. In a recurring survey, the Pew Research Center asks people in developed countries whether their view of China is favorable or unfavorable. In 15 of the 17 regions surveyed in 2021, more than half of the respondents answered "unfavorable"—a sharp increase from 2010, when respondents in only five of the 21 regions surveyed gave that answer.[18] Such increasingly negative sentiment may create complications for MNCs operating in China.

A third type of risk that MNCs may face in China relates to technology—specifically, to the possibility that regulatory changes and geopolitical tensions disrupt their activities in technology sectors. Although investment in domestic research and manufacturing is increasing, parts of China's technology value chain still rely on imports, and those areas are especially vulnerable to disruption. Semiconductors are an obvious example. China was the largest importer of equipment for manufacturing semiconductors in 2021; it imported $41 billion of such equipment, a jump from $13 billion in 2015.[19] But in October 2022, the United States announced new restrictions on exporting advanced computing and semiconductor manufacturing items to China.[20] Such changes could pose uncertainty for MNCs' global value chains.

**998M**

Peak size of China's working-age population (2015)

Furthermore, China is aging at the fastest pace among the world's emerging economies. By 2030, its population will probably have reached the third of three "peaks," each of which represents a challenge for MNCs. First, the country's population of working-age adults (that is, those from 15 to 64 years old) peaked in 2015 at 998 million people, which could create challenges for MNCs seeking workers. Then, in 2016, China's population of children from 0 to 4 years old hit its peak of 91 million; the figure fell to 67 million in 2022. MNCs making products for children may therefore have to rely less on sheer sales volume. And the overall population is expected to peak before 2030, affecting overall demand.[21]

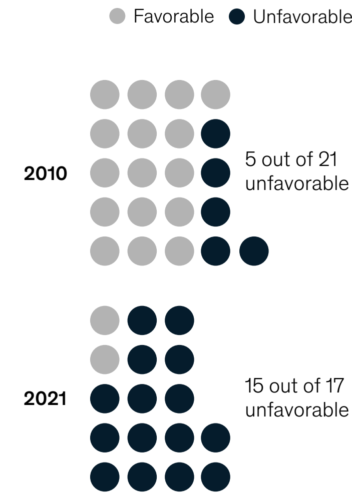
As a result of all those shifts, China's dependency ratio—the number of people up to 14 years old, plus people over 65 years old, divided by the number of working-age people—is expected to increase from 45 percent in 2021 to 71 percent by 2050, according to projections from the United Nations. That would be the same ratio as Japan's today.[22] Demand will be affected in certain sectors; for example, spending will probably increase for healthcare and decrease for goods and services less urgently needed by an aging population.

MNCs in China are also exposed to risk from climate change. Asia as a whole is expected to account for more than 75 percent of the global capital stock that could be damaged from river flooding in a given year.[23] In 2020, 4 percent of outdoor working hours were lost to extreme heat and humidity

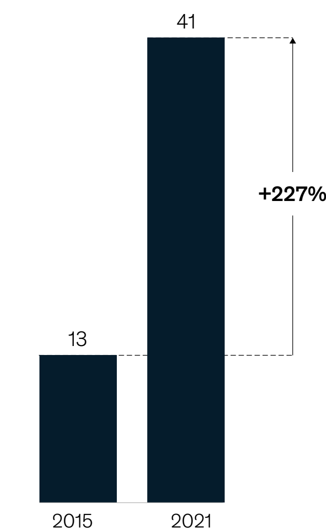
Exhibit 2

## China presents multinational companies with unique risks.

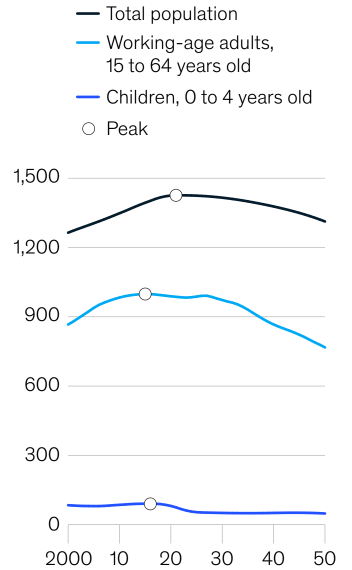
**View of China held by majority of respondents in surveyed economies,** # economies[1]



