Sinolytics Insights

Beyond China

Adaptation Strategies for MNCs

By Jingwen Tong and Jost Wübbeke | October 2023

Key Points

- **Due to increasing geopolitical and economic uncertainties, multinational corporations (MNCs) are re-evaluating their business operations in China.**
- While most MNCs choose to stay in China, some are also interested in finding alternatives. **Asia has emerged as a popular region for diversification**.
- Between a hard exit and a full "doubling down on China," MNCs are employing a spectrum of strategic responses to growing geopolitical and economic uncertainty. **Sinolytics analyzed 80+ MNCs in 12 sectors** and **identified four adaptation strategies**:
  - More than half of the companies are engaging in a so-called "China Plus" strategy: enhancing their China presence while developing backup plans. This response diversifies risks and captures growth.
  - A strategy of "relocation" is about exiting China and moving to third markets, especially Asia. This is mostly limited to sectors with a "China-for-Global" production such as the electronics and textile industries – their supply chains are increasingly under stress due to sanctions and human rights concerns.
  - The least number of companies opt for the **"doubling down"** strategy, a continued deepening of activities in China. While this approach allows companies to reap the full benefits of China's market size and economies of scale it also maximizes dependency risks when geopolitical tensions rise.
  - The last group of companies choose "re-shoring" or "near-shoring", by relocating to home markets or neighboring countries rather than expanding to other Asia markets.
- **Sinolytics Advice to Companies:** We advise that you first determine your China risks before embarking on an adaptation strategy. We find that, in general, leaving China is more a question of "how to" and "to what degree" rather than "should or should not". Remaining successful requires highly tailored, company-specific response strategies that allow for product-level differentiation.

Corporates are rethinking their China footprint

MNCs can no longer ignore geopolitical tensions and China's domestic politics when doing business in China. Their home governments are setting up de-risking programs which often incentivize diversification away from China. Increasing compliance and security risks such as burdensome cross-border data transfer rules and the *Anti-Espionage Law*, coupled with a deteriorating economic outlook, add new challenges to their China operations.

How do companies reevaluate their China footprint in this new political and economic context? What strategies have they adopted?

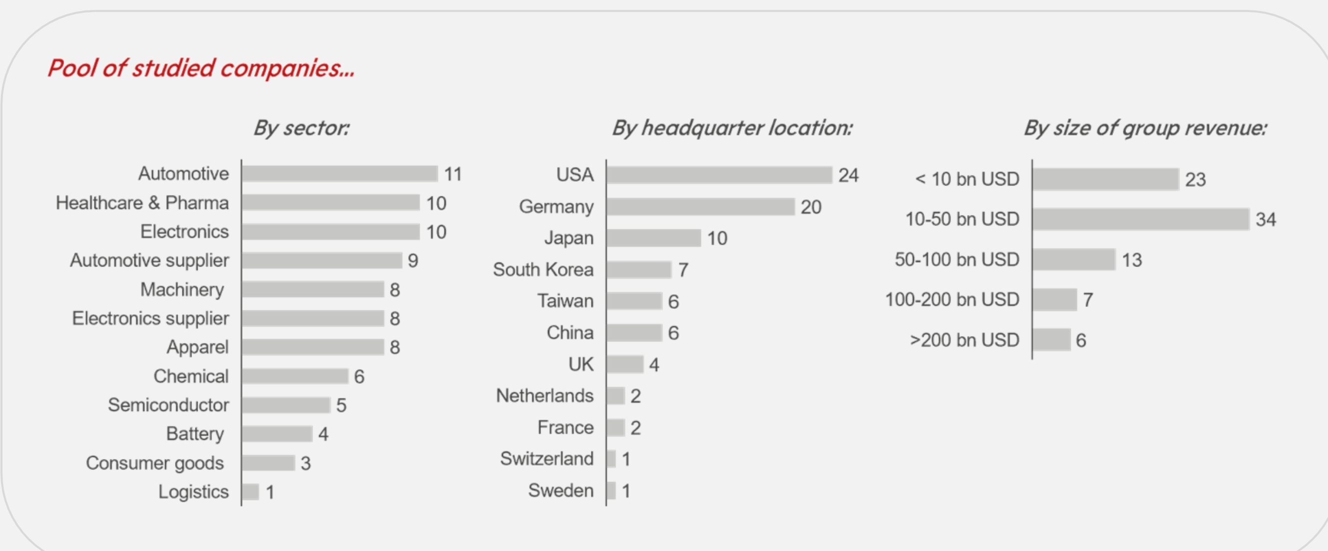
Asia rises as a target region for diversification for both American and European firms.

