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國外第三方物流在中國之發展：探討合併與收購之進入策略

Expansion of Foreign 3PL in China: Evaluating the Entry
Strategy of Mergers and Acquisitions.



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Abstract

Main objective of this thesis is the analysis of foreign 3PL providers expansion in China, with special focus on their M&A activities. At the beginning, an introduction to logistics industry in China is provided, with emphasis on impact of market deregulation and infrastructure development. Consequently the condition of China's 3PL sector is examined, revealing its growth potential and introducing main players in the market. An introduction to M&A, including analysis of driving forces of mergers and acquisitions with emphasis on phenomenon of "guanxi" in China is provided as a background for the study. In order to examine the attractiveness of china's 3PL industry and the success strategies of foreign companies Michael Porter's five forces model and the value net model introduced by Adam Brandenburg and Bary Nalebuff will be applied.

Through examination of recent M&A deals of 3PL multinationals in China its main drivers and characteristics are determined. The thesis also includes an elaboration on the impact of those transactions on the Chinese logistics sector. Moreover, based on the framework introduced in 2nd chapter an analysis of competitive forces and growth strategies of foreign entrants in China's 3PL sector is conducted. Finally, several recommendations for multinationals operating in China including their market positioning and M&A execution are introduced.

Keywords: Third Party Logistics, Value Net Model, Five Forces Analysis, China, M&A

摘要

本論文之主要探討主旨即在分析國外第三方物流在中國的擴張，並且特別著力、聚焦在於對其併購活動的解析。首先，在緒論的部分，即介紹了中國的物流產業，並且強調市場管制鬆綁及基礎建設提升所帶來的影響。接著，便進入了檢視中國國內第三方物流的部分，此部分內容主要在揭露其未來成長潛力，並介紹目前市場中的主力公司。論文的內容中，亦將介紹合併與收購，並著重在探討中國市場上的“關係”現象，以分析促使其併購的驅動力，作為研究的背景。另外，亦將使用兩個常用於產業分析的模型：Michael Porter 的五力分析模型及 Adam Brandenburg 和 Bary Nalebuff 的價值網絡模型，以作為提供整篇研究理論架構的基礎，來檢視國外第三方物流在中國此產業之吸引力及外國公司之成功策略。

經由對於外國第三方物流的國際化擴張計畫在中國的購併行為之探討研究，即可看出促使其從事整體行動的驅動力以及其特色。此篇論文也將詳盡地闡述這些交易行為對於中國物流產業的影響。此外，根據第二章中所提供的架構，亦將介紹及分析外國第三方物流進入中國的競爭力與成長策略。並且，在論文的最終，針對企業國際化擴張進入中國市場經營的市場定位與合併、收購的執行歸結出數項建議。

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Chapter 1: Introduction

1.1 Background

Since the economic reform in 1980's China was the world's fastest growing major economy with growth rates averaging 10% over the last 30 years. This period of prosperity and growth was initiated by the government who decided to open the Chinese economy to the world. One of the major contributors to country's GDP growth in the first years of reforms was international trade. Obviously, exchange of goods with other economies implied the need for their physical flow, in other words - the need for logistics.

In general logistics refers to physical flow of goods, such as raw materials, components or finish products. It may also refer to related stream of information or funds that supports physical flows. Logistics, although often neglected in research, is one of the most important industries as it is complementary for virtually all sectors of an economy. Therefore highly developed and efficient logistics industry is one of the factors determining growth prospects of particular nations. Being important on a scale of a country suitable organization of logistics activities are also crucial for enterprises as consumers demand faster deliveries of cheaper and higher quality products. Therefore, efficient organization of logistics may result in sustainable competitive advantages that significantly affect position of company in the market. Nowadays enterprises can choose to handle their logistics activities in house or outsource it to external providers.

Currently they are five main models of logistics operations:

- First Party Logistics (1PL) - logistics activities are handled in house
- Second Party Logistics (2PL) - providers of simple services such as warehouse space or cargo shipment

- Third Party Logistics (3PL) - companies providing complete logistics solutions for particular logistic function
- Fourth Party Logistics (4PL) - companies providing complete logistics solution acting through integrating resources and capabilities of its own and other organizations to provide comprehensive supply chain solutions
- Fifth Party Logistics (5PL) - providing e- commerce supporting services beside 4PL activities

Logistics has become one the focus of Chinese government strategy since the announcement of 10th Five year plan in 2001. Many policies have been introduced to in order to modernize and increase the global competitiveness of the industry, including loosening restrictions for foreign enterprises. Consequently, government policies, economic development and increasing foreign trade led to rapid expansion of logistics sector. During the 11th five-year plan (2005-2010), the average annual growth of the sector reached 21%¹, boosting the value of total logistics in China to 125,4 trillion RMB. However the efficiency of the sector is still very low, when compared to results achieved by the peers. In 2010 costs of logistics accounted for 17,8 % of GDP whereas the same quotient for US economy stayed below 8%².

1.1.1 Main Players in China Logistics Industry

The main players determining the conditions in China logistics industry belong to three main groups: state owned enterprises, private companies and foreign entrants.

¹ ChinaScope Financial (Data), found online at http://www.lifunggroup.com/eng/knowledge/research/china_dis_issue82.pdf

²John D. Schulz, State of Logistics 2010: logistics costs fall 18.2 percent in 2010, http://www.logent.com/www.logisticsmgmt.com/article/state_of_logistics_2010_logistics_costs_fall_18.2_percent/

Prior to the 1990 "logistics" activities in Mainland China were limited to transportation and warehousing with market dominated by Chinese state-owned enterprises (SOEs) which operations focused on the most developed regions, such as Bohai, Yangtze and Pearl river deltas. Most important so called "top tier" companies at that time included China National Foreign Trade Transportation Co (Sinotrans), China Materials Storage and Transportation Co (CMST), China Ocean Shipping Company (COSCO), and China Post etc. They established branches in provincial capital and medium-sized cities that developed "2nd tier" players, that further set up more local "3rd tier" operators in small towns and cities. That process led to emergence of vertical organization of the industry that is still prevailing in today's China. These largest SOEs established during the 80's maintain a very strong position by controlling a vast majority of China's domestic logistics market. The outsourcing of logistics was very rare. China just started its transition towards the market economy and vast majority of business activities were based on the principles of planned economy copied from the USSR. Most of SOE's were responsible not only for their core operations but also many supporting activities such as providing housing or health care for the workers. The same rule applied to logistics, the companies mainly supported their own fleets and seldom engaged in transportation outsourcing.

Since 1980's, when china initiated its experiments with market economy private companies were allowed to engage in various business activities including operating vehicles and warehouses. Within the decade many traditional transportation or warehousing firms evolved into complete logistics companies. Most successful ones, such as PG Logistics Group (PGL) and Datian W. Group (DTW) operated at a national scale. China entered the age of so called modern "logistics" in the middle 1990's with help of foreign know-how brought by enterprises from developed countries flowing in to the market. However the services were mostly limited to integrated physical distribution, with very few companies

implementing Just-In-Time (JIT), Vendor Managed Inventory (VMI) and providing more sophisticated services such as supply chain management and consulting³.

In the early 1980's China's logistics sector was still in its infancy. One of the major growth constrain was lack of related know-how among domestic enterprises. In order to accelerate development of the sector the government decided to loosen restrictions for foreign entities. They were allowed to operate in Chinese market in form of joint -ventures with local partners to facilitate know - how and technology diffusion. Many multinationals entered China logistics industry in the early 1980's, however the main inflow took place in the 1990's. Nowadays majority of key players in the market have operations in China. At the beginning foreign companies were setting up representative offices in Shanghai or Beijing, mostly to gain more understanding of the Chinese market, especially political and cultural environment drastically different from the one in their home markets. The first major player to enter China was DHL, that set up an office in 1981. After spending five years on market research and preparations DHL started its business operations in 1986 in a joint - venture with Sinotrans, a state - owned giant focused on ocean shipping and freight forwarding. The company was a partner for other major courier service providers such as UPS, FedEx and TNT. Joint - venture was the sole method of entrance since China hadn't opened its logistics market and Sinotrans having a national network, with operations focused on export and import was a natural choice.

1.1.2 Process of China's Logistics market opening

On December 11, 2001, China has officially joined the World Trade Organization (WTO) and pledged to open its logistics market by 2005. Prior to that international logistics

³Xuepin Cen, The Dynamics of the China Logistics Industry, Master Thesis at Massachusetts Institute of Technology 2005 p. 17, found online at <http://dspace.mit.edu/bitstream/handle/1721.1/33311/62311725.pdf?sequence=1>

providers operations in China were rigorously limited. For instance: foreign entities were strictly not allowed to invest in road transportation sector; in the freight forwarding sector only joint - ventures with foreign minority stake were allowed with additional condition that the CEO of the enterprise will be a Chinese citizen⁴.

Figure 1 - 1 Evolution of regulations towards foreign logistics enterprises in China

Services	12/2004, Conditions	12/2005, Conditions
Maritime Services	Joint Venture Companies (JVCs) permitted to operate PRC-flagged fleet, foreign investment not to exceed 49%. Chair of the board and General Manager of the company shall be appointed by Chinese side.	
Marine Cargo Handling, Custom Clearance, Container Station & Depot Service	JVCs with foreign majority permitted	
Marine Agency	JVCs with maximum 49% of foreign investment	
Internal Water Transport	Not allowed. Only international shipping in ports open to foreign vessels permitted	
Freight Transport by Road	100% foreign equity permitted commencing 12/2004	
Freight Transport by Rail	Majority foreign equity permitted	100% foreign equity permitted commencing 12/2007
Warehousing & Storage, Packing	100% foreign equity permitted commencing 12/2004	
Courier and Parcel Services (except for those currently specifically reserved to Chinese postal authorities by law, namely letters)	Foreign majority allowed; international parcel and courier service only	Wholly foreign-owned subsidiaries permitted to handle international parcel and courier services; however, there is no clear indication that these company can or cannot deliver domestic parcels and couriers. That's a grey area that international players can take advantage of.
Freight Forwarding Agency	Foreign majority equity allowed, the foreign partner must have consecutive 3 years' experience.	100% foreign equity permitted

Source: Xuepin Cen, The Dynamics of the China Logistics Industry, Master Thesis at Massachusetts Institute of Technology 2005 p. 17,

⁴ Op. cit., p 19

<http://dspace.mit.edu/bitstream/handle/1721.1/33311/62311725.pdf?sequence=1>

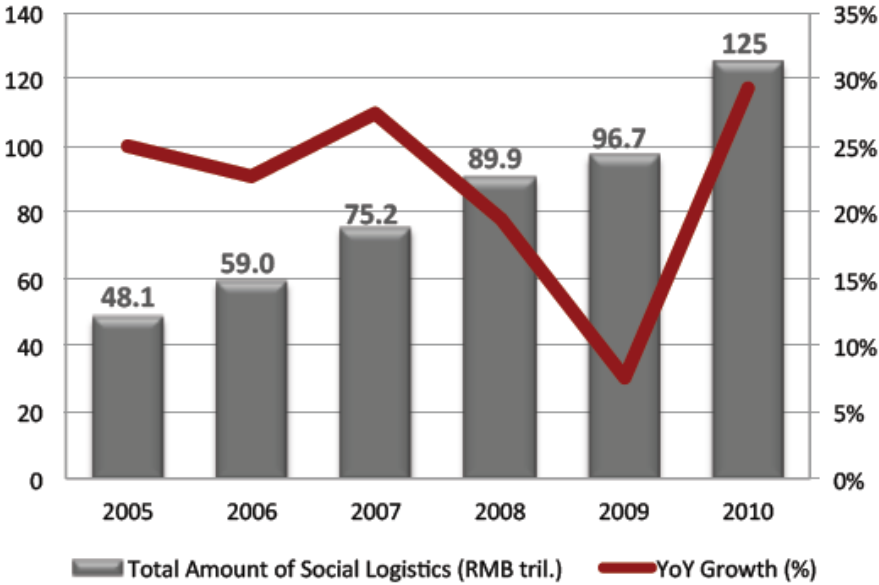
As stipulated in the WTO accession agreement, China has removed most of its restrictions on the logistics industry in 2005, opening the market to the international 3PL providers creating more opportunities for these companies in China.

1.1.3 Special Treatment for Hong Kong and Macau enterprises

Before relaxing restrictions for foreign entities, China had granted Hong Kong and Macau with favorable conditions for investment in the logistics sector. In 2003 CEPA (Closer Economic Partnership Arrangement) was signed and Hong Kong companies were allowed to operate as a wholly owned foreign enterprises. Moreover, the minimum registered capital level was decreased from 1 mln USD to 2 mln RMB, the same as for domestic companies.

