The China Business Casebook

Edited by

John Storm and John Wilson

The China Business Casebook
Edited by John Storm and John Wilson

This book first published 2023

Ethics International Press Ltd, UK

British Library Cataloguing in Publication Data

A catalogue record for this book is available from the British Library

Print Book ISBN: 978-1-80441-000-4

eBook ISBN: 978-1-80441-001-1

Table of Contents

*Some organisations and authors have been anonymised at the authors' request

Introduction

John Storm & John Wilson

However much we know, or think we know, about China, it is in all our interests to try to know a little more, to devote time to understand developments there. It is an economic, political, and military superpower and, directly or indirectly, affects all of our lives. It is the second largest economy in the world after the United States but projected by some economists and thinktanks to become the largest economy by 2030 if not sooner (CEBR, 2022) (it actually became the largest economy in the world in 2013 on purchasing power parity basis).

China's economic rise represents a remarkable transformation, particularly in the period since the policy of opening up and reform began in 1978-79 (Brown, 2018), a period that has been described as 'spectacular' (CRS, 2019, p1) and 'the fastest sustained expansion by a major economy in history' (World Bank quoted in CRS, 2019, p1). The achievements are as varied as they are impressive (World Bank, 2022). It has experienced rates of growth averaging almost 10%, 800m people have been lifted out of extreme poverty, globally-leading companies such as Alibaba, Tencent and Huawei have been established, Millennium Development Goals have been achieved and the hugely ambitious Belt and Road Initiative, first announced in 2013, continues to expand and, as at March 2022, involved almost 150 countries (Nedopil, 2022).

These achievements are to be taken forward by means of its most recent Five Year Plan (FYP) covering the years 2021-2025 inclusive. On 11 March 2021, the 13th National People's Congress of the People's Republic of China (PRC) approved the 14th FYP for National Economic and Social Development and Vision 2035. The Plan lists key targets across five main themes: economic development; innovation; people's wellbeing; green ecology; security/safety. Achievement of its key objectives will build upon one of its two centennial goals announced at the 18th National Congress of the Communist Party of China (CPC) in 2012 i.e. the goal, said to be achieved in 2021, to build a moderately prosperous society in all respects, in celebration of the centenary of the founding of the CPC in 1921, and will help underpin the goal to be achieved by 2049, in celebration of the centenary of the PRC, to build China into a modern socialist country that is prosperous, strong, democratic, culturally advanced and harmonious (State Council, 2019).

Its unprecedented achievements, however, have been accompanied by major ongoing challenges, including those related to the environment, ageing population, job security, workforce skill upgrading, social inclusion, inequality and how to make further sustainable progress from a low-income to a high-income country (World Economic Forum, 2018). In responding to these challenges, China will continue to adjust to the 'new normal' as introduced by President Xi in May 2014 (Green & Stern, 2015) involving, *inter alia*, reduced economic growth, upgrade of the economy and growth driven by innovation and technology rather than input and investment. The new normal, alongside related policy priorities including, for example, the continued anti-corruption drive and China's commitment to the United Nations Sustainable Development Goals, provided the backcloth to the 14th FYP, agreed in the context of the domestic and global economic impact of the pandemic which potentially will give China even greater global influence depending, in part, on relative rates of economic recovery.

In achieving the strategic goals established by central government, the role of business is critical, and it is important to understand how organisations and individual managers respond to these goals, not least when under the type of extreme and unprecedented pressures arising from the Covid-19 pandemic. To this end, and to seek to contribute to some level of greater appreciation and understanding of developments in China, this book presents case studies written by practising managers for their peers, students and those who simply have an interest in China, to highlight a wide range of issues and management challenges faced in a variety of sectors.

The case studies cover: lessons from business history at a successful joint venture (Tao); how a new enterprise may emerge during market turmoil (Fei); how a business may respond to an externally-driven crisis by changing the business model (Underwood); how lessons may be learnt from the evolution of a start-up (Vermeulen); how to respond to macro trends in a specific sector (Huang & Storm); the gradual demise in China of a well-known European brand (Gunaratna); issues to consider in dealing with unsuccessful promotion applications (Henderson); how to enhance position in the market place through increasing customers' perceived value of products (Jiang, Storm & Underwood); strategies to attract customers through a key video-hosting platform (Zhang & Storm); how to use Design Thinking to improve employee retention (Yang & Storm) and to facilitate organisational development (Metz); how to source talent in an ever-increasing competitive market (Zhang, Kuang & Mackrell); the response of a domestic airline to motivation of its pilots during and post-pandemic (Deng); the analysis of culture through use of the cultural web (Jiang); managerial attitudes to corporate social responsibility, and how financial management influences overseas expansion at a State Owned Enterprise (Seufert & Ding).

Given the variety of the cases and the sectors from which they are drawn, it is not possible to generalise beyond saying that they illustrate specific challenges at a particular point in China's development and, as such, provide insights into the management of business organisations in China and questions for discussion. In the context of major global events and trends, the cases are presented as important micro-level opportunities for learning and reflection and provide a foundation for future studies. It is hoped that the cases, anonymised where necessary, are of use for teaching purposes at undergraduate or postgraduate level, may stimulate ideas for research, are of practical interest and benefit to managers or simply be of general interest to the reader as we all collectively help each other understand a little more of a country the significance of which, for all of us and irrespective of where we are located, can hardly be overstated.