Sinolytics frequently encounters these questions in its consulting practice. We analyzed over **80 MNCs across 12 sectors** by looking at publicly announced investments and changes to supply chains in the **past 3-10 years.** We selected companies that have established long histories of operating in China and looked across a wide spectrum of industries, headquarters, and company sizes. We observe **four adaptation strategies**.

This report discusses the strengths and limits of these strategies and what they mean for MNCs pondering similar decisions.

Asia beyond China has become a top choice for balancing risks and opportunities in the context of an intensifying China-US strategic rivalry. In this report we focus especially on diversification efforts to **Southeast Asia and India**.

Sinolytics company database: 80+ MNCs, 12 sectors, various sizes



Intensified search for new "shores"

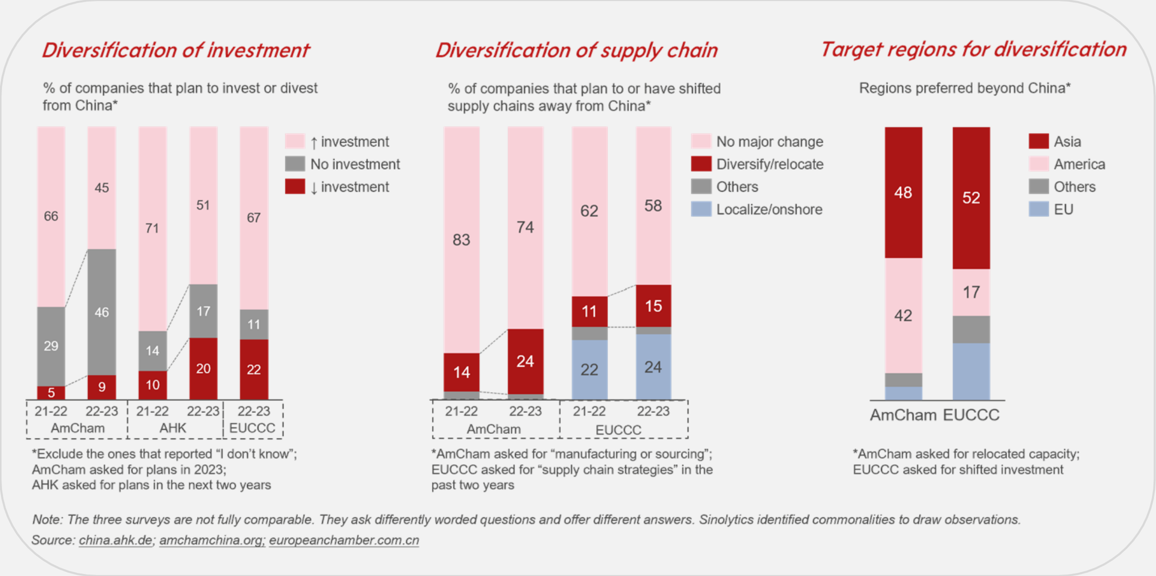
Most companies choose to stay in the China market, but they are also increasingly interested in finding alternatives or backups.

There is currently no mass exodus from China. On the contrary, for now the majority of MNCs are choosing to stay in China. The 2022/23 German Chamber of Commerce business confidence survey shows that around 90% of the German companies do not intend to exit within the next two years. Despite being faced with growing difficulties, respondents stay committed to local operations (e.g., for sourcing and R&D), rather than initiating diversification.

However, this is slowly changing. The number of German companies planning to decrease investment in China has increased from 10% in 2021/22 to 20% in 2022/23. The latest AmCham and EUCCC surveys also attest to this trend: The former found a 10 percentage points increase in the share of respondents who are considering relocating or who have already relocated parts of their supply chain outside of China. Similarly, the percentage of European businesses that are planning for supply chain relocation or diversification grew to 15% in 2023.

A Bloomberg analysis [1] of US public companies' earnings calls and presentations found a surge of mentions of onshoring, reshoring, and nearshoring. The trend is clear: MNCs are exploring new "shores" as the next growth pillar and as a China backup.