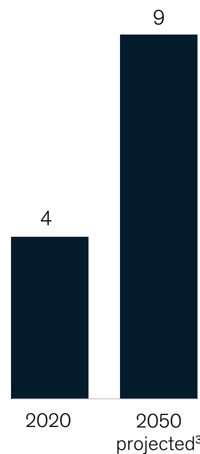

**Value of semiconductor manufacturing equipment imported by China,** $ billion



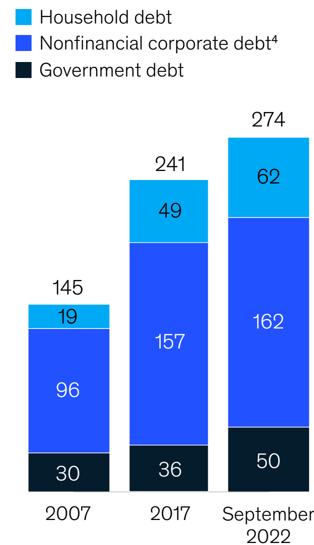

**Population of China,** million people[2]



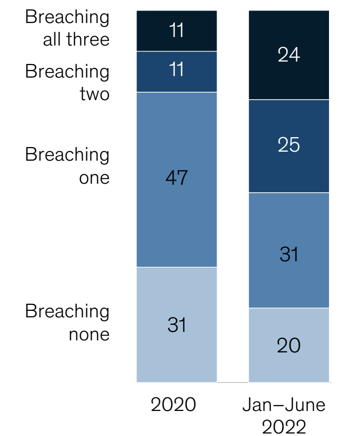

**Share of outdoor working hours lost to extreme heat and humidity in climate-exposed regions in China,** %




**Debt-to-GDP ratio,** %




**Share of Chinese real estate developers breaching the "red lines" indicating risk,** %[5]




[1]The survey question was: "Do you have a favorable or unfavorable view of China?" [2]The projections are United Nations estimates based on medium levels of fertility, mortality, and international migration. [3]Based on the RCP 8.5 scenario, in which global average warming is 2.3°C by 2050. [4]Includes both traditional corporate debt and local government financing vehicles, which are a way for local governments to finance infrastructure and other projects off their balance sheets. [5]The three red lines are indicators defined by Chinese regulators to show companies' risk. To avoid breaching the red lines, a company must have a liability-to-asset ratio (excluding advance receipts) of less than 0.7, a net gearing ratio of less than 1, and a cash-to-short-term-debt ratio of more than 1.
Source: National Institution for Finance & Development; Pew Research Center; Trade Map, International Trade Centre; UN World Population Prospects, Wind; McKinsey Global Institute analysis

in climate-exposed regions in China, and the share could grow to 7 percent in 2030 and 9 percent in 2050, affecting companies' productivity and operations.[24] A heat wave in 2022—the first one lasting over 62 days since 1961—led to droughts in southwest China.[25] In Sichuan, which relies on hydroelectricity for more than 80 percent of its power supply, the resulting power shortage temporarily shut down industrial sites in most of the province's cities.[26]

China's economy presents risks as well. In September 2022, China's ratio of debt to GDP rose to a historic high of 274 percent.[27] As recently as 2007, it stood at just 145 percent. Most of the increase in China's debt between 2007 and 2017 came from corporate debt, particularly in the real estate and construction industries. But since 2017, when the Chinese government began a debt-reduction campaign for companies, most of the increase has come from government and household borrowing. Such high debt could generate heavy debt servicing costs and put pressure on overall economic growth.

A major component of that debt is in real estate and presents a more specific risk for players in that sector. During the first two decades of the century, the value of Chinese real estate grew rapidly, and the economy became reliant on continuing increases in value. If the value of real estate fell, holders of debt in that sector could find themselves underwater. Moreover, an increasing number of real estate developers are breaching one or more of the "three red lines" defined by Chinese regulators as indicators of industry risk.[28] In fact, the share of developers breaching all three grew from 11 percent in 2020 to 24 percent in the first half of 2022.