1.1.4. Market Size of China Logistics

Figure 1 - 2 Value of China's logistics between 2005 - 2010



Source: China Federation of Logistics & Purchasing (CFLP)

Since the economic reform in the 1980s China was the world's fastest growing major economy with growth rates averaging 10% over the last 30 years. Economic development and

increasing foreign trade led to rapid expansion of logistics sector. During the 11th five-year plan (2005-2010), the average annual growth of the sector reached 21%⁵, boosting the value of total logistics in China to 125,4 trillion RMB.

Figure 1 - 3 The total value-added of the logistics industry, 2006-2010

Year	Total value-added (billion yuan)	yoy growth	Share in the tertiary industry	Share in GDP
2006	1,412.0	15.1%	16.7%	6.7%
2007	1,792.5	22.5%	16.6%	6.7%
2008	2,152.8	20.1%	16.4%	6.8%
2009	2,310.0	7.3%	16.1%	6.9%
2010	2,700.0	16.7%	16.0%	6.9%

Source: China Federation of Logistics & Purchasing (CFLP)

The nominal value added reached 2,700 billion RMB after a 17,6% percent average growth during the period. Its relative contribution to services sector remains stable, which indicates that logistics has developed on a par with the rest of the tertiary industry⁶.

Since, China is widely reckoned as a world factory, the logistics value of industrial products accounted for a enormous share of 90.2% of the total market value in 2010. In contrast, imported products had only 7,5% percent of the sector.

⁵ ChinaScope Financial (Data), found online at http://www.lifunggroup.com/eng/knowledge/research/china_dis_issue82.pdf

⁶ Op. cit., p 7

Figure 1 - 4 China's total logistics value by category, 2010

	Value (billion yuan)	yoy growth	Share
Agricultural products	2,236	4.3%	1.8%
Industrial products	113,103	14.6%	90.2%
Imported products	9,431	22.1%	7.5%
Recycled materials	446	39.5%	0.4%
Commercial and personal products	198	14.7%	0.2%
Total	125,413	15.0%	100.0%

Source: China Federation of Logistics & Purchasing (CFLP)

1.1.5 Logistics' efficiency

Despite its continuous and rapid growth, China's logistics industry is still very inefficient. It is reflected by a relatively high ratio of logistics costs to GDP. Although the quotient decreased from 18.3 % in 2006 to 17.8% in 2010 it is still twice as high as those in most developed countries (e.g. USA: 7.7% in 2010⁷, EU 8% in 2007⁸) which implies that there is still huge room for improvement in efficiency of China's logistics industry.

Another factor that reflects continuous progress is decreasing average inventory period, from 51.95 days in 2008 to 48.94 days in 2009 for industrial enterprises and from 42.26 days to 40.11 for commercial entities. Low efficiency comes mainly from high degree of fragmentation in the industry. Vast majority of China's roughly estimated 700,000 logistics firms are single-truck operators. Although decreasing share of management expenses in total cost of logistics is a proof of progressing consolidation, current level of concentration in the

⁷ John D. Schulz, State of Logistics 2010: logistics costs fall 18.2 percent in 2010, found online at http://www.logisticsmgmt.com/article/state_of_logistics_2010_logistics_costs_fall_18.2_percent/

⁸ Dominic Regan, Taking control of global logistics, Manufacturing and Logistics, May 2007, found online at <http://www.logisticsit.com/articles/2007/05/17/2805-taking-control-of-global>

industry is still very low and shows high potential for further Mergers and Acquisitions (M&A).

Figure 1 - 5 The total logistics cost as a percentage of GDP, 2006-2010



Source: China Federation of Logistics & Purchasing (CFLP)

Figure 1 - 6 Share in logistics total cost

	Share in logistics total cost				
	2006	2007	2008	2009	2010
Management	13.2%	12.7%	12.7%	11.9%	12.1%
Inventory	32.1%	32.9%	34.7%	32.8%	33.9%
Transportation	54.7%	54.4%	52.6%	55.3%	54.0%

Source: China Federation of Logistics & Purchasing (CFLP)

1.1.6 Infrastructure Development

Efficient transport infrastructure is a key stimulant of economic growth and since 1980's it was a priority for Chinese government. In 2010 infrastructure spending accounted for 9% of Chinese GDP, a much higher quotient comparing to the 2,4% in the US and 5% in

EU⁹. Similar to the majority of developed countries road is still the most important mode of transport and attracts highest capital investments from the government. However it's position is not as dominant as in Europe and administration consequently increases spending on more cost-effective modes such as rail or water transport.

Figure 1 - 7 China's fixed assets investment in major modes of transport, 2008-2009

Mode of transport	Fixed assets investment (billion yuan)	
	2008	2009
Highway	741.2	1,055.8
Railway	407.3	666.1
Water	120.4	167.1
Air	59.1	60.5

Source: National Bureau of Statistics in China (NBS)

Figure 1 - 8 Freight traffic and total freight tonne-km by transport mode, 2008-2009

Mode of transport	Total freight traffic (million tonnes)		Total freight tonne-kilometers (billion tonne-km)	
	2008	2009	2008	2009
Road	19,167.6	21,278.3	3,286.8	3,719
Railway	3,303.5	3,333.5	2,510.6	2,524
Water	2,945.1	3,190.0	5,026.3	5,756
Air	4.1	4.5	12.0	12.6

Source: National Bureau of Statistics in China (NBS)

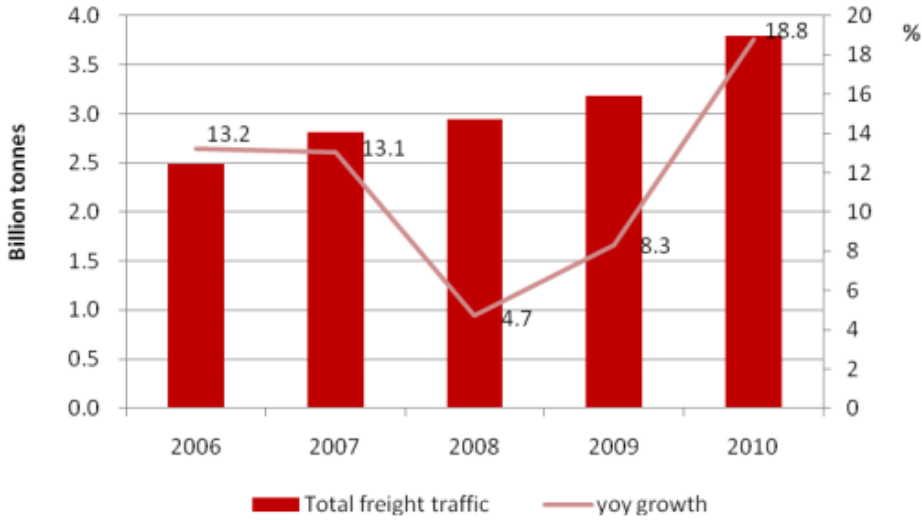
Sea

Since 1980 improving transport infrastructure has always been a priority for the Chinese government. In the first years of pro - market economy reforms administration efforts were focused of enhancing the capacity of Chinese sea ports to facilitate growing export from

⁹ Life in the slow lane, The Economist, April 2011, found online at <http://www.economist.com/node/18620944>

coastal cities. Nowadays China is home to six out of ten busiest container ports in the world (Shanghai, Hongkong, Shenzhen, Ningbo, Guangzhou, Qingdao). Since 1990's, in order to support its development polices (Rise of Central China Plan, China Western Development), the government extensively invested in inland waterways network that with 124,000 km length is currently the biggest system in the world. It's backbone, Yangtze River serves as a main route providing connection to important commercial hubs of central China such as Nanjing, Wuhan and Chongqing.

Figure 1 - 9 Total waterway freight traffic 2006-2010



Source: National Bureau of Statistics in China (NBS)

By 2020, according to the National Plan for Inland Waterways and Ports Layout inland waterways are expected to connect 56 cities with population of over 500,000 people including capitals of provinces such as Nanchang and Changsha¹⁰.

Rail

¹⁰ China Distribution & Trading, Issue 58, April 2009, Li & Fung Research Centre, found online at http://www.lifunggroup.com/eng/knowledge/research/china_dis_issue58.pdf

Whereas seaports were built mostly to serve China's International Trade, the country also needed to develop infrastructure for its internal needs. Rail is one of the most important transport modes in China, used mostly to carry bulk commodities such as coal, iron ore, metals or grain¹¹.

Figure 1 - 10 Main commodities transported by rail in 2009

Products	Freight Traffic (million tonnes)
Coal	1220.8
Metal ores	275.8
Iron & steel and non-ferrous metal	215.9
Petroleum	127.0
Grain	104.7

Source: National Bureau of Statistics, PRC

Figure 1 - 11 Total railway freight traffic 2006 - 2010



Source: National Bureau of Statistics in China (NBS)

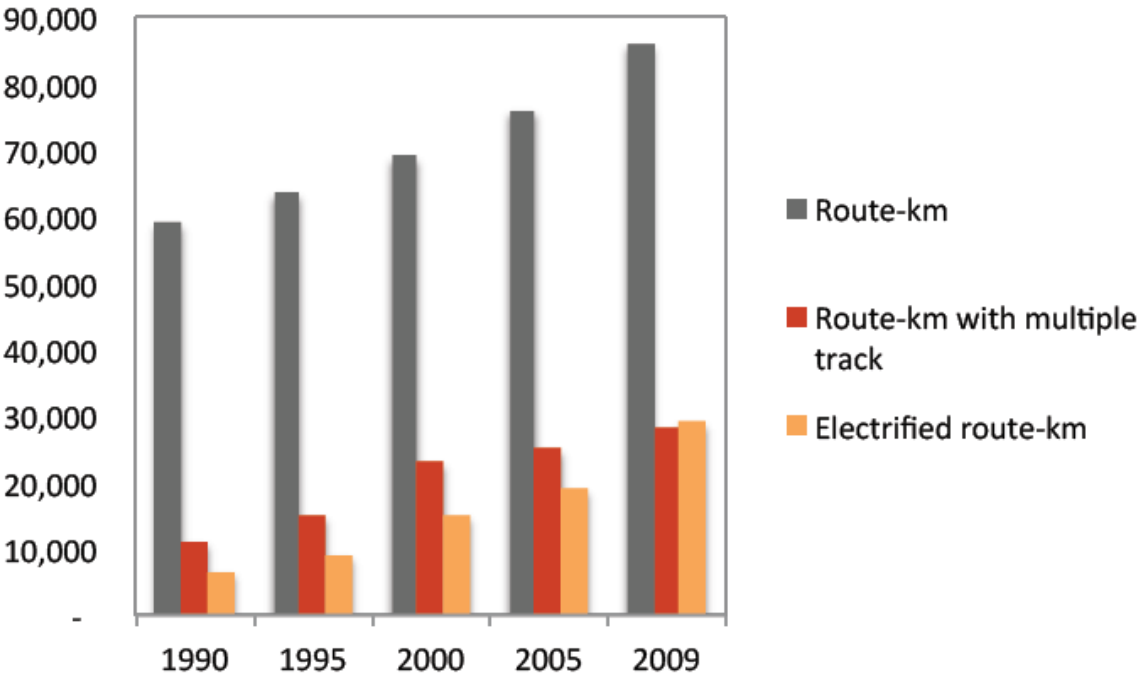
Similar to other parts of infrastructure its condition was very poor when the country embarked on the path of reforms. The fact that steam engines were still very common on Chinese tracks during 80's and 90's reflects the level of rail infrastructure development. Therefore, during the last 30 years government had made a great effort In order to improve its

¹¹ Peder Andersen, Rolling Stock: Locomotives and Rail Cars, United States International Trade Commission, found online at <http://www.usitc.gov/publications/332/ITS-08.pdf>

condition. Electric and diesel engines gradually replaced steam locomotives, old tracks were electrified and upgraded to enable higher speeds, therefore increasing network's capacity. Furthermore, many kilometers of new tracks has been built. In the 90's, an average of 1092 km of tracks was built, and additional 1799 modernized. The construction speed up in the 21st century. Only in 2011 further 7,935 of new railways has been added extending the country's network to 99 000 kilometers¹². After the 2008 crisis, the government has invested enormous amounts of capital in high speed rail as a part of 4 trillion RMB economic stimulus package. Currently, China is already home to the world's biggest HSR network with approximately 10 000 kilometers. According to the newest development strategy, China's railways will reach 120,000 kilometers by 2015, 16,000 kilometers of which will be high speed rail lines.