2022-23 chamber survey data: Increasing interest in diversification; Asia most popular



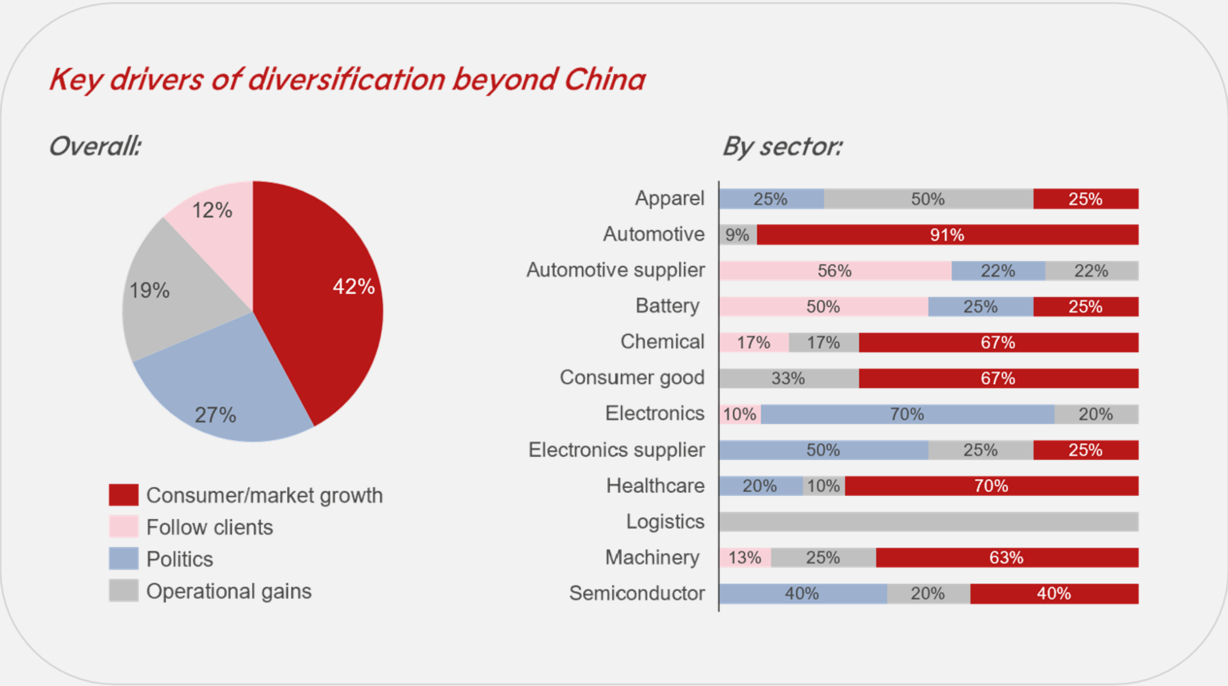
[1] https://www.bloomberg.com/news/newsletters/2022-07-06/supply-chain-latest-ceos-start-to-turn-reshoring-talk-into-action#xj4y7vzkg

Drivers: Risk hedging becomes more important

There are manifold reasons for companies to look at Asia beyond China. Politics is getting increasingly important, but it is not the only driver for diversification from China. In many cases politics is not even the most important one. Sinolytics observed four main drivers for diversification. In many cases, more than one driver plays a role in corporate strategic planning:

- Pursuing market growth in Asia,
- Following relocating customers/clients,
- Geopolitical and domestic policy risk hedging,
- and operational gains.

Sinolytics analysis: 1/3 of the companies report de-risking as the key driver to look beyond China



Market potential and proximity to customers are the key drivers for business expansion into new Asian markets.

Among these, growing demand **and future market potential** of other Asian countries are the most significant factors for expanding business in Asia. These two reasons account for 42% of cases of adaptation. This is especially important for B2C firms in the home appliances and cosmetics sectors. They seek to be closer to their customers to design and deliver localized products.

Geopolitical risks and domestic uncertainties in China are the second most important reasons for diversification. Some companies that manufacture in China for the US market have relocated their facilities to Southeast Asia to circumvent punitive tariffs. China's pandemic controls were another key driver for diversification.

Fearing a backlash in the China market, many companies tend to be cagey when communicating publicly their reasons for changing strategy. However, companies frequently mention "US-China tensions", "trade sanctions", and "COVID disruptions" in their annual reports. They generally cite several goals for their strategic approaches including increasing supply chain resilience and boosting production and trade. But many of them plan to retain their current China operation, while at the same time exploring additional business opportunities or increasing investment in Southeast Asia and India.

Risk-hedging is catching up to business considerations in the decision to diversify…

Risk-hedging triggers such discussions inside companies. However, business considerations usually tip the scales.

Another 19% of the sampled companies reported expected **operational gains** in their consideration to move to other Asian markets. They cite rising costs and increasing competition in China. While not the prevailing factor, this has driven businesses with significant production or labor-intensive operations in China to explore more cost-effective alternatives. Stanley Black & Decker, an American industrial tools and home appliances company, closed its 25-year-old Shenzhen factory in 2020.[2] The company cited rising land and labor costs. The seemingly "sudden" closure had been in preparation for some time: workers recalled that the company had gradually shifted from direct export to the US to routing supply chains through Vietnam, using the latter as its final assembly center.