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When MNCs look at today's China, they see significant opportunities along with complex and growing risks. In the next chapter, we turn to the MNCs' recent performance in China, their local competition, and the role played by regulation.

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# 2. The ground is shifting under MNCs

MNCs operating in China are seeing major shifts in the competitive arena, leading some to question their ability to succeed in the coming decade. The highest-performing MNCs in China have seen their performance surge even more since the start of the COVID-19 pandemic. But the gap is widening between them and the lowest performers, which have done worse than before. Meanwhile, local companies are becoming more and more competitive with MNCs, challenging them for market share and profitability in nearly every industry. And MNCs may need to adapt to an emerging policy agenda.

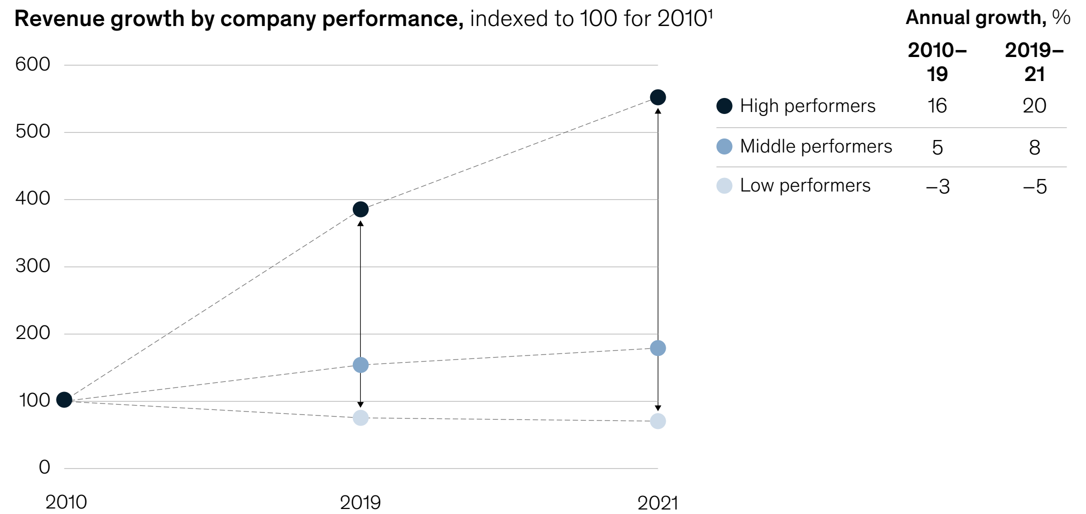
## A widening gap between high- and low-performing MNCs

To study the relative strength of different MNCs since the onset of the pandemic, we looked at the Fortune 500 companies that disclosed their revenues in China and divided them into three categories according to how quickly their revenues grew between 2010 and 2021.[29] High performers were those that saw growth rates higher than the 75th percentile of our sample; middle performers were those with growth rates between the 25th and 75th percentiles; and low performers' growth rates were lower than the 25th percentile.

Our analysis indicates that the high performers have done even better since the pandemic began—and that the low performers have done worse. Between 2010 and 2019, the high performers' revenues grew by 16 percent per year, while the middle performers' grew by 5 percent per year and the low performers' shrank by 3 percent per year (Exhibit 3). Then came the pandemic, which severely tested MNCs' resilience and adaptability. Between 2019 and 2021, the high performers' revenues

Exhibit 3

## The highest- and lowest-performing multinational companies have seen their revenues in China diverge even more since the start of the pandemic.




[1]We began with the 355 Fortune 500 companies that were not Chinese. We were able to analyze the revenues of 112 of those companies, using either the information that they had disclosed directly about Chinese or regional revenues or information from sector-specific data sources.
Note: High performers were MNCs whose annual revenue growth from 2010 to 2021 was higher than the 75th percentile; middle performers' was between the 25th and 75th percentiles; low performers' was lower than the 25th percentile.
Source: Capital IQ; Euromonitor; IHS Markit; McKinsey Global Institute analysis

grew still faster—by 20 percent per year—while middle performers' grew by 8 percent per year and low performers' shrank by 5 percent per year.