For the most part, the language and expressions used by the case study authors have been preserved by the editors.

References

Brown, K. (2018). 'Reform and opening up, 40 years on' *China Daily* 31 May www.chinadaily.com.cn/a/201805/31/WS5b0fa276a31001b82571d73e.html

Centre for Economics and Business Research (CEBR) (2022). 'China's Economy Could Overtake US Economy by 2030' 5 January https://cebr.com/reports/chosun-ilbo-chinas-economy-could-overtake-u-s-economy-by-2030/

Congressional Research Service (CRS) (2019). *China's Economic Rise: History, Trends, Challenges, and Implications for the United States* https://crsreports.congress.gov/product/pdf/RL/RL33534

Green, F. & Stern, N. (2015). *China's "new normal": structural change, better growth, and peak emissions* London School of Economics: Grantham Research Institute on Climate Change and the Environment https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2015/06/China_new_normal_web1.pdf

Nedopil, C. (2022). 'Countries of the Belt and Road Initiative' Shanghai, Green Finance & Development Center, FISF Fudan University www.greenfdc.org

State Council (2019). 'The Two Centennial Goals' 11 July https://.english.scio.gov.cn/featured/chinakeywords/2019-07/11/content_74977591.htm

World Bank (2022). 'Overview' 12 April www.worldbank.org/en/country/china/overview

World Economic Forum (2018). *Future of Consumption in Fast-Growth Consumer Markets: China.* https://www.weforum.org/reports/future-of-consumption-in-fast-growth-consumer-markets-china

Building on Local Understanding, Core Competencies and Global Connections: An HR Consulting Company Adapting to an Evolving Market

Huaiyuan Zhang
Teaching Lecturer: International Business School Suzhou at Xi'an Jiaotong-Liverpool University

Fu Kuang
Director: Cornerstone International Group

Alex Mackrell
Director: Manakai Consulting Ltd.

Abstract

International companies frequently enter foreign countries using business models and products inherited from their home territories. However, opaque and rapidly changing markets do not always conform to theoretical frameworks. The success of a global company may be influenced by how it perceives and analyses the changes within its local market, in addition to how its own core competencies relate to that market. This case study concerns Cornerstone China, the Chinese subsidiary of a global HR consulting group, and its successful expansion to a new market in the face of changing macro- and micro-level headwinds in a rapidly developing market. Rather than apply theory and business models to achieve this, the company took a more intuitive and organic approach to develop their new business, with this based on their understanding of both local and international markets, the competencies and vision of their own company, and benefits gained through membership of global professional networks.

Introduction

Cornerstone is a global organisation in the talent recruitment and development consulting field. Established in the United States (US) in 1989, by 2022 Cornerstone possessed 57 offices across 40 countries worldwide. The majority of Cornerstone's operations fall into two categories: retained executive searches; executive development in the form of coaching and leadership training. Cornerstone's clients span a wide variety of industries, including healthcare, manufacturing, and infrastructure. The group sources talent for a diverse range of executive and specialised roles in functions such as human resources, finance, sales, and supply chain management. Cornerstone entered the Chinese market in 1995 with the establishment of a local subsidiary, Cornerstone China. This has expanded to operate in 6 major cities in China, namely Beijing, Shanghai, Guangzhou, Hong Kong, Taipei and Suzhou, and employs a total of 21 consultants (Cornerstone International Group, 2022).

"Executive Search", one of Cornerstone's core offerings, is often referred to as headhunting (Allan, 2019), though this description has been disputed within the industry as too simplistic. Cornerstone follows a "retained" executive search business model, which features a high-impact, high-quality and time-consuming process, where recruiters are paid at beginning of a search. This is in contrast to the "contingency" executive search model, which places emphasis on speed rather than quality and fit, and where payment is only made upon hiring of a candidate (Allan, 2019). Figure 1 features a description of these two approaches based on the work of Dingman (1993) and AESC (2020). Prior to entering China, Cornerstone had extensively tested the retained executive search model, having come to the conclusion that this more rigorous approach was more effective at maximising client value than the contingency search model.

	Retained search	**Contingency search**
Pay to recruiter	Recruiter is paid when the search begins. Payment is guaranteed no matter the results.	Recruiter is paid only after a candidate is hired and has worked in the position for an agreed period.
Price for service	Fees for both models start at a similar level, usually a percentage of the position's annual salary. However, contingency search fees can sometimes be negotiated down far lower than retained search fees.	
Target position	Usually senior management positions.	Can include middle management or junior-level positions.
Style of service	- Values the "chemistry" or fit between candidate and the client organisation beyond just hiring. - Clients generally engage just one executive search company per position.	- Values the speed and result of hiring over long-term fit. - Clients can assign multiple executive search companies to search for the same position.
Speed/ quality of work	- Usually takes longer to locate and screen candidates, but each assignment is given more attention. - The recruiter typically conducts extensive research on the organisation and industry, and talks to candidates in person to achieve best fit.	- Can locate candidates quickly relying on existing candidate databases, but with limited time spent screening for best fit. - The recruiter typically avoids in-depth research, preferring to persuade both their client and the candidate to complete the hiring process in the shortest time possible.