…as geopolitical tensions and sanctions translate into compliance costs or operational losses.

Finally, for B2B companies, **following their customer** is key to sustaining partnerships and growth. This accounted for 12% of analyzed cases. Their investment decisions are driven by downstream customers who have relocated. This applies to sectors such as electronics, automotive parts, machinery, textiles, chemicals and raw materials.

For example, when Apple announced in 2019 that it was exploring moving some of its China capacity to Southeast Asia, its contract manufacturer Foxconn started to follow suit by relocating iPad and MacBook manufacturing to Vietnam.[3] After the COVID-lockdown of its Zhengzhou factory in late 2022, Foxconn announced further investments in Vietnam and

[2] https://www.scmp.com/economy/china-economy/article/3108207/china-manufacturing-stanley-black-decker-shuts-shenzhen
[3] https://www.cnbc.com/2019/06/19/apple-explores-moving-15-30percent-of-production-capacity-from-china-nikkei.html

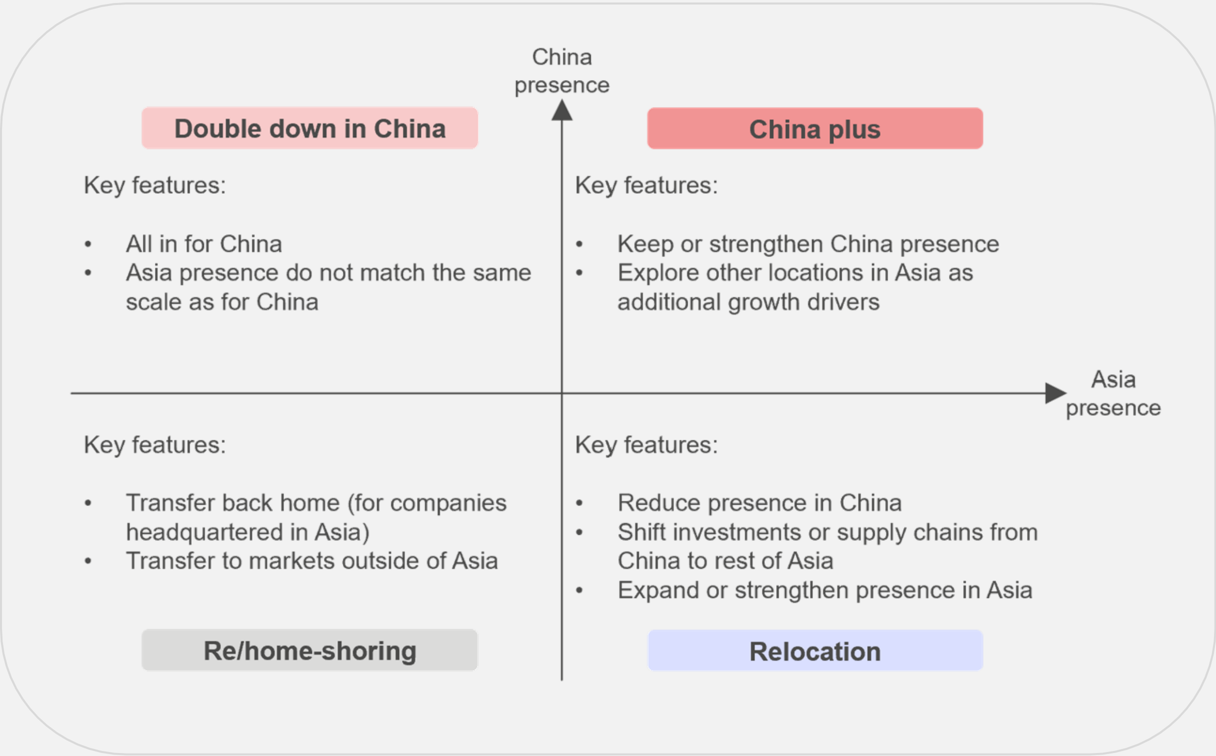
India. Other Apple suppliers moved to Southeast Asia as well, including Chinese ones such as Luxshare and Sunny Optical Technology.

Adaptation Strategies: “China Plus” most dominant

The above section explained why companies diversify from China. In this section we look at how they diversify. We find that companies employ four high-level strategies:

- The China Plus strategy maintains or strengthens a company’s current presence in China while exploring other locations;
- Relocation reduces a company’s China presence while expanding investment or supply chains in Asia beyond China;
- The “doubling down” strategy goes the opposite way by going all in for China. Many of these companies also have presence in other Asian countries but are nowhere near their commitment to the China market;
- Re-/Home-shoring refers to transferring supply chains back to the company’s headquarter country or to other markets outside of Asia.