Figure 1 - 11 Length of railway tracks in China 1990 - 2009



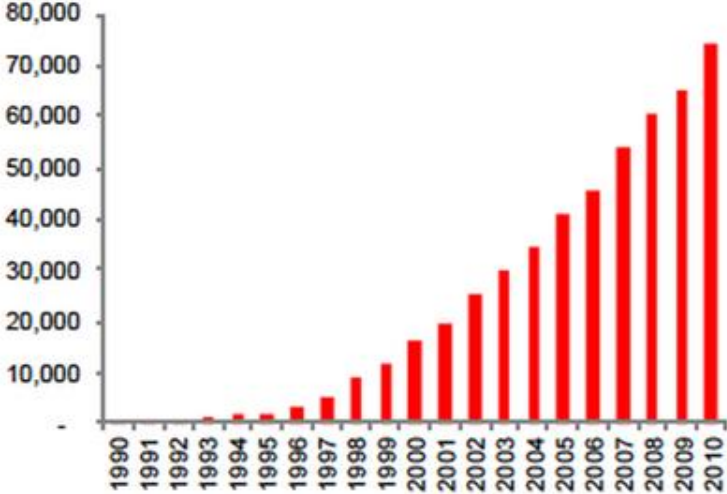
Source: National Bureau of Statistics in China (NBS)

¹² Caixin Online, China's Railway Minister Removed from Position, February 2011, found online at <http://english.caixin.com/2011-02-14/100225416.html>

Road

In the first 15 years of reforms the government focused on development of coastal regions and major seaports. This policy has left China's road network was heavily underfunded and its poor standards was a major obstacle in transporting the goods from and into the country's interior. It was until late 90's when the government switched its priority to road infrastructure. Within two decades China managed to construct an expressway network reaching 85000 km, an engineering project comparable only to American National System of Interstate and Defense Highways launched by Dwight D. Eisenhower in 1956. Having already developed a core of its inter-provincial network the priority in the current 12th Five - Year Plan has switched to local roads. Comparing to western standards China's rural roads are severely underdeveloped, around 1200 townships and 120 000 villages had no paved roads in 2010¹³. Poor infrastructure creates serious bottlenecks and leads to disconnection of rural areas from the country's and global economy. To improve this situation the government plans to provide pave road connections to all townships and 90% villages by 2015.

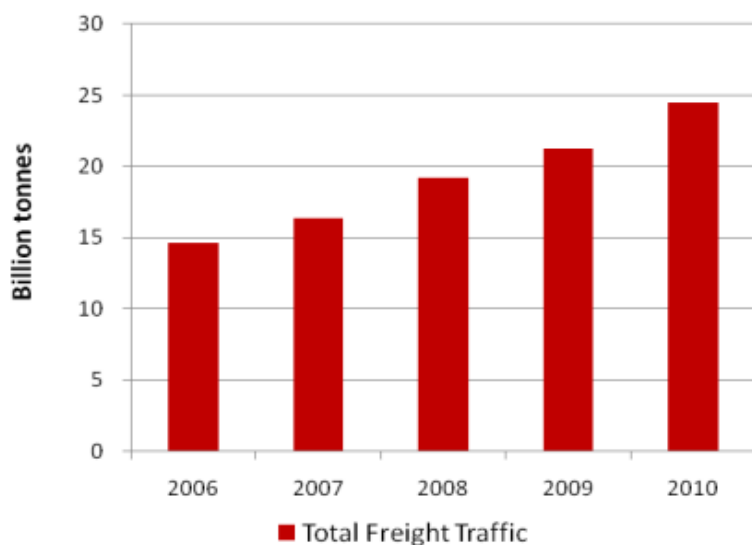
Figure 1 - 12 Evolution of Chinese expressway network (length in km)



Source: National Bureau of Statistics in China (NBS)

¹³ China's 12th Five Year Plan: Transportation and Logistics, KPMG, April 2011, found online at <http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/China-12th-Five-Year-Plan-Transportation-Logistics-201104.pdf>

Figure 1 - 13 Total highway freight traffic 2005-2010



Source: National Bureau of Statistics in China (NBS)

Air

In the last 20 years, air cargo has been definitely one of the fastest growing modes of transport in China with 12 fold expansion between 1990 and 2009¹⁴. Before 2000, inadequate infrastructure has been a major obstacle to the emergence of the Chinese air freight logistics industry. In the early 1990s, only 10% of airports were designed to accommodate large aircrafts and cargo terminals could only handle 65% of potential demand¹⁵. In order to eliminate the bottlenecks and facilitate both domestic and foreign trade the government invested massive amount of 370 billion RMB in airport infrastructure between 1990 and 2010¹⁶. In 2011 China had 195 airports in operations including two of three busiest airports in the world by cargo volume (Shanghai, Hong Kong). Civil Aviation Administration of China

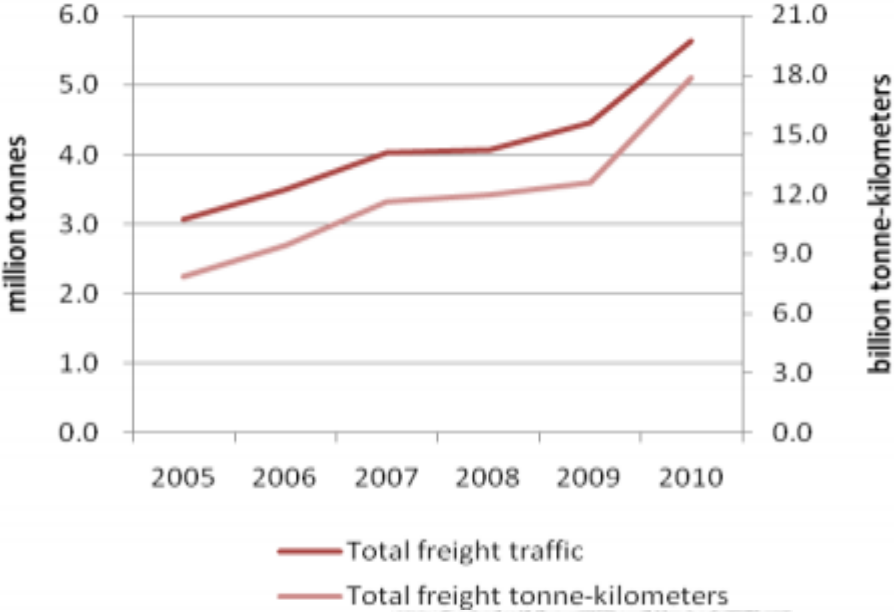
¹⁴ Lilian Chan, Emerging Markets Propelling Air Cargo, Presentation to CNS, May 2011 found online at <http://www.cpsc.net/events/Documents/Lilian-Chan.pdf>

¹⁵ Fung Ka-yiu, Zhang Anming, Leung Chi-kin, Sebastian Japhet Law, The Air Cargo Industry in China: Implications of Globalization and WTO Accession, July 2005, found online at <http://www.baf.cuhk.edu.hk/research/aprc/activities/files/ChinaAirCargoJuly05.pdf>

¹⁶ YANG Xiuyun & YU Hong China's Airports: Recent Development and Future Challenges, May 2010 found online at <http://www.eai.nus.edu.sg/BB526.pdf>

(CACC) has plans to enlarge the network to 230 airports by 2015¹⁷ with total value of future investments in aviation industry reaching 1,5 trillion RMB. Due to planned expansion by 2020 aviation services will be accessible for 82% of the total population that is responsible for 96% of the national output.

Figure 1 - 14 Total freight traffic and total freight kilometers 2005-2010



Source: China Federation of Logistics & Purchasing (CFLP)

1.2 Motivation and objectives

In 2011 China has overtaken Japan and became the world's second biggest economy. There are no doubts among the leading economists that subsequently, China will take the place of USA as the biggest worlds economy, the only question left to answer is when? However, as mentioned in the background part, even though Chinese government introduced various policies aiming to increase the competitiveness of its logistics industry its efficiency is still very low compared to the levels observed in developed countries.

¹⁷ Lilian Chan, Emerging Markets Propelling Air Cargo, Presentation to CNS, May 2011 found online at <http://www.cpsc.net/events/Documents/Lilian-Chan.pdf>

One of the measures the government implemented to increase the efficiency level of logistics industry is loosening restrictions toward foreign entrants. Logistics multinationals started establishing their presence in Chinese market as soon as in the middle 1980's. However it is the change of the government policy related to China accession to WTO in 2001 that marked the beginning of big - scaled inflow of foreign players to China's 3pl market. Many the companies have decided to enter the market through an M&A with a local partner.

Main objective of the thesis is determining the success strategies for foreign 3PL entrants in China market, including their entry mode as well as subsequent market positioning. The special focus will be put on M&A activities of foreign multinationals, analyzing benefits stemming from this particular mode of entry.

1.3 Methodology and scope

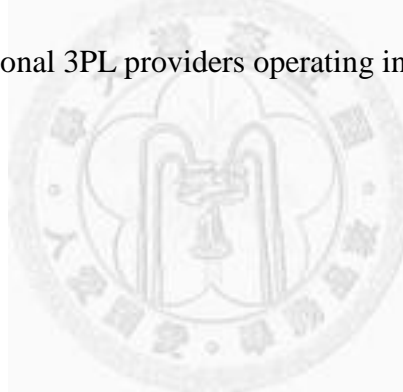
The thesis will focus on analyzing 3PL industry in China including such aspects as business strategies of foreign entrants and key factors determining their success. In order to examine the attractiveness of china's 3PL industry Michael Porter's five forces model enhanced by adding complementors to the analysis will be applied. The value net model introduced by Adam Brandenburg and Bary Nalebuff will be used to examine the success strategies of foreign companies operating in the 3PL industry in China.

Data and information used in the thesis were collected from many sources such as: discussion with the thesis advisor, publication and market research, papers related to industry analysis, interviews with key people in the 3PL industry as well as personal knowledge of the sector.

1.4 Thesis structure

The thesis will consist of five chapters. Chapter one includes introduction of china logistics background, basic overview of 3PL business, motivation and objective of this thesis as well as methodology and scope of research.

Second chapter will introduce theoretical frameworks applied during the analysis. Chapter three will be a thorough analysis of logistics industry in China, with particular emphasis on 3pl sector. Moreover, current trends in the industry as well as evolution of government regulations will be introduced in this part of thesis. Chapter four will be an analysis of market entry strategies and market positioning of foreign 3PL providers with particular focus on their M&A activities. Conclusion of the research as well as some recommendations for multinational 3PL providers operating in china will be included in chapter five.



Chapter 2: Literature Overview

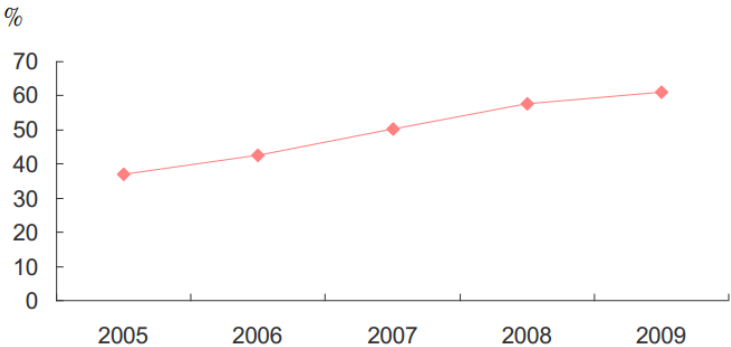
2.1. China Third Party Logistics Overview

Outsourcing of logistics operations is a very common practice in developed economies. Hiring specialized 3PL firms to handle logistics activities enable companies to leverage their resources, spread risks and concentrate on issues critical to survival and future growth. Outsourcing not only reduces the complexity of firms operations, but also significantly reduces capital investments. Along with China economic development, companies are growing in size and engaging in increasingly sophisticated activities. Moreover, due to gradually loosening restrictions for foreign enterprises competition on the market has risen significantly leading to higher pressures for costs optimization. Those changes of business environment together with increasing amount of 3PL providers has resulted in rising popularity of logistics outsourcing among Chinese managers.

2.1.1. Rising outsourcing ratio for both commercial and industrial enterprises

The chart below illustrates steady growth of logistics outsourcing quotient between 2005 and 2009 reaching 61,2% at the end of the period¹⁸.