Figure 1: *Differences between retained executive search and contingency executive search*

Problem statement

Following in Cornerstone's footsteps, Cornerstone China went on to use the retained executive search model exclusively, developing a strong client base among the waves of international companies entering the Chinese market in the 1990s and early 2000s. From 1992 to 2008 in China, foreign direct investment (FDI) increased by over 700% from $11.01 billion in 1992 to $92.4 billion in 2008. At the same time, the number of foreign-invested enterprises rose by more than 400% from less than 85,000 to almost 434,000 (China National Bureau of Statistics, 2022). This expansion drove strong demand for senior management personnel and resulted in equally strong growth for Cornerstone China over this period.

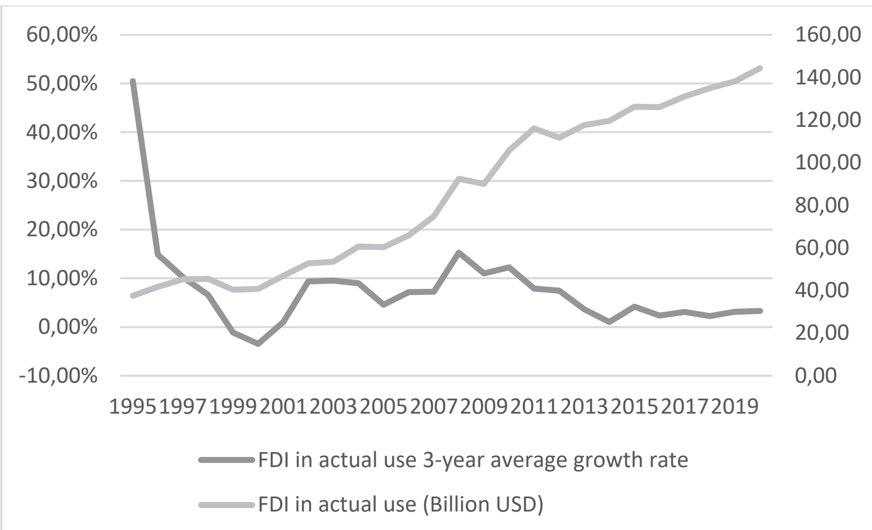

Figure 2: *Change of FDI in actual use in China from 1995 to 2020, calculated according to data from the China National Bureau of Statistics (2022)*

Post-2008, however, several macro and micro level trends began to impact Cornerstone China's market:

1. **Macro-level: Slowdown in foreign-invested enterprises**

   As shown in Figure 2, China experienced a general slowdown of FDI growth beginning in 2008. While FDI grew over this period, the 3-year average growth rate dropped significantly from over 15% in 2008 to approximately 1% in 2014, going on to achieve a 3% average until 2020 (China National Bureau of Statistics, 2022). This macro-level trend indicated that foreign-invested business expansion in China was slowing down, the very expansion that had driven the need for Cornerstone China's international executive search services over the previous decade. With this threat to the company's future revenue growth in this sector came a need to rethink its strategy.

2. **Micro-level: Local preferences differed from Cornerstone's other markets**

   Chinese customers have placed different emphasis on executive search. During Cornerstone China's initial development, differences in local preference were offset by the fact that many of its clients were both international and hiring for scarce and valuable senior level positions – often expatriates. The lucrative era of new business and fast-paced expansion effectively ended after 2010, with the initial wave of foreign businesses in China starting to stabilise. With this came a decrease in demand for senior-level position recruitment services, as well as the localisation of management and operations teams. Cornerstone China found that the lower-priced, faster-paced, and results-oriented "contingency" search model was increasing in popularity with their clients, while Cornerstone's rigorous, process-oriented "retained" search model was becoming less attractive. With this change, the company's focus on the executive search model was increasingly looking like a strategic weakness.

3. **Micro-level: More competitors joined the game**

   In addition to lower demand in general and a change in preference from clients, threat of local competition exploded during 2002 to 2012

> as the number of competing executive search firms grew from 51 to 2,367 companies (Chenli, 2013). A great increase in alternative choices resulted in the strengthening of client negotiation power and served as a significant barrier to further growth (Luo et al., 2020). While Cornerstone China could adopt the "contingency" search model as its competitors to survive, this clashed with the company's (and Cornerstone's) global identity as a high-end, quality-service provider. Cornerstone's core competencies and reputation were founded in providing rigorous and quality-oriented talent allocation, and it was unlikely that Cornerstone China could face off against entrenched industry leaders with extensive contingency search experience. In this case, the wisdom of the proverb "if you can't beat them, then join them" (Titleman, 1996) does not apply to Cornerstone China's scenario.