Our observations of the high performers suggest that they tend to be large; their average revenues in 2021 were $9.9 billion, more than the middle performers' $8.0 billion and the low performers' $3.7 billion. The industries most heavily represented among high performers were pharmaceuticals (with 24 percent of the total) and technology (20 percent). And 76 percent of the high performers were US or European companies. Among the low performers, the auto and retail industries were heavily represented, and so were Asian companies; 38 percent of the low performers were Asian.

## Growing competition from local companies

Over the past 15 years, local companies have grown quickly in China, and the relative position of MNCs in the fast-growing Chinese economy has declined (see sidebar, "China's new crop of innovators"). In 2005, MNCs' share of all exports from China reached 58 percent, the highest point since at least 1993, as they made China an important part of their global value chains. By 2021, that share had declined to 34 percent, as local companies served more and more global demand.[30] MNCs' share of all revenues earned in China declined from 16 percent to 10 percent from 2006 to 2020—although in absolute terms, their revenues grew dramatically, from $924 billion to $3.3 trillion—and their share of all profit made in China declined from 16 percent to 14 percent.[31] In short, MNCs have grown quickly, but considerably less quickly than local competitors.

Local companies are also quickly catching up in innovation-related investment, ramping up their R&D spending more quickly than MNCs are. Many Chinese companies do not disclose their R&D spending, but we identified the 136 biggest ones (by market capitalization) that did in 2021, and we compared them with the 129 non-Chinese Fortune 500 companies that did the same (Exhibit 4).

Between 2017 and 2021, the local firms' R&D spending grew three times as quickly as the MNCs' global R&D spending. Also, in a 2021 McKinsey survey of R&D executives at local companies and MNCs, 62 percent of respondents called China's product-development environment and capabilities already at least as good as those at the best global product-development centers or likely to be in five years.[32] So even in industries in which MNCs currently have a technological advantage, they may face intensified competition from local companies that are investing three times as quickly in innovating in next-generation products and services.

Chinese technology companies are growing especially rapidly. On the Shenzhen and Shanghai stock exchanges, the share of all valuation that is represented by Chinese technology companies (defined as companies providing software and hardware products and services across sectors) grew from 19 percent in 2010 to 27 percent in the third quarter of 2022, according to our analysis. In 2018, the Hong Kong stock exchange started admitting biotech companies in the pre-revenue stage; as of December 2021, 48 such companies, 47 of them Chinese, had raised $14 billion, and 23 more were planning to go public in 2022.[33] Those are signals that the public recognizes the value of domestic technological innovation. True, China's value chains for technology are still highly interdependent with global ones; that is, it needs many foreign inputs, such as intellectual property (IP) and semiconductors, to make technological products. But the role played by local companies is expanding.

## China's new crop of innovators

To describe the competitive landscape in China in more detail, we grouped industries into four categories according to the type of innovation they relied on.[1] In industries relying on science- or engineering-based innovations, we found that local companies still had capability gaps but were starting to catch up with MNCs. In industries relying on customer-focused or efficiency-driven innovations, local companies generally held strong market positions already.

In the industries relying on **science-based innovations**, local companies still face high barriers to entry, and MNCs continue to capture most of the market, both in China and around the world. For example, local Chinese companies were widely estimated to account for less than 5 percent of the global market for original drugs in 2021. Some of these industries are seeing more funds flowing in, a shift that might accelerate innovation in local companies, although it often takes a long time for this kind of innovation to be commercialized and pay off.

In industries relying on **engineering-based innovations**, local companies show mixed performance. In the commercial aviation sector, where the technology barrier remains high, domestic manufacturers of commercial aircraft accounted for 5 percent of the China market in 2019, an increase from 2 percent in 2010.[2] In 4G and 5G infrastructure, where local companies have learned quickly and the government has created a large domestic market, local companies already own most of the market—85 or 90 percent in 2021, a rise from 50 or 60 percent in 2015.

In industries relying on **customer-focused innovations**, local companies have already established strong positions by upgrading their value proposition from "good enough" to "cheaper and better." Examples include smartphones, in which local companies' market share in China grew from 57 percent in 2014 to 73 percent in 2021, and e-commerce, in which local companies held more than 95 percent of the China market in 2020.[3]

In industries relying on **efficiency-driven innovations**, local companies likewise hold a strong position, thanks to vast manufacturing ecosystems, a focus on reducing costs through economies of scale, and process innovations. Examples include solar panels (in which Chinese companies held more than 72 percent of the global market in 2020) and commodity chemicals.

