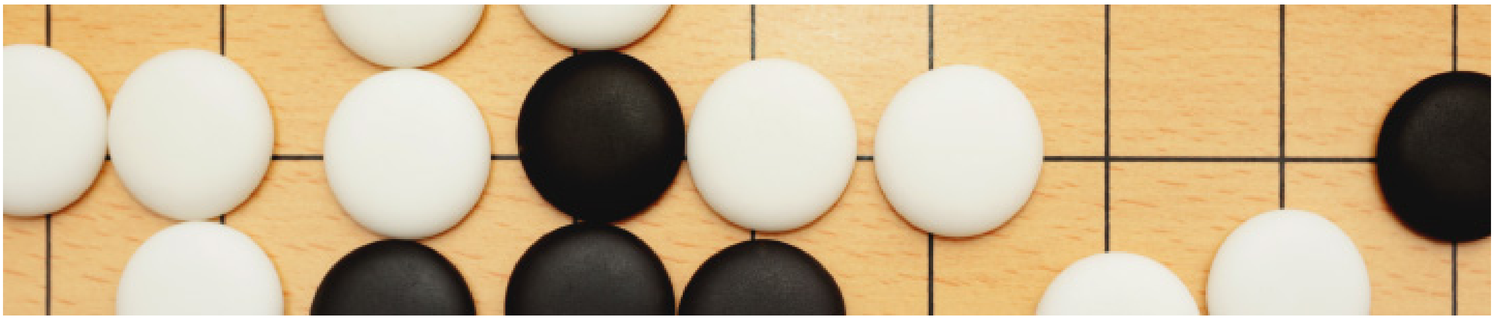
TOMORROW'S CHALLENGES



THE ONLY TWO THINGS THAT MATTER FOR DIGITAL COMPANIES IN CHINA

THERE IS MASSIVE INNOVATION IN CHINA BUT ALSO CREEPING ECONOMIC RESTLESSNESS

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I recently spent a week visiting companies in China, trying to learn as much as I could about digital transformation and trends in that country. I suspected that there were major differences between how digitization was viewed in China versus the West. There were.

As I visited large corporations like Didi Chuxing (the Chinese competitor to Uber that recently received an injection of $1 billion in funding from Apple), as well as mid-size companies and startups, I learned that only two things matter to Chinese digital executives: scale and speed. All else is secondary. Simply put, they want to get really big, really fast.

Culturally, we might liken it to the Chinese game of Go. Go, unlike relatively complex Western games like Chess, is a straightforward battle for territory. The player who controls the majority of the board at the end, wins. The Chinese digital landscape today is comparable to a game of Go.

Scale and speed make life interesting in China. Yet, in the race for space, many traditional aspects of business are being sacrificed, like revenues, profits, and operational rigour. Cheap money, massive organic growth, and friendly government policies are hiding a multitude of operational sins.

Unfortunately, Chinese firms are not alone in this. Plenty of Western unicorns (privately held firms valued at $1 billion or more) are following a similar strategy: get scale first, worry about revenues and profits later. Facebook and Google have spectacularly shown how this business approach can work. But, these are the exceptions. Companies such as Snapchat, Twitter, and LinkedIn have gained scale, but are still struggling to build solid business cases. Many others have failed, or will fail.

Indeed, failure is on the minds of Western digital firms. Many remember the dot.com bubble of the late nineties and its subsequent collapse. Even if their memories do not stretch that far, the financial crisis of 2007-2009 is hard to overlook. Western tech investors are (thankfully) starting to look much more closely at business model sustainability today.

By contrast, Chinese companies have only known growth and success. There was no dot.com collapse in China, and the financial crisis was barely a blip on the Western horizon. Chinese growth continued unabated. Chinese businesses do not fear failure, because they have never felt its sting. This is great for innovation, and make no mistake, there is massive innovation happening in China today, but it can lead to economic recklessness.

The role models do not help. In China, successful digital giants cast a long shadow. Alibaba and its founder Jack Ma, for instance, are revered in China, which was clearly evident when I visited the company's headquarters in Hangzhou – a city half a step behind Shanghai, Beijing and Shenzhen in the Chinese urban hierarchy.

Alibaba is impressive to be sure. It embodies both the speed and scale that Chinese businesses aspire to reach. The company grew by providing great services at no cost. It vanquished eBay in China by not charging the buyer or the seller to conduct business on its Taobao marketplace. Free services are hard to compete against. Even today, Alibaba makes relatively little revenue ($3.7B in the most recent quarter vs $29B for Amazon and $18B for Google), considering the gross merchandise volumes of goods and services sold across its various marketplaces ($113B in the most recent quarter).

The Chinese businesses and entrepreneurs I met consistently cited Alibaba as a model for success. Alibaba is big, fast, and profitable. The problem is that it is only profitable because it is big. Baidu, Alibaba, and Tencent (the Chinese BAT digital giants) are winning the game of Go in China. Scale benefits matter, but not everyone can be so big. The BATs are succeeding because they can take razor thin margins on very large numbers of transactions, or because they can subsidize free services in one area with paid services in another. However, as Chinese consumers get more and more accustomed to very low prices, free services, and huge discounts, it makes it more difficult for others to compete.

This situation cannot last forever, or can it? I have called for a correction in Western digital markets, and one might expect the same to happen in China. However, there is one important difference in China that argues against it. The government is unabashedly pumping money into the commercial sector. During my recent visit, I heard multiple stories of local, regional, and national government agencies subsidizing labour, rent, and providing cheap business loans. Very few of the companies I visited were making a profit. Some seemed confused by the question! As long as the government props these companies up, they will continue to exist.

A cavalier attitude to commerce, combined with attractive incentives, and a so-so grasp of business fundamentals is a dangerous mix. The Chinese digitization growth story is impressive, to be sure, but it is not sustainable without generous and persistent government intervention.

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He is Director of the Global Center for Digital Business Transformation and co-Director of IMD's new Leading Digital Business Transformation program (LDBT) designed for business leaders and senior managers from all business areas who wish to develop a strategic roadmap for digital business transformation in their organizations.

He is also co-director of the Orchestrating Winning Performance Program (OWP).

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