Given the above, decision-makers at Cornerstone China concluded that the executive search market was no longer viable for long-term growth, particularly the sector pertaining to the "retained" search model. Despite this negative outlook, it was understood that Cornerstone China had not lost any of the core competencies that had brought it success in China, and the company embarked on a journey to develop new business opportunities and differentiate themselves from their current competitors.

Strategic or entrepreneurial: Re-positioning with a new vision

To develop new opportunities in the China market, Cornerstone China did not turn to frameworks for strategic analysis, such as Porter's Five Forces Model. Many of these models are built on the assumption that information about the market and competitors is transparent and available, and this definitely was not the reality around the time Cornerstone launched in China (Grundy, 2006). Instead, Cornerstone China chose to leverage the most important assets a knowledge-driven company possessed: the reputation, knowledge, and experience of their expert team of consultants.

Although not restricted by complex supply chains or similar factors of production, intangible assets such as reputation, expertise, diversified offers and connection through partners are crucial factors for executive search companies like Cornerstone China (Harvey et al., 2019). Rather than turning to organisational or management theory to identify a strategically valuable niche, Cornerstone China decided to apply its existing experience, expertise, connections, and market insights to an iterative approach. It was decided that this more organic or entrepreneurial approach, based on trial, error and adjustment, was more suited to the complex, opaque and rapidly evolving Chinese market, as well as the strong emphasis on relationships in a business community.

When establishing a reputation in a new field, it is beneficial to shape perceptions of the company as a well-established “first mover”, allowing a company more effectively to “get into the mind” of potential clients (Demaris et al., 1992). This relates to the importance of “being known for something”, which brings with it higher returns, increased resilience and interest from customers (Lange et al., 2011). For this reason, instead of answering the question “what is wrong with the current business and how should it be improved?”, Cornerstone China implemented the transformation by looking at their business in a different way (Ready & Mulally, 2017) by asking: “what new business will best show our identity as a high-quality global human resources service company in the Chinese market?” It then split this into two main areas concerning the company and its market.

1. **External/Market focus for new value proposition:**
   a. What will be the “next big thing" in our field?
   b. What will be our role to play within this new trend in the market?

2. **Internal/Company focus for capacity building:**
   a. How can we develop internal expertise for this “next round of the game”?
   b. How should we develop a client base in this new field?

Implementation: nurturing a business plan B

These above questions align with Hoffman and Casnocha's (2012) three questions to answer when starting a new enterprise, namely 1) “what the company’s assets allow it to do”; 2) “what the company is aspiring to do”; and 3) “what the market needs the company to do”. They argue that while it is important to keep a business’ most competent resources as its core focus (Plan A), a company should also create a Plan B by aligning its assets, vision and market needs to prepare for a time when Plan A could fail or when the time is ripe for Plan B to offer bigger benefits. In line with this, Cornerstone China did not drastically change its main business focus or invest heavily in exploring a new business, and continued to pursue their Plan A (retained executive search). However, they simultaneously developed their Plan B by answering the two sets of questions above with reference to the following analysis.

Mature markets offer key insights into the future of developing markets

To “predict” China’s future, Cornerstone China looked to the past. The US, a mature market in HR management field where Cornerstone had originated, proved to be an excellent guide for pinpointing the direction in which the company’s industry in China was headed. Cornerstone China determined that China in the 2010s was following a similar growth pattern to the US in the 1990s. This was characterised by fast economic growth brought by new technologies like the internet, with businesses investing heavily in expansion but largely ignoring the high possibility of the economic contractions endogenous to capitalism (Sherman, 2014). The US experienced severe downturns in the IT and internet industries in the late 1990s, and the China economy was showing a similar trend in the face of years of rapid expansion. Therefore, Cornerstone China concluded that, similar to the US, the upcoming stagnation and contraction in China would result in increases in labour costs, competition, corporate bankruptcies and layoffs, as well as a decrease in investment going towards further expansion.

While this assessment offered a bleak prediction for the executive search industry as a whole, these trends did drive a rise in "employee outplacement" services in the US: dismissals conducted with professional care to achieve successful job transitions and minimise the negative effects for the organisation (Stacho & Stachová, 2015). Based on this analysis, Cornerstone China determined that their "next big thing" would be the provision of employee outplacement services to international businesses in China seeking to reform or reallocate their workforces. This direction would also allow Cornerstone China to leverage its existing expertise in talent sourcing, understanding of the Chinese market and reputation among foreign invested companies in China to become a leader in this emerging market.

Building reputation, capacity and leads: the business-community partnership

With their Plan B identified, Cornerstone China set out to build the capacity and reputation they would need to take advantage of this developing market trend. As the skillset and knowledge required for employee outplacement overlapped with the company's existing work in executive search, talent acquisition to support the new business was not initially a concern. Instead, Cornerstone China took a "learning by doing" approach, allocating a percentage of its current team's time between major projects of retained executive search to developing practical expertise that would grow as the company found outplacement projects. They then focused on establishing the external channels required to generate leads and establish a new client base.