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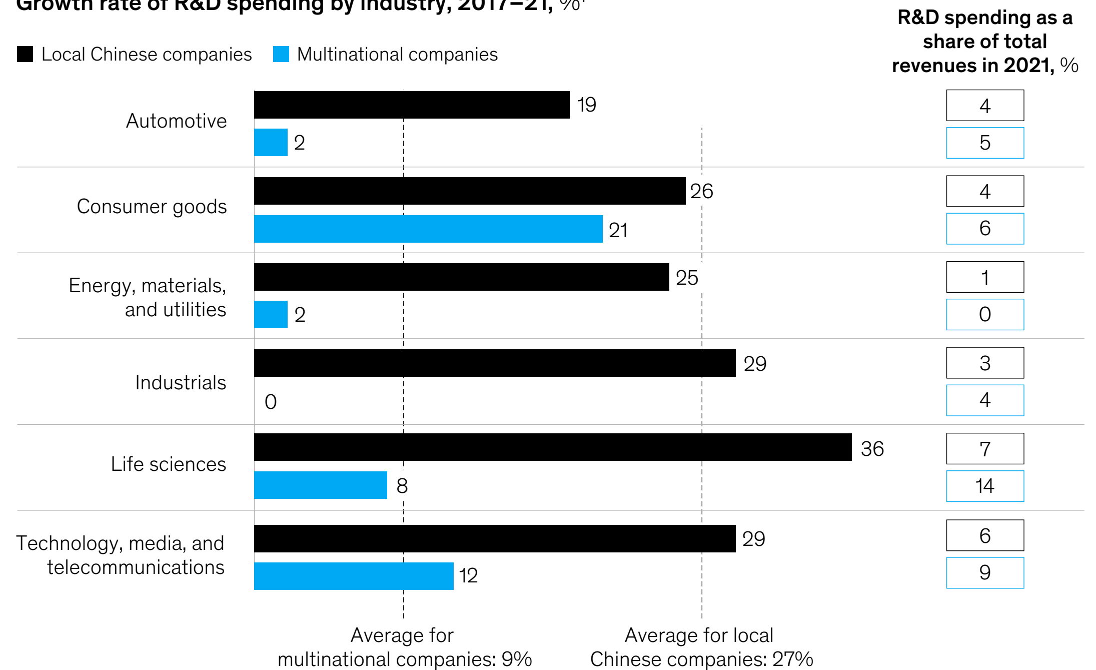
Exhibit 4

## Local Chinese companies are ramping up their R&D spending more quickly than multinational companies are.




[1]The local Chinese companies are the 136 biggest ones by market capitalization that disclosed R&D spending in 2017 and 2021; the MNCs are the 129 non-Chinese Fortune 500 companies with the same disclosure.
Source: Bloomberg; Fortune 500 2021; McKinsey Global Institute analysis

Meanwhile, within China, local consumers increasingly prefer local brands. For example, 46 percent of Chinese consumers' mobile-phone purchases (among the top 20 brands) were from domestic brands in 2013; that share rose to 64 percent in 2021. Chinese consumers are choosing local brands for their quality and level of innovation, not just because of low prices or from a sense of national pride.[34]

In this paper, we have primarily been considering competition within China. But as Chinese companies grow, more and more of them are competing regionally and globally as well. Of all smartphones shipped worldwide in 2021, 34 percent were from three Chinese brands, a jump from 18 percent in 2015. Also in 2021, Chinese companies captured 76 percent of the smartphone market in India and over 60 percent in Africa.[35] Of the ten biggest solar-panel suppliers, eight were from China in 2021, as were six of the ten biggest suppliers of batteries for EVs in 2022.[36] China was also the largest EV exporter in 2021: it sent 500,000 EVs abroad, 230,000 of them to Europe.[37]

That trend will surely continue, driven by declining growth in the domestic market in certain industries and by some companies' strategies of seeking growth elsewhere. And given Chinese companies' increasing presence in global markets, withdrawing from the China battleground may not help MNCs secure a global position for long; indeed, it might hurt their global reputation and innovative power. Instead, some may choose to strengthen their global capabilities by replicating elsewhere what they have learned in China.