Figure 2 - 1 Outsourcing rate of Chinese enterprises between 2005-2009

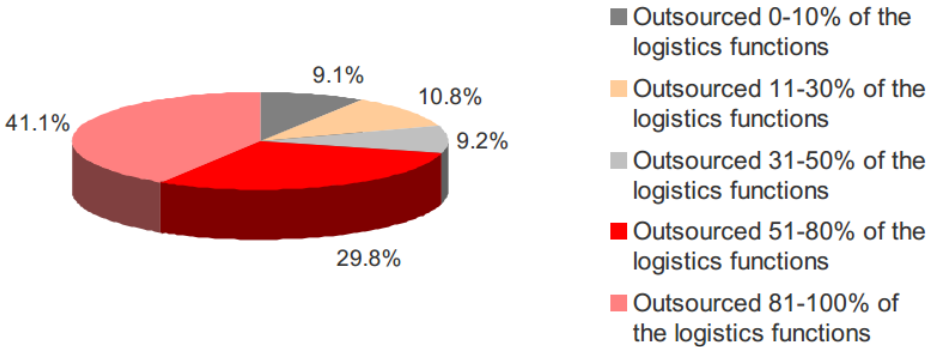


Source: NRDC and Nankai University

¹⁸ Li&Fung Research Centre, China's Logistics Industry Update, May 2011, found online at http://www.lifunggroup.com/eng/knowledge/research/china_dis_issue82.pdf

Based on data published by NDRC and Nankai University, among the companies participating in the survey, over 70% outsourced at least half of their logistics functions by volume in 2009. In addition, 41,1% of enterprises included in the study outsourced over 80% of their logistics operations to third party providers. Data collected by the survey reflects growing importance of outsourcing concept for both commercial and industrial enterprises in China. The fact, that majority of the companies turning to outsourcing does it with a significant fraction of its logistics operations is a proof that once a firm had experience with hiring 3PL providers, the management quickly realizes its benefits and increases the volume of outsourced activities.

Figure 2 - 2 Proportion of logistics functions outsourced to total logistics volume, 2009



Source: NDRC & Nankai University

2.1.2 Types of Outsourced Activities

According to the survey, basic functions such as transport and distribution were the ones most often outsourced by the Chinese enterprises, with significantly less emphasize on more sophisticated activities such as logistics system design or inventory management. However, based on information provided by the respondents this trend is likely to reverse in the upcoming years. When asked, what activities would be considered for outsourcing in the future, majority picked more advanced logistics functions such as logistics information

management of logistics system design. This trend can be seen as another evidence of growing acceptance for logistics outsourcing among Chinese enterprises.

Figure 2 - 3 Types of logistics services outsourced, 2009

	Proportion of industrial and commercial enterprises surveyed
Transportation	42.6%
Distribution	38.3%
Logistics information management	15.6%
Warehousing	15.5%
Logistics system design	10.7%
Packaging & processing	13.5%
Inventory management	5.4%
Others	2.1%

Source: NRDC and Nankai University

Figure 2 - 4 Types of logistics services to be outsourced in the future, 2009

	Proportion of industrial and commercial enterprises surveyed
Logistics information management	37.5%
Logistics system design	24.0%
Packaging & processing	16.7%
Warehousing	12.5%
Inventory management	8.3%
Distribution	8.1%
Transportation	4.2%

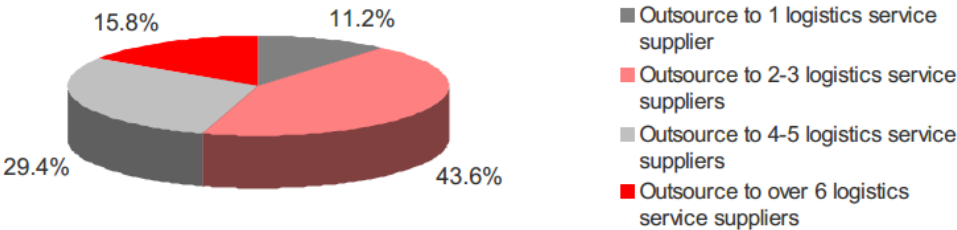
Source: NRDC and Nankai University

2.1.3 Number of Logistics Service Suppliers

According to the survey conducted by NDRC and Nankai University Chinese enterprises tend to outsource their logistics activities to more than one supplier. Companies outsourcing to an optimal number of providers are able to reduce transaction and risk by increasing bargaining power. Moreover, they can use services of companies specializing in

certain field of logistics. Based on the data provided by survey, it is observable, that more than 73% enterprises decided to outsource their logistics operation to 2 between 5 suppliers. Only 15,8% hired more contractors, since bigger number could result in higher transaction costs and complexity.

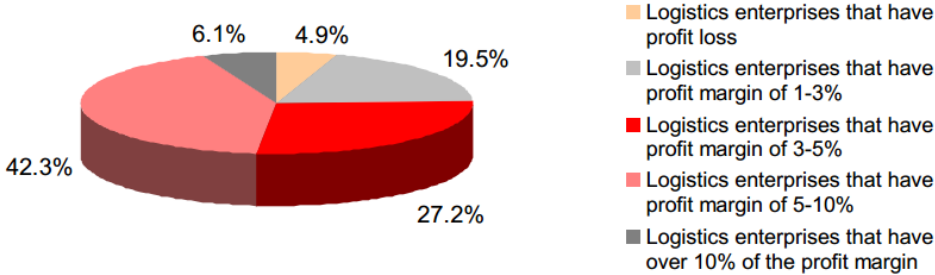
Figure 2 - 5 Number of Logistics Service Suppliers



Source: NRDC and Nankai University

2.1.4. Profitability of logistics companies.

Figure 2 - 6 Profitability of Chinese logistics companies in 2009



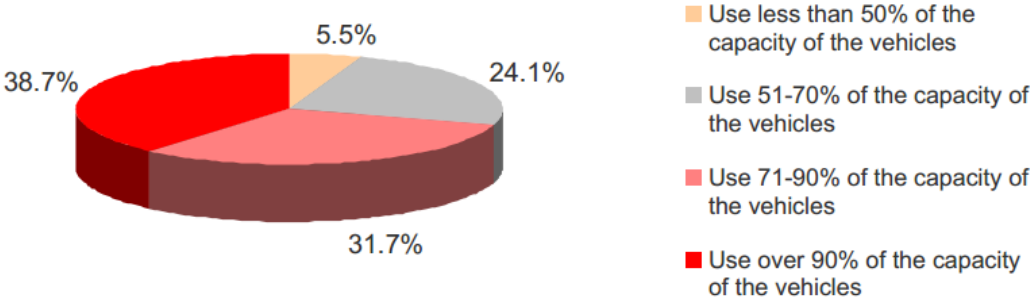
Source: NRDC and Nankai University

Based on data provided by the 8th National Survey on Logistics Market by the NDRC and Nankai University, approximately 42 % of logistics firms reached a profit margin of 5-10%, whereas 27.2% indicated a profit margin between 3-5% in 2009. Moreover, according to the The 2010 National Statistical Survey Report on Logistics of Key Enterprises by the

NDRC, National Bureau of Statistics (NBS) and CFLP Chinese logistics companies recorded average profit of 6.0% in 2009.

One of the most critical factors determining profitability of logistics companies is vehicle utilization rate. According to the survey In 2009, only 38,7% of the enterprises managed to fill over 90% of the capacity of their vehicles, whereas 70.4% of them exceeded 70% utilization rate. A decrease from 73.4% is observed when comparing to data from 2008.

Figure 2 - 7 Vehicles utilization rate of Chinese logistics companies in 2009

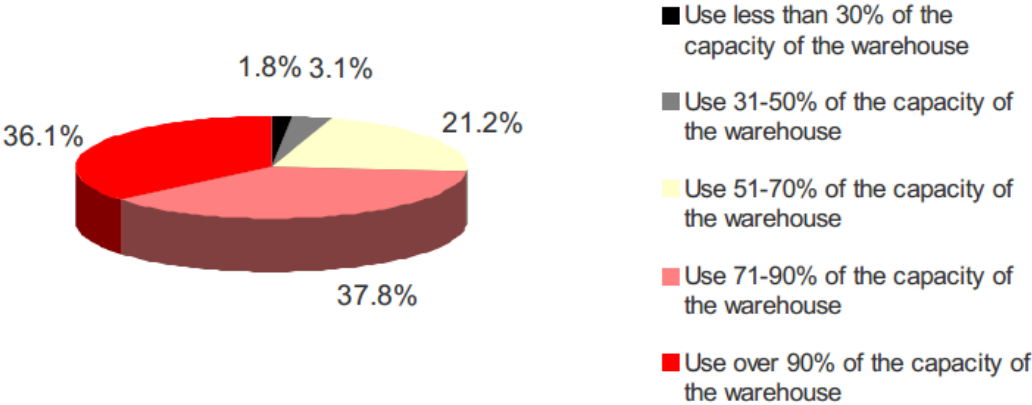


Source: NRDC and Nankai University

Warehouse utilization rate is an another factor with critical impact on profitability in logistics sector. According to the survey only 36,1% third party providers managed to use more than 90% of their warehouse capacity in 2009, whereas 73.9% of the surveyed enterprises employed over 70% of the capacity, indicating a drop from 75.0% and 78,1% in 2008 and 2007 respectively.

Generally, logistics enterprises in China show rather low levels of profitability, however 2009 results were severely affected by the financial crisis. Due to sharp decline in demand many ships and trucks remained idle resulting in cost escalation and as a result, poorer financial performance.

Figure 2 - 8 Warehouse utilization rate of Chinese enterprises in 2009



Source: NRDC and Nankai University

2.1.5 Scale of leading 3PL providers in China

Figure 2 - 9 Size of 3pl providers in China

Number of logistics enterprises with sales revenue	2007	2008	2009
Exceeding 1 billion yuan	43	43	50
Exceeding 2 billion yuan	28	28	32
Exceeding 3 billion yuan	24	23	24

Source: CFLP

According to data provided by CFLP, there were already 50 logistics companies with revenue exceeding 1 bln RMB in 2009, comparing to merely 34 in 2004. Total revenue of the top-50 logistics companies in China reached 450.6 billion RMB in 2009. Although, Chinese 3PL show strong growth in domestic market, only one of them - Sinotrans have entered the global top 10. However, if ranked by fleet size, 3 sea freight companies, COSCO Container L. (中遠集裝箱運輸有限公司), CSCL (中海集裝箱運輸股份有限公司), OOCL (東方海外) are among 20 biggest container shippers in the world.

Figure 2- 10 Top 20 logistics providers in china by revenue in 2009

Ranking	Enterprises	Sales revenue in 2009 (billion yuan)	Ranking	Enterprises	Sales revenue in 2009 (billion yuan)
1	China Ocean Shipping (Group) Company 中國遠洋運輸集團總公司	104.62	11	Shuohuang Railway Development Co. Ltd. 朔黃鐵路發展有限責任公司	8.75
2	SINOTRANS & CSC Holdings Co. Ltd 中國外運長航集團有限公司	71.62	12	China Railway Container Transport Co. Ltd 中鐵集裝箱運輸有限責任公司	8.19
3	China Shipping (Group) Company 中國海運集團總公司	44.60	13	China Railway Express Co. Ltd 中鐵快運股份有限公司	7.24
4	Kailuan Group 開灤集團國際物流有限責任公司	27.47	14	The S.F. Express Company 順豐速運（集團）有限公司	6.44
5	China National Materials Storage and Transportation Corporation (CMST) 中國物資儲運總公司	17.74	15	Beijing Huayou Natural Gas Co. Ltd, CNPC 北京華油天然氣有限責任公司	6.07
6	Xiamen Xiangyu Group Co. Ltd 廈門象嶼集團有限公司	16.98	16	International Cargo Transport Limited of China 中國國際貨運航空有限公司	5.33
7	China Railway Material Company 中鐵物資集團有限公司	14.08	17	Yunnan Logistics Industry Group 雲南物流產業集團有限公司	5.16
8	Jizhong Energy Group Co. Ltd. 冀中能源峰峰集團邯鄲鼎峰物流有限公司	11.16	18	SINOPEC Pipeline Transport & Storage Co. 中國石油化工股份有限公司管道儲運分公司	4.47
9	China Petroleum Transportation Corporation 中國石油天然氣運輸公司	10.01	19	Shandong International Transportation Corporation Maritime (Group) Co. Ltd 山東海豐國際航運集團有限公司	4.74
10	Henan Coal and Chemical Industry Group Co. Ltd. 河南煤業化工集團國龍物流有限公司	8.81	20	Chongqing Port Logistics Group Co. Ltd 重慶港務物流集團有限公司	4.01