Conceptual map: Four adaptation strategies based on China/Asia presence



Half of the companies from diverse industries chose “China Plus”: enhancing China presence while developing backups.

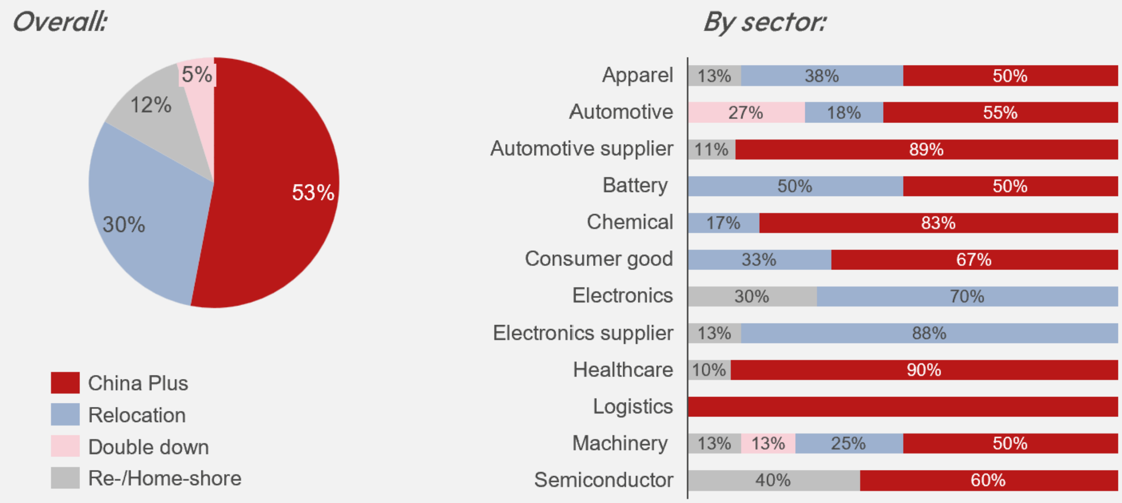
About half of the studied companies adopted a **China Plus** strategy. These companies operated in a diverse range of industries including in the automotive, machinery, chemicals, and healthcare sectors. The majority are medium-sized companies with an average annual group revenue of around 30 bn USD.

Another third, mainly from the apparel and electronics sector, chose **relocating** away from China as their preferred option. Geopolitical tensions resulted in export controls on a growing set of technologies including on semiconductor technology and catalyzed a gradual withdrawal from China. This has prompted a search for alternative manufacturing hubs. Especially production in China for US American and European markets is increasingly unsustainable.

Only 5% of the studied companies **doubled down in China** (“**localization**”). For these companies, there is no “second China” – the market is simply too big to ignore. In addition, many of them have invested in production facilities that are too costly to replicate somewhere else and/or have not achieved a full utilization rate yet. Localization of operations and supply chains is also a way of building more independent China entities and risk hedging against import disruptions from developed countries.

Adaptation strategies vary markedly by industry sector

Adaptations strategies observed



Lastly, about 12% of the companies chose "home-/re-shoring". Many of them are headquartered in Japan, South Korea, or Taiwan. Transferring assets back home has obvious advantages including increased operational efficiency, effective resource integration, and playing in a familiar market. Furthermore, such a move is often endorsed by their home governments and supported through a variety of policy interventions.

Below, we investigate how China Plus, relocation and doubling down work in practice and illuminate their strengths and weaknesses through case studies. We do not consider re/home-shoring as Asia is not a focus here for European and US companies.

Strategy 1: China Plus

"China Plus" diversifies risks, captures growth, yet faces challenges in geopolitical bifurcation and inadequacy of ASEAN markets.

The China Plus strategy is a balanced approach. As many companies rely heavily on China for sales and sourcing, leaving the market is not an option. At the same time, many companies feel that their position in China is challenged in the long term, either due to increased Chinese competition, discriminatory industrial policies, or the impact of geopolitical tensions.

China Plus is a strategy that allows MNCs to secure their China assets while diversifying risks and exploring new markets. This approach also avoids the potential economic and political repercussions from making a publicly visible "exit." For companies eyeing a long-term adjustment, China Plus offers a good defensive posture to extend the profit window in China while scaling to a critical mass in other markets.

While politics is a push factor, for most companies adopting China Plus, the market potential in Asia writ-large is the major pull factor. Some companies have incorporated diversification into their Asia strategy already in the 2010s (see Case Study of Japanese automotive OEMs below).