Rather than going local, Cornerstone China chose to build partnerships with global communities of employee outplacement and career transition service providers. One example of these was Career Partners International (CPI), a network covering over 300 locations around the world (Career Partners International, 2022). Connected as a member of these communities, Cornerstone China was not only able to gain leads from other members, but also had access to valuable capability development resources such as career transition coach certification. These would serve to enhance the credibility of Cornerstone China's consultants and the company's ability to adapt to this emerging business. Such practice, known as "business-community partnerships", benefit their members with problem solving, resource integration, exposure, new opportunities, and information exchange. Organisations in a community become "citizens" that both contribute to and receive resources from the community, with this particularly advantageous at a global level (Loza, 2004). As a representative and member of these communities in China, Cornerstone China was able to implement its vision of "global business with local operations", gaining opportunities and exposure internationally while providing a portfolio of outplacement solutions (rehiring, coaching, and training) that evolved alongside the Chinese market.

Evaluation

Cornerstone China's experience reflects a less systematic but more piecemeal application of business theories and frameworks, which is more common in the real business world. In the preparation stage of business change, one highlight is that even for an established global company, entrepreneurial thinking, intuition, experience, and grit in front of uncertainty can make a huge difference when repositioning for a new business. Cornerstone China's case emphasises the importance of grounding business strategies into local market realities, as well as the company's current core competencies and vision. It also shows the advantage of being a global company with local operations: Cornerstone China maintained its global identity and used global networks to acquire key leads and resources to develop a strong client base, but delivered by well-equipped local teams able to satisfy the needs of multinational firms. Such a strategy allowed them to differentiate themselves from both local competitors with no international expertise and international competitors with a limited understanding of the local context.

In terms of implementation, Cornerstone China chose to explore by allocating a small percentage of their resources to a Plan B while maintaining most of their focus on their core business (Plan A). This organic strategy leveraged the company's existing competencies and reputation to build new business, allowing the company and its team to learn by trial and error with minimal reputational or financial risk. Costs were incurred in terms of the re-/up-skilling of personnel and membership to the global business community, but these were far smaller than would have been the case if Cornerstone China had ventured into a new market or hired a new team. This parallel approach, supported strongly by connecting to global networks, allowed the company to build the capabilities of its team, a new client base and a global reputation useful for targeting international companies in local contexts.

Results from such an approach took time to build. In the early 2010s, and as they built their Plan B through trial, error and learning, Cornerstone China serviced an average of 20 executive outplacements per year, with this accounting for around 10% of the company's total revenue per year. Though small in number, these initial outplacement projects served as important practical learning experiences and sources of reputation growth, with many coming from internationally renowned giants, such as world-wide leaders in e-commerce and digital payments. In 2019, Cornerstone China secured its largest outplacement project ever with the China subsidiary of the largest information software and service provider in the world to provide outplacement services for its over 1,300 managers and executives, which made up over 50% of Cornerstone China's total revenue of the year. Furthermore, this invaluable experience provided tools, knowledge and insights that was shared with and benefited Cornerstone group.

Conclusion

This case highlights the importance of a proactive and organic approach to growth based on market and industry trends, particularly in markets with rapidly developing political, technological, and economic environments. Equally important is an understanding of the company's core competencies, how these related to their market and industry, and how these competencies can be leveraged or adapted to take advantage of new growth sectors. While Cornerstone chose a more intuitive and piecemeal approach not entirely based in theory or classic business modelling, their actions and outcomes do align with findings on areas of entrepreneurial practices, business community partnerships, and business transformation.

References

AESC. (2020). *Retained Executive Search vs Contingency: What's the Difference?* Association of Executive Search and Leadership Consultants (AESC). https://www.aesc.org/insights/blog/retained-executive-search-vs-contingency-whats-difference

Allan, C. (2019). *Executive Headhunters vs. Executive Recruiters*. Cornerstone International Group. https://www.cornerstone-group.com/2019/06/18/executive-headhunters-vs-recruiters/

Career Partners International. (2022). *Company Overview*. https://www.cpiworld.com/about/company-overview/

Chenli, R. (2013). *Research on the development of the headhunting sector in China*. Nanchang University.

China National Bureau of Statistics. (2022). *National Data*. https://data.stats.gov.cn/easyquery.htm?cn=C01&zb=A060A&sj=2021

Cornerstone International Group. (2022). *About Cornerstone*. https://www.cornerstone-group.com/about/

Demaris, R., Ries, A., & Trout, J. (1992). Positioning: The Battle for Your Mind. *Journal of Marketing*, *56*(1), 122. https://doi.org/10.2307/1252139

Dingman, H. B. (1993). The right fit: Executive search by retained recruiters. *Human Resources*, *34*(6), 26–31.

Grundy, T. (2006). Rethinking and reinventing Michael Porter's five forces model. *Strategic Change*, *15*(5), 213–229. https://doi.org/10.1002/jsc.764

Harvey, W. S., Beaverstock, J. V., & Li, H. (2019). Common Threats and Managing Reputation in Executive Search Firms. *British Journal of Management*, *30*(4), 847–868. https://doi.org/10.1111/1467-8551.12312

Hoffman, R., & Casnocha, B. (2012). *The Start-up of You*. Crown Business.