Source: Li&Fung

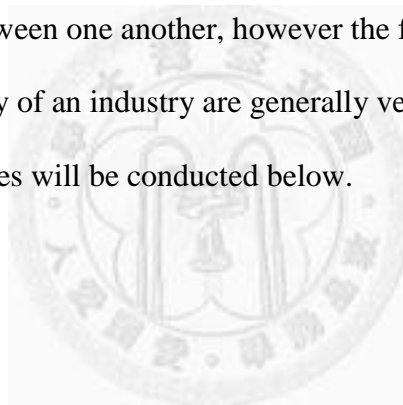
Figure 2 - 11 Top 15 global 3PL providers by gross revenue

Ranking	Enterprise	Gross Revenue mIn USD
1	DHL Supply Chain & Global Forwarding	30,486
2	Kuehne + Nagel	19,476
3	DB Schenker	18,999
4	Nippon Express	18,450
5	C.H. Robinson Worldwide	9,274
6	Ceva Logistics	9,091
7	UPS Supply Chain Solutions	8,670
8	DSV	7,587
9	Panalpina World Transport	6,887
10	Hyundai Glovis	6,303
11	Sinotrans	6,286
12	Bollere/SDV Logistics	6,163
13	Expeditors International of Washington	5,968
14	Geodis	5,578
15	Toll Holdings	5,303

Source: www.3plogistics.com

2.2 Five forces analysis

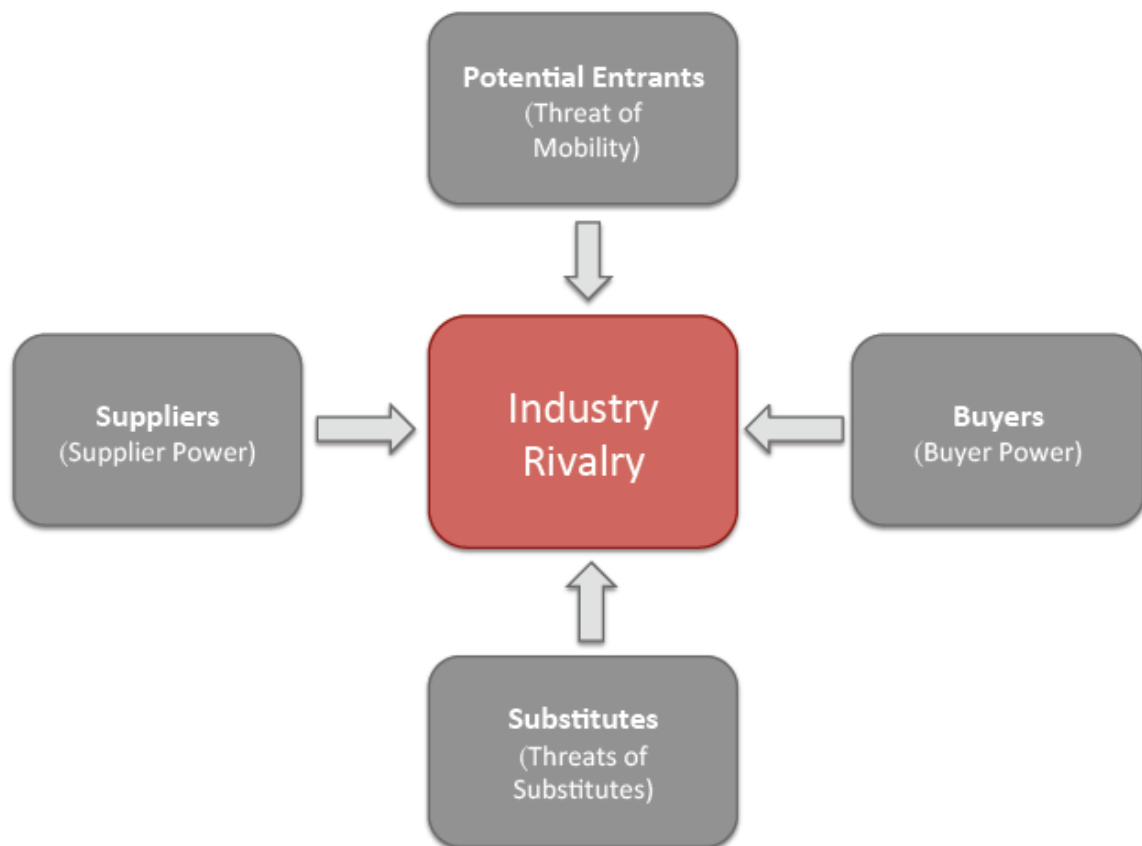
Five forces analysis is a popular model used during the decision process concerning entering an industry, and determining the positioning of a company within a sector. The framework helps to identify the levels of the competition and the potential profitability of the industry¹⁹. The five forces model was developed by a professor of Harvard Business School Michael Porter in the year 1979²⁰. It analyzes the impact of five competitive forces on the profitability of the industry. The model includes three horizontal competitive forces coming from potential entrants, substitutes, and established competitors as well as two vertical forces such as bargaining power of suppliers and customers. Although the relations between entities in different industries vary between one another, however the five forces which affect the level of rivalry and profitability of an industry are generally very similar. More detailed analysis of respective five forces will be conducted below.



¹⁹ Roger Bennett, Jim Blythe, December 2002, international marketing strategy planning, market entry & implementation, 3rd Ed. Kogan Page, Ltd,

²⁰ Porter, Michael E. 1979. How competitive forces shape strategy. Harvard Business Review. March-April 1979, pp. 137-145.

Figure 2 - 11 Michael Porter's Five Forces Model



2.2.1 Threat of new entrants

When return on capital in one industry exceeds the cost of capital, it will become attractive for outside companies to enter this industry²¹. The new entrants may become a threat by expanding the capacity and therefore leading to decrease of profitability of the industry. However, in majority of cases the new entrants are unable to enter the industry on the same conditions as the established firms did. According to Michael Porter's model, there are six major barriers that impede the expansion for new entrants. The higher the barriers are the higher the long-term profitability of the incumbent will be. Entry barriers consist of economies of scale, capital requirements, product differentiation, absolute cost advantages, distributions channels access as well as governmental and legal restrictions.

²¹ Porter, Michael E. 2004. Competitive Advantage, Free Press

Economies of Scale

Economies of scale arise when the cost of a product or service decreases as a result of extensive size of operations. When an industry is dominated by big players who conduct their activities such as production, service, financing, marketing or distribution on a large-scale the new entrants in order to successfully compete with incumbents will be also forced to enter on a large scale which may end up in high costs resulting from unutilized capacity in the initial state²². Economies of scale may become a huge barrier for potential entrants in some industries. The automobile industry in which cost efficiency starts from producing at least 3 million cars a year, is a good example of high entry barriers sector.

Capital Requirements

When potential competitors plan to establish their presence in an industry, it often requires a substantial financial investment to gain the ability of competing with the incumbents. The financial capital is mostly required to cover such expenditures like R&D and marketing campaign as well as to purchase fixed and current assets such as facilities or inventories²³. Obviously different industries require different amounts of capital, which mostly depends on the scale and level technological advance of the sector. For example the costs of developing new drugs significantly limits the number of potential entrants to pharmaceutical industry. On the other hands there are some industries where capital requirements are low, such as e-commerce.

²² Robert E. Hoskisson, Micheal A. Hitt, R. Duane Ireland, Jeffrey S. Harrison, August 2007, *Competing for advantage*, Cengage Learning,

²³ Porter, Michael E. 1998. *Competitive Advantage: Creating and Sustaining Superior Performance*. Free Press

Absolute Cost Advantages

When entering a new industry new companies typically face cost disadvantage comparing to the incumbents. Absolute cost advantages are not connected with scale. They usually stem from better access to raw materials, company's experience, learning curve, favorable locations or government subsidies. A good example of such advantage are mining companies based in countries rich with mineral resources.

Product Differentiation

According to Michael Porter's analysis product differentiation boosts brand recognition and loyalty among the customers which create high barriers for new entrants. However the importance of customers' loyalty to a brand varies from industry to industry. For example cigarettes or apparel sector will be characterized with high degree of customer brand loyalty whereas in case of garbage bags the level will be low. If the new entrants want to pursue comparable levels of brand loyalty that incumbents enjoy they will have to spend significant amounts of capital marketing campaigns in new markets²⁴.

Access to Distribution Channels

Suitable distribution channels are a key factor determining the success of a product or service. They generally consist of distributors, wholesalers, retailers or e-commerce platforms. Since the incumbents already possess favorable relations with distribution channels it is very difficult for new entrants to gain a significant presence, with forward integration of distribution activities becoming the only feasible choice in some cases. Retailers may have not enough of free space to fit new product offerings and may not be willing to accept a risk of selling a product unknown in the market, that often includes fixed additional expenditures

²⁴ Porter, Michael E. 1998. *Competitive Advantage: Creating and Sustaining Superior Performance*. Free Press

related to promotion. Therefore, lack of access to effective distribution channels is one the main barriers for potential market entrants.

Governmental and Legal Barriers

In many cases the governments regulate the level of competition in the markets through various policies and laws. The restrictions may take form of licenses, standards or safety regulations that increase entry barriers for potential entrants. Such obstacles are very common in financial industry where a license from the related administration organs is required before the company can start its operations.

2.2.2. Threats of substitutes

According to Michael Porter's model substitute product is a source of threat for the company's profitability, since it significantly limits the price that can be charged for the goods, unless the enterprise is successful in product differentiation. This situation takes place because the consumers reservation price depends partly on the accessibility of substitute products²⁵. The availability of substitutes increase the cost effectiveness of an industry simultaneously decreasing profitability of its players. The substitutes can be divided into three different groups: product-for-product substitution, substitution of need by a new product or generic substitution²⁶. The severity of the threat generated by substitutes depends on such factors as the difference between the prices of goods, switching costs or consumer's propensity to substitute.

²⁵ Porter, Michael E. 1979. How competitive forces shape strategy. Harvard Business Review. March-April 1979,

²⁶ Johnson, Gerry & Scholes, Kevan, 2002. Exploring Corporate Strategy. Essex: Pearson Education Limited.

2.2.3 Rivalry between competitors

The level of competition between incumbents determines has a significant impact on the profitability of the industry²⁷. In extreme cases the competition is so stiff that companies are forced to sell their products below the cost of production leading to industry-wide losses. However, in some industries, the competition may occur mainly in form of advertising or product innovation. There are five key factors that determine level of competition between the incumbents in particular industry.

Concentration

According to Michael Porter, the level of competition is strongly affected by the number of competitors in the industry and their level of competence²⁸. The competition is stiffer when the industry consists of a large number of similar sized players. On the other hand in the market dominated by a single firm the intensity of competition is low and the company has a significant level of freedom in its pricing strategy. When there are few players dominating the market the intensity of competition is limited and cartels that set the price level may emerge. The concentration ratio of a industry may be measured by combing the market share of 4 leading producers or by using the Herfindahl-Hirschman Index.

Diversity of Competitors

Another factor that determines the rivalry between the incumbents is the diversity of competitors including the strategies they choose pursue. For example, if the main players in the market have chosen aggressive growth strategies the competition will become more intense.

²⁷ Porter, Michael E. 1998. *Competitive Advantage: Creating and Sustaining Superior Performance*. Free Press

²⁸ Porter, Michael E. 1998. *Competitive Advantage: Creating and Sustaining Superior Performance*. Free Press

Product Differentiation

The level of product differentiation is another factor determining the intensity of rivalry within an industry. In case, when rivals tend to offer less differentiated products the more customers will be prone to switching which result in rise of price competition levels. In a sector where the products marketed by competitors are identical, the companies compete only with price. On the contrary, in the industry characterized by high differentiation of offered the price competition may be weak, despite a large number of competing entities.

Excess Capacity and Exit Barriers

According to the Porter five forces model the profitability of the industry is also influenced by relations between demand and capacity. If capacity exceeds the demand the intensity of competition in the industry will rise. If such situation persist the factor determining the level of competition are exit barriers of a sector. For example when industry characterizes with high amount of fixed assets or strict job protection rights it may be very costly to leave the sector and as a result lower the industry capacity levels. When excess capacity leads towards price competition, the cost structure is the key factor determining the price. If fixed costs are relatively high comparing to variable costs, the firms will continue to serve customers at any price above the variable costs, resulting in significant losses among the players in the industry²⁹. The benefits stemming from scale economy provide additional motivation for enterprises to engage in aggressive price competition with the intention of increase their sales volume.