Others adopted China Plus not to capture growth opportunities, but as a response to challenges in the Chinese market. For example, faced with dwindling Chinese sales, Kia considered an investment to transform its China production facilities into a base for exporting to Southeast Asia, expanding into a regional market that is traditionally dominated by Japanese companies.

China Plus is not right for everyone. Industries highly dependent on China's market size may find that Southeast Asia does not offer sufficient demand. For companies that prioritize capital efficiency, it may be too costly to duplicate operational setups in Asia. While ASEAN's current balancing position between China and the US provides business opportunities, those countries may have to choose sides as geopolitical bifurcation intensifies.

Case study: Japanese OEMs and Chinese EV brands

Many Japanese OEMs have a strong presence in both China and Asia, especially Southeast Asia and India. For them, market growth is the key driver. Toyota, for instance, partnered with Chinese automaker FAW to establish a large electric vehicle factory in Tianjin. At the same time, Toyota has been planning strategic investments into Indonesia to elevate its position on electric vehicles with local technology partners.

The OEMs' diversification strategies also send a signal to their suppliers. For the latter, "following clients" is the primary driver behind the intensified engagement in Southeast Asia. But many smaller suppliers also face a dilemma when asked to localize supplies in Southeast Asia: while these markets may be too small to sustain the business expansion, failing to localize risks losing orders and client relationships.

Chinese electric vehicle OEMs in a way practice the China Plus strategy themselves: They are growing quickly in China but also seek to expand globally, including in Asia. BYD, SAIC and Great Wall Motor are eyeing the growing electric vehicle market in Southeast Asia as an opportunity, to "overtake" the Japanese OEMs. Local government subsidies (e.g.: from Thailand) have incentivized them to invest in local production plants. Recent sales data shows that 7 out of 10 top selling electric vehicle models in Thailand are Chinese brands.[4]

Strategy 2: Relocation within Asia

Companies relocate to mitigate risks and optimize costs.

Among the sampled companies, relocation within Asia is mainly driven by hedging in response to increasing geopolitical risks. The growing politicization of supply chains, either due to ESG concerns and technology competition, led many MNCs in affected sectors to seek alternatives to China. For instance, in the apparel industry, Puma cited U.S. tariffs and concerns about forced labor as primary drivers, while sportwear company Under Armour pointed to tensions arising from the U.S.-China trade war.

[4] https://autolifethailand.tv/

Cost structure optimization is another reason to relocate to other Asian countries. The comparatively cheap labor and continued economic and trade integration under the Regional Comprehensive Economic Partnership (RCEP) provide opportunities to streamline and build a more cost-effective supply chain. In this case, relocation is often carried out as a process of incremental adjustments: gradually suspending or downsizing unprofitable factories in China, selling off business segments to local partners, etc. This helps companies extend their profit windows while being on the lookout for new opportunities.

But China's established supplier network remains significant.

However, in many cases China's advanced technology ecosystem, skilled workforce, and established supply chains made Asia an inadequate replacement in comparison. Just as the Raytheon CEO said in an interview with FT, it is "impossible" to shift away from its thousands of suppliers in China[5]. While some parts of the production can be relocated to other regions, dependence on Chinese imports persists.

Relocation takes time. Unless a major global security conflict arises, substantial relocation is a process of decades, not years. Apple could deliver about 25% of its products from outside of China by 2025. But that means the other 75% remain dependent on China for the time being.[6]

Case study: Electronics industry

The biggest and most impactful relocation processes within Asia are taking place in the electronics industry. South Korean and Japanese giants such as Samsung, Sony, and Sharp adopted progressive relocation strategies in response to early political backlashes in China in the 2010s and, partially as a result of it, declining market shares in China.

Samsung and Sony progressively downsized smartphone production and closed remaining Chinese factories in 2019. Samsung transferred its smartphone production to Vietnam, while Sony chose Thailand. As of now, Samsung has become Vietnam's top foreign investor, boasting substantial facilities and employing over 110,000 people in the country. Nowadays, 60% of Samsung smartphones are made in Vietnam.

[5] https://www.ft.com/content/d0b94966-d6fa-4042-a918-37e71eb7282e
[6] https://www.reuters.com/technology/apple-may-move-quarter-iphone-production-india-by-2025-jpm-2022-09-21/

Case study: Textile and toys

Relocation is a trend that started in the textile industry as early as the 2010s and is now accelerating. Adidas down-sized sourcing for its footwear from China from 39% (2010) to 15% (2021). The company strengthened its sourcing from Cambodia and Turkey for example, while building its "speed factory" in Germany.