Lange, D., Lee, P. M., & Dai, Y. (2011). Organizational Reputation: A Review. *Journal of Management*, *37*(1), 153–184. https://doi.org/10.1177/0149206310390963

Loza, J. (2004). Business–Community Partnerships: The Case for Community Organization Capacity Building. *Journal of Business Ethics*, *53*(3), 297–311. https://doi.org/10.1023/B:BUSI.0000039415.90007.56

Luo, S., Lei, Q., & Li, W. (2020). Investigation on the development of the headhunting industry in South-eastern China—Investigation in Guangzhou, Shenzhen and Changsha. *Enterprise Reform and Management*, *6*, 201–204.

Ready, D., & Mulally, A. (2017). How to Become a Game-Changing Leader. *MIT Sloan Management Review*, *59*(1), 12.

Sherman, H. J. (2014). *The Business Cycle: Growth and Crisis under Capitalism*. Princeton University Press. https://doi.org/10.1515/9781400862047

Stacho, Z., & Stachová, K. (2015). Outplacement as Part of Human Resource Management. *Procedia Economics and Finance*, *34*, 19–26. https://doi.org/10.1016/S2212-5671(15)01596-8

Titleman, G. (1996). *Random House Dictionary of Popular Proverbs and Sayings* (1st edition). London: Random House

Discussion questions

1. Cornerstone China based their new business direction on three main factors: the company's core competencies, emerging market requirements, and vision and core values of the company. When facing a changing market environment and the need to adjust your business offering, what other key factors would you consider, and why?

2. Cornerstone China did not apply theoretical frameworks or business knowledge in a systematic way, which resulted in a piecemeal and intuitive approach. Why do you think it is often challenging to apply business tools or theories in practice? In your own experience, what are the challenges in implementing learning from management education?

3. Companies must take care when deciding on how to explore new business opportunities, as the reallocation of financial and human resources away from the company's core offering can pose a risk to current operations. Do you consider Cornerstone China's Plan A / Plan B strategy a good approach, and why?

4. Cornerstone China benefited greatly by joining a global business community in their newly identified field. Describe these benefits and how your organisations could profit from a similar approach.

CRRC's Management of Foreign Exchange Risk

Juergen Seufert
Honorary Lecturer: University of Aberdeen

Keren Ding
University of Pennsylvania

Abstract

This case study addresses the foreign-currency management of a rolling stock manufacturer and its subsidiaries. We introduce various hedging methods as means to mitigate foreign currency exchange rate risk inherent in long-term service contracts and industry-specific, long cash conversion cycles. This case provides practical insights into the management of foreign exchange rate risks relevant to internationally expanding companies in today's unstable global economy.

Introduction

China Railway Rolling Stock Company Limited (CRRC) is the world's leading rolling stock supplier with large scale, diverse product portfolio with first-class technologies. CRRC ranks among the Global 500 and China's top 100 companies, with products exported to 105 countries and regions. In 2015, state-owned enterprises CNR (China Northern Railway Group) and CSR (China Southern Railway Group) merged to form CRRC Corporation Limited (CRRC 2015) which was subsequently listed in Shanghai and Hong Kong Stock Exchange (Figure 1).

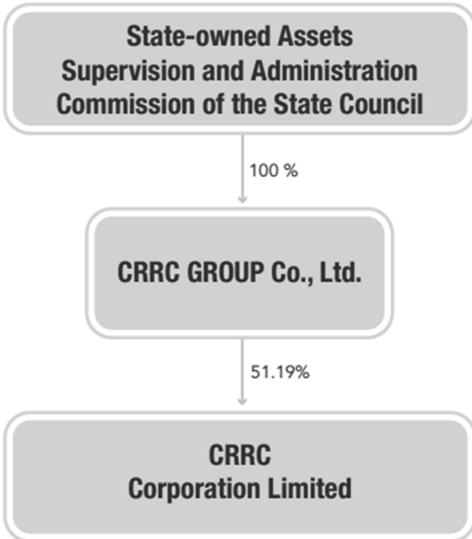

Figure 1: *CRRC's ownership structure*
Source: CRRC (2021a, p.118)

In 2021, the CRRC achieved revenue of RMB225.73 billion and a net profit attributable to shareholders of the company of RMB10.30 billion. As at the end of December 2021, the consolidated total assets of CRRC were RMB426.82 billion (CRRC 2022). (note: China's official currency is the Renminbi, i.e. RMB, of which the principal unit of account is the Yuan, abbreviated as CNY i.e. Chinese Yuan).

For the past decades, CRRC has played an indelible and important role in China's railway market, while expanding globally. By the end of June 2021, CRRC had set up 82 first-tier subsidiaries (Chinese and international including subsidiaries with minority shareholders), 18 Research and Development (R&D) centres, and more than 40 organisations overseas. In 2021, CRRC held more than RMB3 billion (including USD249 million) accounts receivables in foreign currencies and USD327 million short-term borrowing (CRRC 2022).