## A shifting regulatory landscape

The ground beneath MNCs is also shifting because of regulation. In areas such as income distribution, sustainability, and technology, the Chinese government is regulating more actively, and MNCs aiming to succeed in China will need to take note and adapt.

0.47

China's Gini coefficient in 2021

One prominent area is the "common prosperity" agenda, which seeks to combat China's growing income inequality. Although the country's economic growth has increased income at all levels, the boosts have been larger for the rich than for the poor. Income inequality as measured by the Gini coefficient—in which zero indicates total equality and 1 total inequality—reached a peak at 0.49 in 2008, according to the National Bureau of Statistics of China. It remains high and was 0.47 in 2021, higher than the United States' 0.38 and the European Union's 0.30.[38] It remains to be seen exactly which policies will be enacted as part of the common prosperity agenda, but some of them will probably encourage enterprises to help address inequality.[39] MNCs in China will need to adapt to that increasing focus on corporate social responsibility.

Another area of increased regulation is sustainability. China's declared goals of hitting peak emissions before 2030 and achieving carbon neutrality before 2060 include action plans for various industries, such as energy, transportation, and construction. The action plans, in turn, include measures such as emissions inspections and assessments. Chinese companies' commitment to emissions targets remains low—they account for only 4 percent of all companies committed to the Science Based Targets Initiative.[40] This gives MNCs an opportunity to shape best practices in China by bringing knowledge and best practices from around the world.

China has recently introduced or revised a series of laws related to technology and innovation. The Data Security Law was passed in 2021 to promote a categorized and classified system to manage data collection, storage, and transmission. The Personal Information Protection Law, also passed in 2021, regulates the protection of personal information. Another important trend is that China is tightening its legislation governing the protection of IP and improving its overall IP system. As China continues to make those efforts, MNCs may have more potential both to bring IP into China and to create IP there.

Finally, China has gradually been making progress in opening its markets to foreign investment. The number of subsectors in which foreign investment is restricted or banned fell from 93 in 2015 to 31 in 2021.[41] In 2020, China removed limitations on foreign ownership for securities and fund-management firms, allowing them to set up wholly owned units in the country, and it did the same for passenger-vehicle manufacturers in 2022.[42] It also now allows approved institutional investors from other countries to invest as much as they want in the Chinese stock and bond markets.[43] The ongoing reforms could help improve the business environment and expand MNCs' ability to attract investment.

We have described areas of regulation that affect most industries, but we should note that many sector-specific regulations exist as well. For example, the medical technology industry has been affected over the years by the definition of "locally made" (a classification that allows products to be sold to some public hospitals) and more recently by volume-based procurement, a system in which the manufacturers of drugs and medical devices that offer the lowest prices receive very large sales opportunities. Similarly, changing pharmacopoeia standards have affected makers of vaccines.

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Challenged by increasing local competition but rewarded by significant growth if they do things right, many MNCs know that this is the time to recalibrate their plans for China. But how?

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# 3. MNCs need to reconfigure their China strategy

MNCs operating in China need to reconfigure their China strategy. They have a choice of strategic postures ranging from investing heavily there to beginning to invest elsewhere to making an outright exit. As they confront that choice, they should investigate two factors. First, what is at stake for them in China? Second, what will it take to derisk that stake?

## Strategic posture

Four courses of action exist for MNCs trying to define their strategic posture in China: renewing commitments, accelerating selectively, diversifying, and reducing stakes. As MNCs decide which course—or courses—they will follow, they should be prepared to consider how their presence in China affects their valuation in the eyes of investors as well as their standing in the eyes of other stakeholders. And they should ask some key questions about the opportunities and risks involved.

— **Opportunities.** How big a share of the global market does China represent for our sector? What are our growth targets for revenues, margin, and market share in China, in the short run and in the long run? Do we expect to overperform in China in relation to our broader footprint and therefore have a growing exposure to China in the future? What role should China play to drive value for us: an R&D center, a sales market, or a supplier? What expectations for performance in China are embedded in our market capitalization?