Toy makers are heading in the same direction: Hasbro for instance relocated much of its sourcing to Vietnam and India, reducing the China share from 68% in 2018 to 52% in 2022. Others are even further: German toy brands Ravensburger and Simba Dickie reduced their China exposure, with China supply for Ravensburger now being at only 10%.

Strategy 3: Doubling Down

The "doubling down" strategy involves ramping up investment in China as well as localizing supply chains and R&D. Whereas the China Plus approach seeks to establish a second pillar beyond China, "doubling down" does not involve significant diversification.

Despite increased interest in diversification, salChina's market remains crucial. Its sheer size and developed consumer bases continue to offer significant opportunities for businesses. Some consumer brands use the China market as a testing ground for new products before launching them in Southeast Asia. The increasing competitiveness of Chinese players and the changing profiles of Chinese Gen Z consumers – indifferent to "foreign" brand values – also pressure MNCs to localize. Many MNCs have chosen to develop China as their central production hub to serve the broader Asian market.

MNCs that adopted the "doubling down" strategy actively brand it as their long-term commitment to China. They can expect preferential policies and tailored government support that might be unattainable elsewhere. The government supports such companies as it seeks to counter declining inward FDI numbers and create employment opportunities. Being more localized also limits the vulnerability to trade sanctions of the US and its allies against China.

A dependency on this scale also creates supply chain and market risks when geopolitical tensions rise.

But the downsides are clear too. Dependency on the Chinese market exposes MNCs to considerable risks, especially given the volatility of the market and geopolitical uncertainties. While the Chinese government supports foreign investors for now, they could be driven out of the market by state-supported Chinese competitors in the long-term.

Lastly, economic and political engagement in China could turn into consumer backlashes or reputational damage in their home countries who increasingly view China unfavorably, potentially impacting group brand image.

Case study: German automotive OEMs

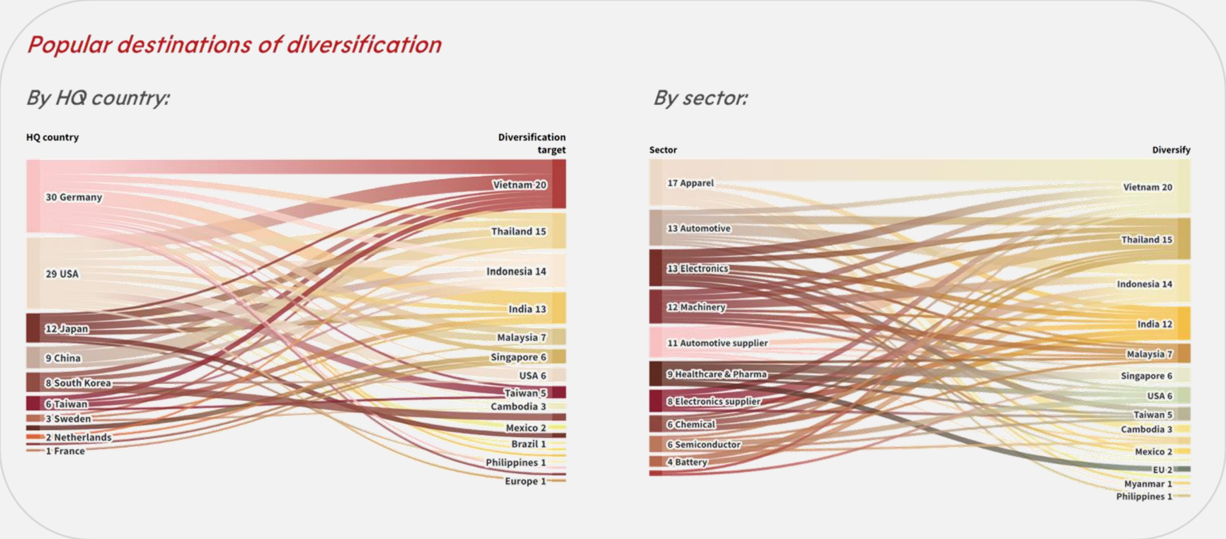
Despite growing geopolitical tensions and intensifying debates about economic decoupling, major automotive companies like Volkswagen and BMW remain steadfast in their long-term commitment to China, the world's largest automobile market. Volkswagen has over 40 production facilities in China. Meanwhile it has only one assembly center in Southeast Asia.

And it is looking to invest more to catch up to China's robust EV ecosystem. Volkswagen aims to expand its EV business, set up 17,000 charging ports in China by 2025 and invest 15 billion euros through joint ventures. These commitments stand in challenge of US and EU government efforts to de-risk from China economically.