²⁹ Grant, R. M. 2010. Contemporary Strategy Analysis (7 Ed.). Chichester: John Wiley & Sons Ltd.

2.2.4 The bargaining power of buyers

The bargaining power of customers has a significant impact on the profitability of various business sectors. In a industry where buyers bargaining power is high, they consumers of goods can negotiate either better price or higher quality of products³⁰. There are two key factors determining the strength of the buyers, their price sensitivity and relative bargaining power. The price sensitivity of buyers will rise if the products purchased have significantly affect their cost structure or the level of differentiation in the industry is low. One of the main factors affecting the bargaining power of buyers is their size and concentration in comparison to the suppliers. The bargaining power of a customer rises if there are few buyers purchasing in big quantities. Second factor having a significant impact is buyer's information. If buyer is well informed about cost structure of supplier it can negotiate a better price. The last key factor is the ability of buyer to engage in vertical integration. As a result buyers may threaten suppliers that might start manufacturing the product by themselves if their purchasing price is too high.

2.2.5 The bargaining power of suppliers

In case when suppliers have high bargaining power they can choose to raise the prices or reduce the quality of provided products. High bargaining power of suppliers may lead to decrease of profitability among the companies within a industry if they are unable to transfer the growing costs to the customers by increasing the price of their products. The bargaining power of suppliers will be high if the concentration among them is high, a high level of differentiation among their products exist and the the switching costs are high. In a real economy suppliers often try to increase the switching cost on their own in order to increase

³⁰ Porter, Michael E. 2008. The Five Competitive Forces That Shape Competition. Harvard Business Review. Jan P79-93

their bargaining power. Unavailability of reliable substitutes and ability of forward integration among the suppliers also leads to an increase in their bargaining power.

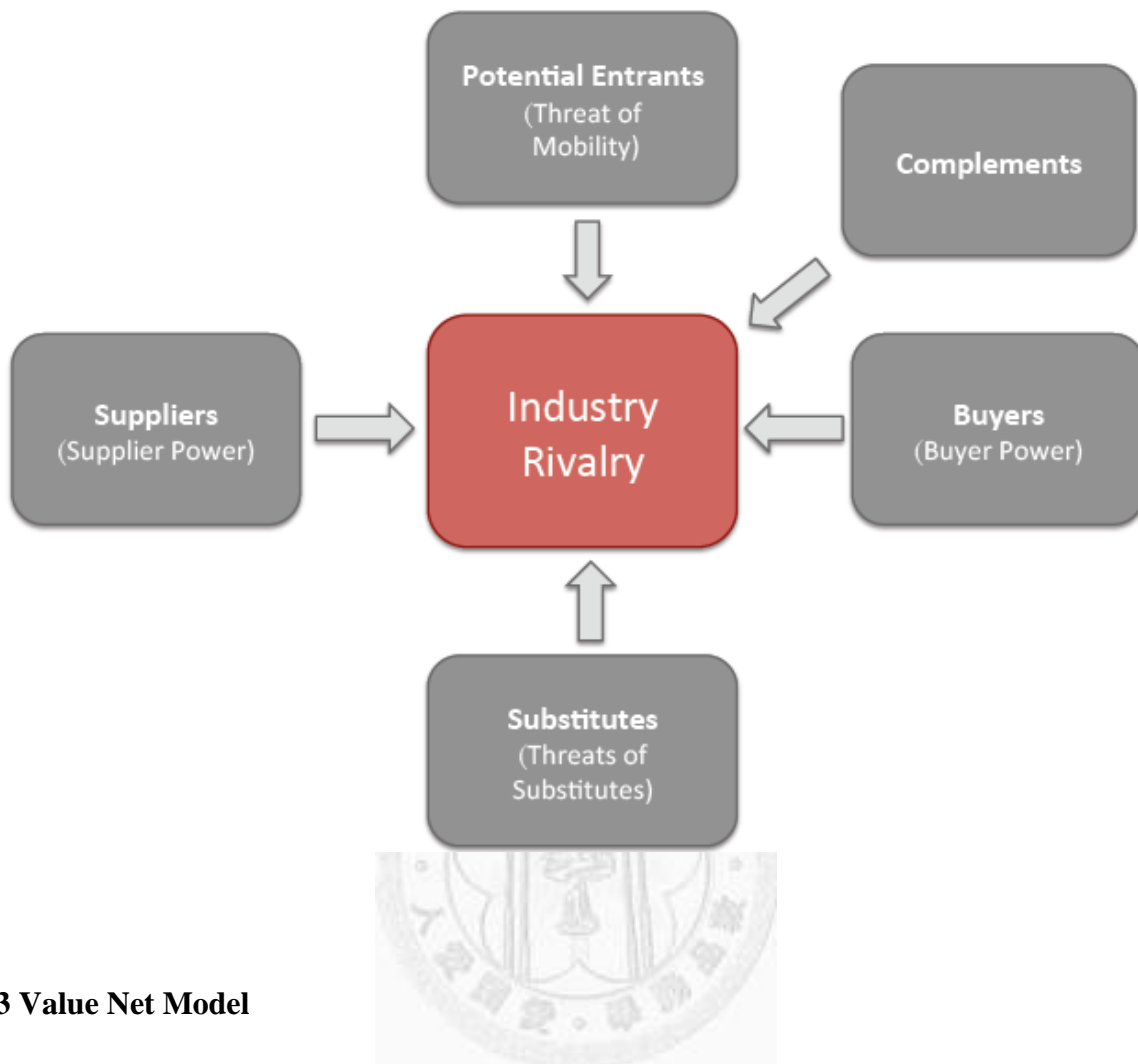
2.2.6 Criticism and extending the five forces model by adding complements to the analysis

Porter's five forces is one of the most popular tools use to analyze the competition within a particular industry. However, it has also been a subject of criticism, mainly because of two reasons. Firstly, Porter's constructed the model under the assumption that the competitors, buyers and suppliers are unrelated and do not engage in collusion, which is not the case in the real economy. Secondly, some economists believe that the industry environment impact on company's profitability is insignificant³¹.

Michael Porter's five forces analysis correctly identifies threat of substitutes as a factor reducing the profitability of the enterprises operating in one industry. However, the model doesn't elaborate on the impact that complements have on the condition of a industry. In theory of economy complements, are those goods or services that increase the demand for the particular product, which means they have a opposite impact than substitutes. For example, the situation in the car market depends heavily on the price of gasoline and other services such as maintenance etc. Therefore, when making a decision of purchase the customers analyze the value of whole product set instead of just one of its elements.

³¹ Grant, R. M. 2010. Contemporary Strategy Analysis (7 Ed.). Chichester: John Wiley & Sons Ltd.

Figure 2 - 12 Five forces model enhanced by adding complements to analysis



2.3 Value Net Model

Value net is alternative model to five forces analysis and it was clearly was inspired by Michael Porter's predecessor. It was created in by two economists Adam Brandenburg representing Harvard Business School and Bary Nalebuff from Yale school of management in 1995.

The model treats industry as a game in which four actors are competing for its share of created value. Those four actors are respectively: customers, substitutors, suppliers and complementors. The framework provides a platform for analysis of division of the value created within the industry as well as interdependence between the players of the game. The model is based on the concept of Co-opetition. The authors argue that nowadays relation

between the different players of the business environment may include cooperation and competition at the same time. If companies work together, they are able to create larger and more valuable market than if they only work individually. Afterwards the companies can compete with each for their share of the market value. By analyzing the value net model of its respective industry companies can try to seek for ways of creating sustainable competitive advantages by changing the rules of the game, so that they can gain a favorable position against other players and will be able to receive the bigger share of the value created³².

According to the model the business game consists of five elements: players, added values, rules, tactics and scope, which detailed description takes place below. In order to change the rules of the game at least one of the elements have to be influenced by the participant.

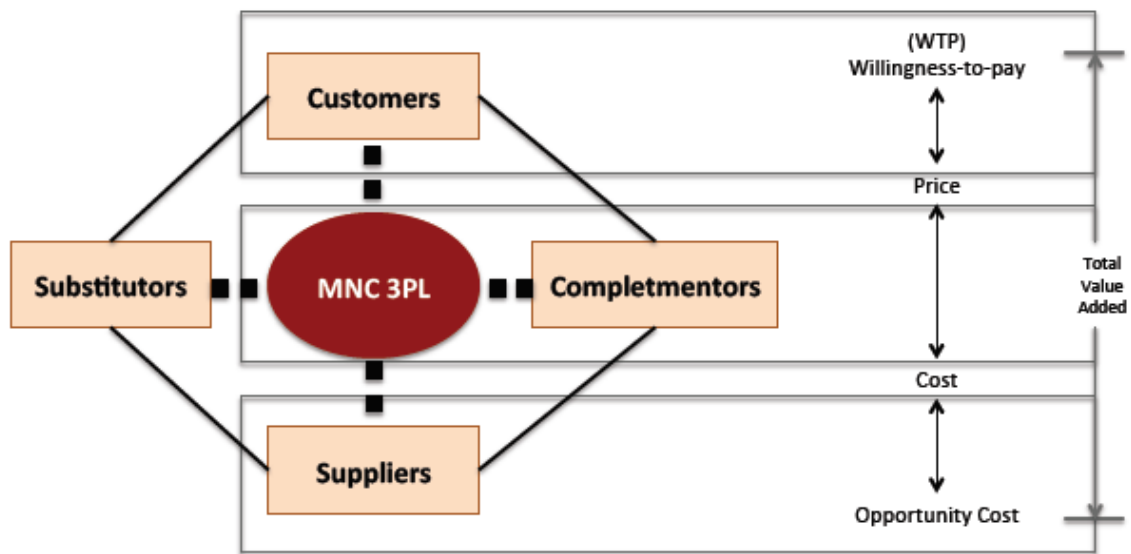


³² Adam Brandenburg and Bary Nalebuff, CO-OPETITION: A Revolutionary Mindset That Combines Competition and Cooperation 1998, found online at http://www.uni-potsdam.de/db/jpcg/Lehre/SS_04/HS_Gesch_ftskonzepte/coopet.pdf

2.3 Value Net Model and the role of Guanxi

The relationships between the players of the game and the basic rules of value creation are explained by the diagram below.

Figure 2 - 13 Value net model by Adam Brandenburg and Bary Nalebuff



In order to facilitate the understanding of the framework the key elements of PARTS model are explained below:

Players

Inflow or outflow of market players have a significant impact of the overall market value of the entire value net. Therefore, before an enterprise decide to enter a market it should conduct an analysis based on the question: for which of the current players my participation will provide the highest amount of added value. Subsequently determine the way to persuade that player to pay for your involvement.

Added Value

Added value of a value network consists of sum of the values added by all participants. Therefore when a new enterprise joins the network the net increase of the total value of the network will be equal to the new entrant contribution. A company should focus on maximizing its own added value.

Rules

Although many participants of the value net tend to assume that rules of the business are set and not a subject to any further negotiation, it is just not true. Enterprise should first thoroughly understand the rules determining the situation in the market and subsequently strive to change them in a way that will benefit the company. However, other participants may also try to change the rules of the game at any time. Moreover, the party with the biggest bargaining power market usually sets the rules.

Tactics

Tactics of market players are used to shape the perceptions of other participants in the value net. The game can be influenced by changing the way other players perceive it. Every action of a company sends signals, based on which other participants create their perception of the situation within the value net. The game is equal to the collective sum of those perceptions. Most industries are characterized by presence of fog of uncertainty, scraps of information and deliberate misinformation. Tactics can help an enterprise either to clear up the fog, preserve it or stir up new one.

Scope

In the world of business value nets are not isolated from each other. In fact each value net has a link with other value nets through common players or same location of business

operations. As a result of those linkages value nets can influence each other. In other words, every value net is situated in a bigger environment, which boundaries can be changed at any time by the participants of the net. Gaining understanding of relationships between neighboring value nets is necessary for a company to form a successful business strategy and as a result create more added value.

The concept of Guanxi in China.

The social and cultural environment in China is significantly different than the ones of the Western countries. The country possesses many cultural traditions and specific habits. It is widely known that cultural differences highly influence the business practices of a country. As a result, it is extremely important for Western enterprises to understand those differences when investing in China. Moreover, the commercial activities in Chinese society are highly influenced by the concept of “relationship” called “guanxi” which is significantly different from the one used in the West.