— **Risks.** How much risk are we willing to take in China, and what types of risk will we be exposed to? How do those risks affect our finances and operations in China and globally? How should we manage public and investor sentiment about our operations in China?

The first course of action is **renewing commitments** in China—staying heavily invested there and increasing capital investments when necessary. That approach makes sense when China represents a large share of an industry's global market, when risks in the industry are relatively light, and when a company has a competitive edge. The automotive industry, in which China accounts for 31 percent of global demand, is a good example. Many car manufacturers are renewing their China commitments; for instance, Tesla finished building a factory in Shanghai in 2019 and then invested about $170 million to expand production capacity.[44]

The second course is **accelerating selectively**, choosing to focus on segments that are more promising in China and pulling back from others. For example, to take advantage of growing whiskey consumption in China, Diageo built an R&D center and a malt whiskey distillery there in 2021.[45]

Third, some MNCs are **diversifying**—optimizing their China operations by reallocating resources to other countries. This course tends to be pursued in industries in which risks are relatively high. Prominent examples exist in consumer electronics, in which China accounts for 24 percent of world demand.[46] In 2022, for instance, Apple began asking its suppliers to do more work in India and Vietnam.[47]

Finally, some MNCs are **reducing stakes** in China to focus on operations elsewhere. Companies may follow that course when the China market is not large or when they are losing market share and do not have a clear way to correct course. For example, one global retailer sold the majority stake in its China business to a Chinese e-commerce company. Mead Johnson sold its China infant milk formula business to Primavera in 2021. Sometimes, reducing stakes means exiting China entirely.

## How to derisk

Many MNCs, especially those opting to take the first two courses of action, are thinking about derisking their China business by making their presence there more local. But it is hard to out-local local companies. Furthermore, MNCs should be wary of losing the advantages that come from being global. The world remains deeply interconnected, despite increasingly popular narratives about deglobalization; in fact, resilience comes from more interdependency, not less.[48]

In six areas, MNCs will face a spectrum of choices as they seek to derisk. By translating their decisions in these areas into better operating and governance models, they can help their global boards and their China leadership agree about strategy and direction. They can also empower local leaders, giving them more autonomy and the freedom to work quickly without sacrificing their accountability to headquarters.

### Capital and ownership

MNCs' choices about capital and ownership include such options as using only local sources of funding, using funding from both local and global capital markets, and having just one global source of capital.

Companies may choose to raise funds locally. For example, Anheuser-Busch InBev raised $5 billion in an IPO for its Asia–Pacific subsidiary, Budweiser APAC, in Hong Kong in 2019.[49] In 2016, when Yum! Brands spun off Yum China, two Chinese companies invested $460 million in the new firm.[50] The high performers we described in the previous chapter tend to gain access to local financing effectively.

Alternatively, an MNC's global headquarters could fund business in China with global capital and maintain a greater degree of control over Chinese subsidiaries. One way to achieve that—in industries

with regulations that allow it, such as financial services and cars—is to buy equity stakes of local joint-venture partners, as Goldman Sachs and BMW have done.[51] Another way is to sell equity to finance commercialization plans.

### Supply chains

MNCs have a spectrum of options for managing and deploying their supply chains, including implementing an "in China, for China" strategy (in which components are produced in China for domestic production and sales), building a regional supply chain for both China and nearby markets, and maintaining a global supply chain of which China is one part.

Local supply chains can enhance efficiency, agility, stability, and end-to-end testing capabilities, and they can reduce the time it takes to respond to changing demand. In 2018, BASF announced a plan to invest $10 billion by 2030 to build new plants in Zhanjiang, and it inaugurated the first of them in September 2022.[52]

At the same time, diversified global supply chains allow companies to allocate resources dynamically and comply with regulatory requirements. Furthermore, localizing supply chains and concentrating production in one place increase risk, whereas building a more regional or global supply chain could enhance MNCs' resilience, as many discovered during the pandemic. For instance, in 2021, Intel invested $475 million in its Vietnam assembly and manufacturing facility.[53] In a November 2022 survey about supply chains, more than half of Japanese manufacturers said that they were planning to reduce their dependence on Chinese suppliers.[54]

### Innovation

MNCs likewise have many options for innovation. They could heavily invest in their China-based R&D capabilities to mainly serve the China market, use China-based R&D capabilities to serve global markets, or tap into opportunities in China without major investment in local R&D units.