Where are companies going?

While each one of the countries in Asia provides unique opportunities, Vietnam is by far the most popular destination in our sample. The country has become a manufacturing center for electronics and apparel sector. Samsung, for example, has built Vietnam into a key production hub for the regional market and has leveraged its billion-dollar investment for favorable policies and market conditions from the government in return.

Sinolytics analysis: Vietnam most attractive as diversification target



ASEAN countries provide unique strengths and industry opportunities. But Vietnam tops the list of diversification targets.

Thailand is an interesting market for consumer goods and the automotive industry. It also presents an opportunity for businesses seeking highly skilled and specialized workers.

Indonesia, with its rich nickel and cobalt reserves, is attracting many investments in the battery and electronics sectors, including Chinese battery material suppliers. Indonesia's relatively stable political environment, compared to some of its neighbors, provides an added layer of security for long-term investments. However, some companies are concerned about the country's regulatory complexities and bureaucratic hurdles.

Singapore is not traditionally considered a "cheap" manufacturing hub. But its sound infrastructure and specialized talent pool have attracted many production and R&D facilities from high-tech industries such as healthcare and pharma. The city-state's well-established legal and regulatory framework also make it an attractive destination for regional headquarters and corporate governance functions.

Recommendations

There is no one-size-fits-all for diversification beyond China. The specific strategy will depend on the industry, supply chain setup, and specific customer base of the business.

Through its close interactions with a broad set of clients, Sinolytics has identified the following best practices:

1. Assess your need

Who should be thinking about de-risking or diversification? In the current political environment, the option of diversification should be discussed in every board room. While this does not necessarily need to lead to major changes, you should know your risk and the pressure to diversify.

The pressure is even higher in two cases: If you are in what China sees as "strategic industries" (a broad set of high-tech industries). Or if you have critical dependencies on China in your supply chain, including the tier-X level.

Especially in strategic industries, be aware that China's industrial policies state a clear ambition for developing national product substitutions for some foreign imports. While there is a window for short-term growth, the long-term opportunities may diminish. This will be especially true if Beijing sees less and less value in a foreign business' contribution to national goals.

2. Leaving China is not a "yes or no" question

Leaving China is a question of "how to" and "to what degree".

There are good reasons to stay in China. China is still growing even if at a slower pace. The country boasts a mature system of suppliers and an increasingly globally competitive technology ecosystem. For businesses that have built and benefited from decades in China, leaving China is not a matter of "should or should not", but a question of "how to" and "to what degree".

Between a hard exit and an "all-in", there is a whole spectrum of responses to the China question. Companies can mix and match various strategies based on their specific needs: China Plus supports the identification of new promising markets; relocation provides cost optimization necessary to extend profit windows in China; doubling down, for example in R&D and innovation, enhances customer-centricity and product competitiveness.

3. Define your strategic goals

Define clear strategic goals to guide your diversification efforts.

Before deciding the "how", executives need to understand the "why": what are the strategic objectives that companies are trying to achieve? Assess whether the goal is to reduce market dependence, enhancing supply chain resilience, or another strategic motive. Diversification is also not an end in its own. Ask yourself if diversification will actually decrease your political and business risks.

Your strategic goals will guide the selection of new locations and the evaluation process of new hubs. The considerations are wildly different if the primary goal is to reduce costs versus to reduce political risk exposure.

Vietnam, for example, is emerging as a cheap manufacturing alternative to China, but the firms that moved away from China due to its political concerns would likely avoid Vietnam for the same reason.

4. Don't start from the scratch – build on your existing resources

Map and scale your resources in the region; allow for differences at the Business Group level.

Comprehensively map your current value chain within the region. This should include commercial functions (e.g. production) all the way to enabling functions (HR, regional headquarters). This will allow you to identify emerging manufacturing hubs, with a special focus on ecosystems emerging around your customer base. Your pre-established networks within the region will provide you with the essential go-to-market expertise and know-how. Moreover, by tapping into existing resources, you enhance operational efficiency and avoid unnecessary duplication.

5. Allow for differences at business level

For companies that operate across various industries, they may need an industry-specific or product-specific adaptation plan. This requires in-depth understanding of the Asian markets: the emerging industry clusters in different countries, unique business opportunities and risks that can vary for each business unit.

About Sinolytics

Sinolytics consults clients to successfully navigate in China's and Asia's policy-driven economy, providing strategic and management advice based on in-depth policy research, expert analysis and trend forecasting:

- Assess and forecast impacts of industrial policy and geopolitics in Asia
- Build strategies for engagement in China and diversification in Asia
- Ensure compliance with China's regulations

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