The term "guanxi" can be translated as “relationship” or “connection”. To be more precise in the Chinese language word "guanxi" is a phrase which consists of two characters. The first one "guan" is a noun that literally means - gate, barrier. The second one "xi" is a verb that means to “connect” or “link”. There are many definitions of "guanxi", according to Pye (1982), "guanxi" is considered as "friendship with implications of reciprocal exchange of favors³³". Alston (1989) defines it as a "special relationship based on personal affiliations between two persons³⁴". Finally, Yeung and Tung (1996) describe that the term refers to building up a

³³ Pye, L. Chinese Commercial Negotiating Style. 1982. Cambridge: Oelgeschlager, Gunnand Hain Inc.

³⁴ Alston, J. (1989). Wa, Guanxi, and Inwa: Managerial Principles in Japan, China, and Korea. Business Horizon, March, 26-31.

"linkage between two individuals who could exchange mutual interests and benefits by personal or social transactions to ensure the maintenance of such a personal relationship³⁵".

"Guanxi" is one of the main forces that shapes dynamics in the Chinese society. It does not only refer to a very special relationship between two people, but also involves continuous exchange of favors and is regarded as an interpersonal networks of reciprocal bonds. Based on those descriptions it is obvious that interpersonal relationships in China are established by cultural-rooted criteria that are very abstract especially for Westerners. Its importance is even bigger considering the fact that, "guanxi" is often the main factor that determines relationships between people or organizations, including businesses. As a result the development of "guanxi" becomes as a major competitive advantage in Chinese business environment which often helps local enterprises to overcome its resource shortage comparing to the multinational entrants. Therefore it is then very crucial for the foreign investors to consider cooperation with a local partner in case of commencing operations in China.

2.4 Benefits of entering China Market through an M&A

2.4.1 M&A trend

Since 1990's Mergers and acquisitions have significantly increased in popularity and nowadays are a common alternative for internal expansion. According to Hitt, Harrison and Ireland globalization and technological progress are one of the factors that determined growing importance M&A, including cross-border M&A³⁶.

³⁵ Yeung, I. Y. M. & Tung, R. L. (1996). Achieving Business Success in Confucian Societies: The Importance of Guanxi (Connections). *Organisational Dynamics*, 25(2): 54-65.

³⁶ Hitt A. Michael, Harrison S. Jeffrey, & Ireland Duane R. (2001). *Mergers and Acquisitions: A Guide to Creating Value for Stakeholders*. New York: Oxford University Press.

Economists believe that there were five M&A waves in the world. The first one occurred between 1893-1904, in the U.S. consisting mainly of horizontal mergers, in such industries like oil, mining, steel, telecommunications. It was enabled by spanning the country with a comprehensive railroad system that provided an impulse for integrating companies operating on a regional scale into national giants. The wave ended before the First World War resulting in monopolization of major key industries in USA³⁷. The second one occurred between 1919 and 1929. Besides continuing consolidation of the key industries commenced in the first wave, it is characterized by emergence of automobile industry which led to rising popularity of vertical integration M&A. This wave was ended by the Great Depression in 1929³⁸. During the third wave which began in 1955 and ended between 1969 and 1973 the concept of “conglomerate” has emerged and has been widely accepted by American business strategists³⁹. The idea of conglomerate promotes growth of companies by entering new industries and achieving more benefits from diversification. The fourth wave of M&A occurred started between 1974 and 1980 and lasted till 1989. This period is strongly marked with emergence of hostile takeovers supported by investment banks and began with the acquisition of Inco by ESB with assistance of Morgan Stanley. *“This successful hostile bid opened the door for the major investment banks to make hostile takeover bids on behalf of raiders.”*⁴⁰

In the middle 1990s, the fifth M&A wave have begun. The period is characterized by five - fold growth in value of mergers and acquisition when comparing to the 1980's and dramatic increase in importance of cross-border M&A. During this wave, the parties involved in the M&A are usually enterprises of a significant size. As a result of mergers, many of the

³⁷ Lipton, M. (2006, 09 14). Merger Waves in the 19th, 20th and 21st Centuries. The Davies Lecture (pp. 3.)

³⁸ Lipton, M. (2006, 09 14). Merger Waves in the 19th, 20th and 21st Centuries. The Davies Lecture (pp. 4.)

³⁹ Lipton, M. (2006, 09 14). Merger Waves in the 19th, 20th and 21st Centuries. The Davies Lecture (pp. 5.)

⁴⁰ Lipton, M. (2006, 09 14). Merger Waves in the 19th, 20th and 21st Centuries. The Davies Lecture

companies became the major players in their respective industries⁴¹. The fifth wave of M&A is the first one with a truly global impact. Its emergence was enabled by many factors such as rapid development of science and technology, in particular major breakthroughs in communications solutions that facilitate managing on a global scale. Secondly, commencing of WTO which pushed government towards liberalizing their capital inflows policies created more favorable environment for cross-border M&A. Along with continuous economic growth and rising levels of globalization, more and more countries became aware of the benefits of foreign direct investments for both recipient and source of capital. As a result, governments provide various kinds of support for domestic enterprises interested in cross-border acquisitions such as investment insurance or providing information concerning target market. Moreover, the levels of competition on the global market are rising making M&A one of the key activities determining the performance of an enterprise on a worldwide scope. By engaging in cross-border mergers and acquisitions companies can quickly improve their competitiveness, expand scale of operations, and as a result, increase the significance of its business on the global market.

The value of cross-border M&A has experienced significant growth in the last fifteen years⁴² Although the majority of them still take place between entities based in developed countries, emerging economies gradually catch up and are increasing their importance as destinations for cross-border M&A, mainly due to huge growth potential of their large markets. Therefore, acquisition of a local company is becoming a popular alternative for internal growth, significantly shortening time required for market entry enabling enterprises to grasp the opportunities arising on fast growing markets.

⁴¹ Shimizu, K., Hitt, M. A., Vaidyanath, D., & Pisano, V. (2004, 07 24). Theoretical foundations of cross-border mergers and acquisitions: A review of current research and recommendations for the future. *Journal of International Management* ,(pp. 307-353.)

⁴² Dunning, J., & Lundan, S. (2008). *Multinational Enterprises and the Global Economy* . Cheltenham,UK: Edward Elgar Publishing Limited.



2.4.2 M&A in China

According to J.H. Dunning, position of countries in terms of inward and outward FDI depends on their development level. His theory, that encompasses phases is called “investment development cycle”⁴³.

The earliest stage is called the initial period of countries’ FDI. Due to low economic development of the state, including inefficient legal and commercial systems, underdeveloped infrastructure and unskilled labor force, as well as low purchasing power of citizens, the inflows of foreign investment are very limited and there are almost no outward investment flows occurring.

During the second stage, domestic market reach certain size that enables enterprises to benefit from economies of scale significantly reducing the cost of servicing those markets. *“Once adequate transport and communications facilities are established, investment to exploit national resources may occur”*⁴⁴ As a result, the inflows of FDI significantly speed up combined with much slower emergence of outward direct investment.

When a country enters the third state, it implies that its economy has moved to a more advanced level with productivity, technologies, capacity and know-how that can match international standards set by leading economies. Along with the increase of disposable income among its citizens, the consumers demand for high quality imported goods also rises significantly. Major domestic enterprises have radically increased their competence leading to arise of competitive advantages. Moreover, the progress of local companies diminishes

⁴³ Dunning. (1982). Explaining the international direct investment. In J. Dunning, & J. Black, International capital movements: papers of the fifth annual conference of the International Economics Study Group (pp. 84-116). Surrey: Macmillan Publishers Ltd.

⁴⁴ Dunning. (1982). Explaining the international direct investment. In J. Dunning, & J. Black, International capital movements: papers of the fifth annual conference of the International Economics Study Group (pp. 84-116). Surrey: Macmillan Publishers Ltd.

competitive advantages of foreign entrants. As a result investment inflows per capita begin to drop, whereas the outward FDI are on the to rise.

During the stage four, local firms not only have the competence to compete with rivals from abroad, but also are capable of exporting their advantages to various foreign markets, which result in further growth and geographical diversification of domestic MNEs. As a result, during the fourth period outward investment flows overtakes inflows in terms of value and importance.

According to J.H. Dunning' s model this currently China's investment capacity is somewhere between the second and the third stage. In 2000, the government during the "16th National Congress of Communist Party of China" has issued a proposal regarding international capital flows, which included the combination of "bring in" and "going out". It implicated that China will continue its path of opening the market and becoming an active stakeholder of the global economy. However this is the first time when the going out policy is emphasized in a document issued on national level ⁴⁵.

In 2001, China has successfully entered the WTO, which marked the beginning of a new era for Chinese economy. Market liberalization implied facilitated inflow of not only products and services but also know-how and management skills. This was also a key factor determining rising popularity of M&A transactions in China.

In 1985 total value of M&A deals in China reached US\$124 million⁴⁶, whereas in 2010 the number of 622 deals had been conducted growing 111.6% year-on-year in terms of number of deals from the 294 in 2009. Among those 622 transactions 501 were altogether worth 34,8 billion USD⁴⁷. This statistics sufficiently reflect the growth that this form of business transaction has experienced during the last two decades and prove that nowadays

⁴⁵ Yin, X. (2009). Studying on the Current Situation and Developing Tendency of China's Outflow FDI, (pp. 63-67.)

⁴⁶ Bacani, Cesar and Sima, Katherine Peavy "The great buyout: M&A in China", The Economist Intelligence Unit (2006), p. 4

⁴⁷ <http://www.pedaily.cn/Item.aspx?id=205626>

foreign companies planning to invest in China are not only limited to greenfield investments. In addition to the typical FDI, foreign enterprises have obtained the possibility to engage in many other types of investments such as spin-offs, mergers, holding companies or a direct acquisition. As a result M&A transactions have gained on significance and became a common and increasingly economically important feature in China's financial system. The key factors supporting the rising popularity of M&A activities besides the condition of Chinese economy is the government's commitment to loosen the restrictions that previously were a major obstacle in the growth of M&A transactions level. Moreover, majority of foreign investors perceives China as a "land of limitless opportunity"⁴⁸. As a market of 1,3 bln consumers providing a big opportunity for selling their goods and services, invest in companies or buying them out. It also implies abundant workforce that can produce and supply them with goods for exports. Obviously those benefits don't come easily and there are still many difficulties in establishing successful business operations in China. However, according to statistics foreign investors keep flocking into China making it obvious that the pros and cons analysis they conducted are still in favor of entrance and they often decide on trying their luck in this difficult market. However single sided interest of foreign companies is not a sufficient condition for M&A growth. Fortunately, management of Chinese enterprises also shows a lot of interest in attracting potential investors. Their motives are various such as simply selling the company or finding a partner who would bring additional capital and know-how to their companies. Another key driving force of M&A in China is the government which pursues privatization of state owned enterprises, although the pace of the process is rather slow. Moreover, the level of concentration in many sectors in China is uncommonly low, which leaves a big space for consolidation through M&A.

⁴⁸ Bacani, Cesar and Sima, Katherine Peavy "The great buyout: M&A in China", The Economist Intelligence Unit (2006), p. 6

2.4.3 Main benefits of entering China Market through an M&A

Before deciding the form of future investment in China or any other country is crucial to determine the main reasons for commencing operations in the Middle Kingdom. The strategic goals or specific features of a company can be the main factors behind the motive for choosing M&A as a preferred form of foreign market entry. However, the reasons may vary depending on current situation, for example, sometimes the main purpose of transaction is cost reduction or increasing the market share, whereas it may be just driven by personal connections or perceived asset undervaluation when the buyers believes that the acquired company can be sold later with profit. Furthermore, expansion on other market is a popular way of diversification and reducing the level of risk for the company. To sum up the main three goals of a foreign investors are resource seeking, efficiency seeking and market seeking. In case of China resources seeking mean mostly cheap and abundant labor, which makes manufacturing there more cost effective than in home countries of majority of foreign investors. Another example of acquiring resources are less strict environmental laws that enable multinationals to engage in production banned in their own countries or at least burdened with enormous fines. Efficiency seeking can be also connected with acquiring cheaper workforce, that due to less strict labor regulations can allow production 24 hours a day that result in more efficient usage of fixed assets. However, definitely the most important aspect that determines attractiveness of foreign investments in China is market seeking. With its 1,3 billion army of consumers China is a vast market for virtually any products and services and at the same time it still having huge potential for growth. Therefore, establishing

operations in China is crucial not only for the present performance of the company, but is also a wise strategic decision for the future as well.