These international operations are not without risk. Unpredictable changes in the global market, political and economic instability in the foreign countries (e.g., Brazil, Argentina, South Africa, Zimbabwe, USA) long-term contracts common to rail equipment industry, as well as plants and facilities (non-current assets) in foreign countries have exposed CRRC to foreign currency exchange rate risk. Industry specific characteristics make foreign currency exchange rate risk particularly pronounced:

1) Long-term contracts – from signing the contract to the delivery of products or services might take years while the amount denoted in foreign currency is not changing, e.g., USD converted into local currency RMB (Figure 2). For example, in 2014 CRRC Springfield, Massachusetts, was rewarded a USD566 Million contract to manufacture 152 Orange Line cars and 132 Red Line cars, yet these cars were scheduled to enter service between five and nine years later i.e. 2019- 2023.

Figure 2: *– 10 years exchange rate chart of Chinese Renminbi (CNY) and US Dollar USD*
Source: XE (2022)

2) Long cash conversion cycles – The cash conversion cycle expresses how long it takes for a company to turn its investment into inventory (raw materials or components) and other resources (e.g. labour) into cash inflows from sales (customer payment). From the construction of a railway vehicle to its delivery and final payment it can take years. Wang (2019) reports an industry (not single contract) average cash conversion cycle of 290-350 days

3) Demand driven markets – Many railway markets are dominated by one or few rail service providers (historically large rollingstock companies which were previously nationalised and combined with their country). Due to their dominant position their negotiation power is strong while competition among rolling stock manufacturers (see Table 1) is fierce and profit margins are limited (EU 2014).

Rank	Company	2019 Revenue ($ Billion)	Country
1	CRRC Corporation	32.4	China
2	Bombardier Transportation	15.8	Canada
3	Siemens Mobility	10.1	Germany
4	Alstom Transport	9.3	France
5	GE Transportation	3.8	US
6	Stadler Rail AG	3.4	Switzerland
7	The Greenbrier Co	3	US
8	Trinity Rail Group	3	US
9	Hyundai Rotem	2	South Korea
10	Hitachi Rail Systems	1.7	Japan

Table 1: *World's largest rolling stock companies*
Source Statistica (2022)

4) High fixed asset intensity - Fixed assets account for a high proportion of a company's total assets while there is high leverage from financing lease liabilities, bank loans and other loans arising from the purchase of production line and manufacturing equipment. It is crucial to manage assets well and ensure the value preservation and appreciation of assets.

Problem statement

While CRRC's 46 wholly-owned subsidiaries (mainly in Mainland China and Hong Kong SAR) are consolidated within the CRRC group (while operating and financing themselves individually, they also compete against each other), these subsidiaries have set up operations abroad and manage foreign exchanges individually. The management of foreign currency cash flows by each individual subsidiary caused suboptimal cash management. That is, some subsidiaries are net receivers of foreign currencies while others are net spenders or in need of foreign currencies for their overseas investments. For example, CRRC ZELC (Zhuzhou Locomotive Co., Ltd) received USD500 million for its service contract with the Turkey Transportation Department in 2018 (CRRC 2018), a maintenance contract of USD84 million with the Argentine Ministry of Transportation in 2021 (CRRC 2020) while CRRC Changchun, in China, spent an initial USD95 million on its Springfield, USA, investment (CRRC (2016).

These asynchronous cash inflows and cash outflows across subsidiaries mean that the total volume of RMB exchanges into foreign currencies and vice versa increased, resulting in more overall cash-holding and higher foreign currency risk exposure. Just in the 3rd Quarter 2020 financial expenses increased by 76.94% compared to the same period of the previous year, which was mainly due to the impact of exchange rate fluctuations and the increase in exchange rate losses (CRRC 2022).

Given the specific industry characteristics (long-term contracts, long cash conversion cycles, demand driven markets and high asset intensity), CRRC's international expansion and the related foreign currency exchange rate risk trigger the questions: How can CRRC minimise its exchange rate risk while still internationally expanding and remaining profitable? Which hedging instruments are available and feasible options for CRRC?

Theory

According to the theory of corporate risk management, the level of hedging (to limit or to qualify risk) depends on various factors:

- **firm size** – larger companies can benefit from economies of scale which allows them to hedge comparatively at lower costs (Nance et al 1993),

- **financial distress risk -** optimal hedging theory suggests that distress risk encourages firms to reduce the variability of their future cash flows, thus reducing probability of bankruptcy (Smith and Stulz 1985),

- **exposure to foreign exchange rate risk** – firms with higher foreign exchange risk exposure tend to hedge more (Gonzalez et al 2010).

- **growth opportunities** – firms with growth opportunities tend to hedge to ensure the availability of funds for future investment opportunities (Myers 1977)

- **level of liquidity** – firms with higher levels of liquidity tend to hedge less, because liquid assets can be a substitute for hedging, and probability of default is less (Nance et al 1993).