MNCs establish local R&D centers to stay close to local market needs and consumer insights. Those centers can design products tailored to Chinese consumers and get them to market more quickly. An example is General Motors, which developed the Global Small Electric Vehicle platform through a joint venture in China. The Wuling Hong Guang MINIEV, which uses that platform, has been a best-selling vehicle in China.[55]

Others have created R&D centers in China whose innovations can be replicated elsewhere. Those centers also ensure flows of knowledge around the world, enabling Chinese branches to participate in global R&D efforts. For example, in 2019, AstraZeneca created a Chinese team with 1,000 employees to support global R&D efforts for innovative medicines.[56]

### Branding

**49%**

Share of Chinese consumers preferring the quality of Chinese brands

MNCs' branding choices include localizing their branding and their distribution channels (such as China-specific e-commerce apps); localizing while maintaining a consistent global brand story and distribution channels similar to those in other countries; and retaining a global image and mostly traditional distribution channels.

Chinese consumers increasingly prefer local brands , as we pointed out earlier. In a McKinsey survey, 49 percent of Chinese consumers deemed the quality of Chinese brands better than that of foreign brands; only 23 percent said the reverse.[57] Some MNCs could therefore improve their presence with a local brand image that resonates with local customers. For example, L'Oréal acquired domestic beauty brand Magic Holding to expand its brand portfolio in China and reach new Chinese customers.[58]

But high performers tend to adapt to Chinese consumers' increasing preference for local products without discarding their global story. An example of that approach is Gucci's recent release of a collection of tiger-themed clothing and accessories to celebrate the Year of the Tiger.[59] Often, such companies use digital channels, precision marketing, and the adoption of local cultural elements, and many premium brands use digital advertising and brand ambassadors to preserve alignment with their global image.

**Talent**

MNCs could develop localized talent pipelines and fill most critical roles with local hires, draw leaders from China and abroad, or reserve key positions for international executives. How much to empower local managers by giving them responsibility for finances and flexibility with decision making is also a critical choice.

China's talent pool is expanding, localizing, and improving. In a 2021 survey, more than 31 percent of overseas students said that they planned to return to China immediately after obtaining their degrees, an increase from 13 percent in 2015.[60] The number of people with higher education acquired in China grew from eight million in 2010 to 12 million in 2021.[61] By 2030, China will account for 37 percent of college graduates with degrees in science, technology, engineering, and math (STEM) in OECD and G-20 countries, more than India (27 percent) or the United States (4 percent).[62]

MNCs and local companies competing for the best local talent could devote resources to discovering and developing those employees. For example, Honeywell's decision to eliminate English proficiency as a job requirement and to conduct interviews in Chinese enabled it to recruit local workers, retain those who could perform well but lacked English-language skills, and boost sales productivity.[63]

At the same time, MNCs need to maintain inflows of high-caliber global talent, a precious resource for companies everywhere. MNCs have long done that by offering rotational programs, which ensure an exchange of global and local talent and bring global best practices to China, but that may become harder in a postpandemic world with more travel restrictions.

**Technology and data**

Several Chinese laws, such as the Personal Information Protection Law (2021), the Data Security Law (2021), and the Cybersecurity Law (2017), require MNCs to locate their data-storage and technology infrastructure in China. High performers are agile at both following local cybersecurity laws and complying with global data security requirements. For MNCs trying to decide how local they should be, another consideration is cost: installing new systems in China requires investment.

Companies may choose various paths to manage that trade-off. For example, Apple complied with local regulations by migrating its Chinese customers' data to a data center in Guizhou.[64] Siemens partnered with a local company to work on the industrial Internet of Things in China while keeping its general enterprise software and other operational data in cloud storage supplied by a global provider.[65] Partnering with local digital players could allow MNCs to upgrade traditional value chains, accelerate the digital transformation of their infrastructure, or offer customers their products on more platforms.

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China is changing and presenting MNCs with a challenge: how to take advantage of significant opportunities while managing emerging risks. By reconfiguring in these six areas, MNCs can start to answer the challenge and capture greater value in China.

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