Mishkin & Eakins (2019) mention different mechanisms:

1. Forward Market – it allows firms to fix the exchange rate between two currencies (e.g., USD and RMB) for settlement in the future at a fixed future date (up to 10 years later). The forward rate is fixed when the contract is established, and no payments are made until the future value date. Banks commonly trade forward contracts for their clients and themselves.

2. A foreign currency swap – this instrument allows one party to swap a loan's principal and interest in one currency (e.g., RMB) for principal and interest in another (e.g., USD). Commonly, the swap parties borrow different currencies, exchange the receipts, and then settle each other's debt. This eliminates exchange risk and exposure to future currency fluctuations. Another benefit is that sometimes a domestic company can borrow at a cheaper rate than a foreign company.

3. Money Market - the firm exchanges the currency (e.g. RMB to USD) at the current spot rate (today) and invests the proceeds in the money market (trading in very short-term debt investments such as treasury bills, commercial paper, certificate of deposit, trade credit, bills of exchange, promissory notes etc) until they are needed.

4. Direct risk reduction methods – an exporter invoices in their own domestic currency, offsetting payments against receipts in the foreign currency (Matching), setting off intercompany credit against debit balances (Netting).

In the Chinese context hedging developed as shown in Fibure 3:

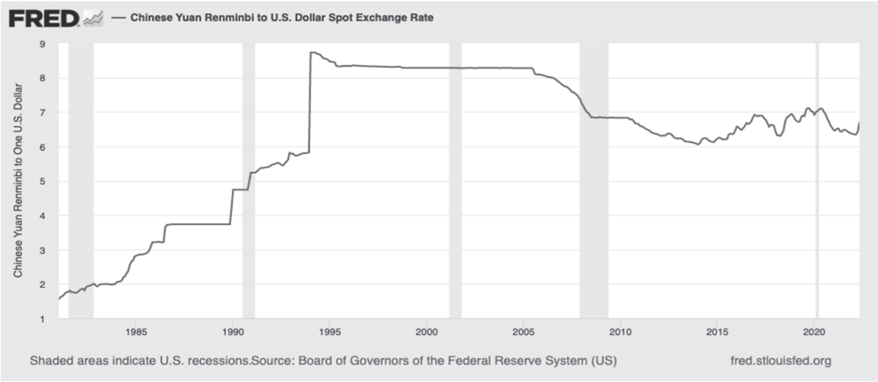

Figure 3: *The China's foreign-currency management since 1978.*
Source: FRED (2022)

Stage 1 – 1978-1995: After 1978, China's foreign economic activities were dynamic and expanding. In 1980 to prevent "disorder" in foreign currency exchange and circulation of RMB, the Chinese government issued "foreign exchange certificates", which were withdrawn in 1994 and replaced by a managed floating exchange rate regime, ending 16 years of depreciation of RMB. During this period, many enterprises, including CRRC, used foreign exchange certificates as the only means of international settlement. Enterprises in this early stage had not formed an awareness of foreign currency management while their global business accounted for a relatively small proportion of their revenues. Therefore, financial management tools lag behind technological progress, companies lack foreign currency management while China had limited foreign currency reserves and followed conservative policies.

Stage 2 – 1995-Current: China's foreign exchange reserves had expanded as the economy grew. From 2005, China adopted a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. After the "811 exchange rate reform" (State Council 2015) in 2015, the fluctuation range of exchange rate further expanded. In 2015, 684 listed companies reported a total exchange loss of RMB51.74 billion, 2.96 times higher than 2014. In the past decade, Chinese enterprises have gradually established foreign exchange risk management with the increase of global business. In addition to the increasing willingness to manage the risks, the State Administration of Foreign Exchange is also strengthening its supervision of the foreign exchange market, and advancing Foreign Exchange Management Regulations.

Actions taken

Firstly, since 2020 due so lower growth in its home- and high-end markets of Europe, America, and Australia, CRRC prioritised Asia, Africa, and Latin America as export markets. It also changed its export mode from single product sales to comprehensive global rail solutions (railroad cars and auxillary services). For example, CRRC (and its subsidiaries) independently established a consortium to win the bidding of a Public Private Partnership project in Mexico (Duran 2020). These actions helped to establish a number of overseas R&D centres. R&D and intellectual property are not subject to exchange rate risk and at the same time provide CRRC with tangible benefits. Thus, CRRC is matching overseas revenues with expenditure to optimise the distribution of overseas resources.

Secondly, direct risk reduction methods. For CRRC's exports, the company's policy requires it to quote foreign business contracts based on the expected value of exchange rate movements over the duration of the contract. For negotiations in foreign business, the range of exchange rate fluctuation and the foreign currency exchange rate risks to be borne by both parties shall be specified in relevant contract clauses (CRRC 2021a).

Thirdly, foreign exchange hedging. For CRRC's import business, subsidiaries are required to settle foreign exchange payables on time (or earlier if the exchange rate is considered favourable) and control foreign exchange risks using forward contracts or swap agreements. Table 2 sets out the sensitivity analysis on foreign currency exchange risk, reflecting the effect of reasonably possible changes in exchange rate of the euro (EUR) against the USD, as well as the impact on net profit under the assumption that all the other variables are held constant.