Nowadays M&A has become an increasingly popular ways of expansion into the Chinese market. However, during the first period of Chinese experiments with market economy through 1980s and early 1990s the most common form of FDI were joint ventures. Subsequently they were dominated in the late 1990s and early 21st century by a rising number of wholly foreign-owned enterprises (WFOEs). However in the recent times, the mergers and acquisitions are particularly on the rise. Being a shortcut for establishing presence and gaining economies of scale foreign direct investments in form of M&A are obviously becoming a more and more common way for a foreign company to conduct the expansion into the Chinese market. Moreover, they are also an efficient method of overcoming difficulties related to unfamiliarity of the political and social characteristics that determine the rules of the game in the market⁴⁹. According to Woodward and Wang by expanding in to Chinese market through an M&A foreign enterprises can gain a “quantum leap in market share and broader distribution in highly fragmented already saturated markets: strong regional brands can be acquired for less than it would take to build up the same company from the ground”⁵⁰. To sum up, there are various benefits of choosing M&A as a mode of expansion into Chinese market when compared with other forms of investment such as engaging in a joint venture or setting up a wholly owned subsidiary etc. By conducting an M&A the foreign multinational in a short period of time acquires the market share of the domestic company, as well as its know-how, employees, suppliers and access to informal networks between the players of the game. Whereas, if the investor chooses to establish a wholly owned subsidiary, decides to implement direct sale, using agents, or sets up representative, the whole process of building the

⁴⁹ Doing business in China – M&A and due diligence”, Grant Thornton (2002), found online at <http://www.gthk.com.hk/cgi>

⁵⁰ Woodard and Wang , <http://www.chinabusinessreview.com/public/0411/woodward.html>

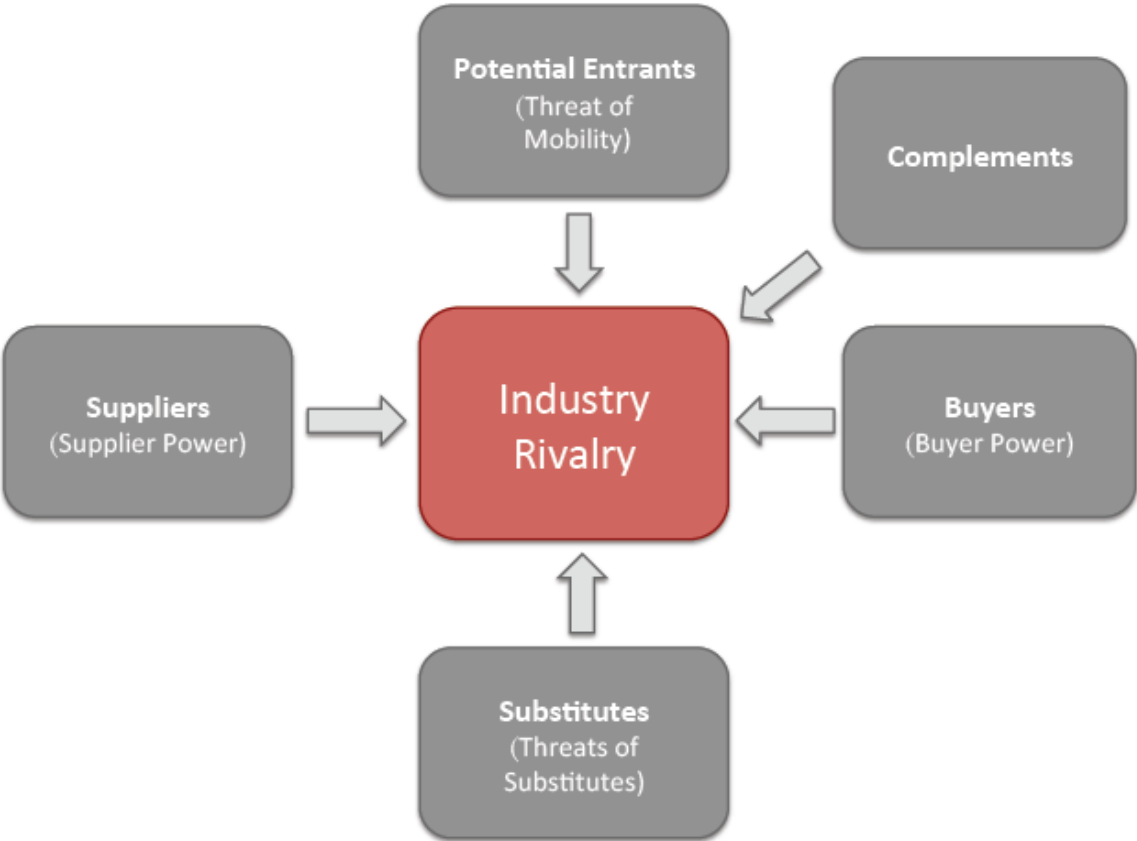
company's presence in the Chinese market has to start from scratch. Moreover, personal connections are very important in Chinese business environment, therefore acquiring a company together with key employees and their relationships with major entities as well as their extensive market knowledge is even more essential than when conducting business in other countries. However, those benefits can also be earned when choosing to invest in a form of joint venture, in case which foreign company can leverage Chinese partners' skills and know-how. Furthermore, in contrast to hiring agents, using direct sale or representative offices M&A is more suitable for investments with longer time horizon or when a broad target group of customers exists. When choosing those less sophisticated methods of investment, reaching a large group of customers might be difficult, therefore an M&A would be more suitable in this case as it enables foreign enterprise to leverage customer base of target company and use it as a starting point for further expansion. If the foreign entrant choose to cooperate with an agent it would certainly restrict its capacity as well as control of operations in the market. When a company is registered in China, the division of responsibilities is easier since the operations are run on behalf of the company and not by one specific person. However, in case of investment in a form of joint venture many conflicts regarding split of profits and control may arise. When foreign investor is confident about its goals and strategy and wishes to manage the company based only on his own preferences, such division of control may cause problems. Furthermore, if major conflicts emerge, and both parties don't see any possibilities to continue their cooperation in the future, the procedures related to dissolving the joint-venture may be complicated and costly. Especially in case of a contractual joint venture, where specific rules regulate such major events like buy-outs, change of partners or the time period of the joint venture.

Chapter 3: Analysis of Logistics M&A in China as a market entry mode

3.1 Five forces analysis

Due to specific characteristics of the thirty party logistics sector six forces model is used to examine the industry. The main difference with the Michael Porter's five forces analysis is that complementors are added to better reflect the relations between different entities constituting environment of 3PL sector. Six forces analysis in a chart below is helpful to understand the industry condition and can be used to examine the decision of market entry and its form by foreign companies.

Figure 3 - 1 Five forces model enhanced by adding complements to analysis



3.1.1 Supplier power

While china's logistic industry is still in development stage concentration levels are low and majority of suppliers operate in a highly competitive market, which result in low price of offered goods. However, due to vast size of China market and specific business market environment strongly relying on personal connections only few companies sell their products on a countrywide market, majority operates only in one province or even smaller region. Such situation diminish benefits coming from purchasing bargaining power of large multinational entrants, since they often need to procure from many different suppliers in particular regions.

Suppliers may be divided into three main groups; facilities, utility and equipment providers. Majority of utility companies are vast in size and prices are controlled by the government. They often enjoy monopoly in a specific area giving multinationals in 3PL industry little opportunity to exercise their bargaining power. Providers of facilities, mainly real estate such as warehouses or cooling storages tend to be strongly connected with state administration. Very often their main core competence includes favorable relations with the local government officials. Those connections give them opportunity to obtain the right of land use in preferable location and on condition than entities from abroad or even different provinces in China. Since its almost impossible for new international entrants to posses such competence in advance, entrance in form of M&A is a possible solution for this constrain. By acquiring local operator foreign enterprise can quickly get hold of key employees who posses favorable relations with and administration and major suppliers. Equipment providers are often in a weak positions comparing to the multinational entrants when it comes to bargaining power, since their market is very fragmented and characterized with high level of competition. Moreover, along with the growing size and sophistication of the Chinese market suppliers are

continue to improve their offer leaving 3PL providers with sufficient choice and negotiation power.

3.1.2 Threat of entrants

Since majority of foreign 3PL giants already operate in China, potential competitors may emerge from two main groups of entities. First one includes spinning off in house logistics divisions of huge state owned enterprises. Due to support of huge domestic market and Chinese government promoting foreign expansion of state owned enterprises those companies could pose a threat not only in China but also in the global 3PL market. Second group may emerge from forward integration of private manufacturers.

- In house logistics: although the outsourcing rate of logistics services in China is on the rise there is still a significant number of state owned enterprises that continues to perform those activities internally. Moreover, there are some companies considering to reinforce their logistics competence and migrate towards in house operations, similarly to their original business model inherited from dominating strategy during the planning economy period. Considering that state owned enterprises are suspected of being recipient of generous government subsidies and posses vast amounts of assets that were often acquired below the market price they may conduct their logistics activities with lower costs than those offered by foreign providers operating solely within market economy rules.
- Forward integration of manufacturers: for the last 30 years economy was booming with an average growth rate of 10% per year. Quick market growth provided many opportunities but also required huge capital expenditures for the emerging private companies. 3PL outsourcing provided an efficient

solution to reduce those spending and enabled them to focus on grasping the opportunities arising in the market. However in the future, when the economy growth will slow down, many private enterprises will have vast amount of idle cash and less chances to invest. One of the solutions is forward integration of their operations towards logistics services. Those divisions can easily reach the economy of scale only by serving their mother company. Once the increase their service competence level based on cooperation with its anchor customer they may start providing services to other entities and become a potential threat even to major multinational enterprises. Good example of implementing such strategy is leading producer of consumer electronics and home appliances Haier, that perceives its supply chain abilities as an important source of competitive advantage and continues vertical integration of its logistics activities instead outsourcing.

3.1.3 Buyer power

Recent development of logistics industry give buyers more bargaining power since they are many companies providing comparable services, especially in the parts of the market characterizing with lower added value activities. Although it is very easy to find providers, that will advertise themselves with lower cost of services, their quality varies significantly, and many, especially small sized buyers tend to switch suppliers often in order to find a suitable one.

Bigger sized buyers tend to focus more on quality and are willing to pay more for higher value services. Their bargaining power therefore is not as high as it could be if only their size is considered. The reason for that is a limited amount of companies that operate countrywide and providing one stop shopping service, especially when it includes

international deliveries or sophisticated supply chain management. Moreover, their operations are often strongly integrated with logistics providers, therefore bigger companies looking for higher quality services often prefer longer cooperation because of considerable switching costs. However, basic rule of company size still applies and they still can enjoy more significant bargaining power than smaller local customers. Among the entities being in the best negotiation position with suppliers are FMCG manufacturers and distributors since they often characterize with particularly high volume of transported goods.

3.1.4 Complementors

Existence of suitable complementors is a key factor of success within 3PL industry. Many of them don't possess many fixed assets and create value by leveraging assets and abilities of other companies. Therefore proper selection of cooperating entities is very important and often determines success or fail of a 3PL provider. It is especially essential in such a specific market like China, which differs significantly from western markets where majority of globally recognized 3PL providers originate from. Through M&A foreign entrant can quickly acquire positive relations with many complementors which are often based on personal relationships between employees and hard to develop within a short period of time. Small size of complementors often operating only within a region or province, creates a market opportunity for 3PL providers who may act as 4PL and focus on integration of their services.

Moreover, multinationals should also strive to enhance competence of its complementors, since it is closely related with perceived value of their offer. However there is a risk that cooperating partners may transform into competitors in the future, especially when

their management will start to believe that foreign 3PL fail to create more value in their cooperation process.

3.1.5 Substitutors

So far there are no reliable substitutes for majority of logistics activities, except mail services that in most cases has been successfully replaced by e-mail. If only 3PL is considered in house logistics is the only available substitute. In general Chinese market follows global trends and outsourcing rate is growing steadily, however there is still a significant number of companies who prefer to handle their logistics activities internally. As a solution foreign 3PL companies should persuade its customers of higher quality of services they provide particularly leveraging their advantages arising from know-how and global presence.

3.1.6 Competitors

Although the Chinese market is growing particularly fast which implies many business opportunities the competition is very stiff, especially after the economic crisis in 2009. Moreover, the dynamics of Chinese foreign trade volume growth is decreasing putting particular pressure on international companies specializing in providing import and export related services. In general multinational 3PL cater to MNE operating in China or Chinese firms with global presence providing highly value added services, whereas local companies focus on serving domestic market, mostly competing with price. Such market positioning decreases the level of rivalry between foreign and domestic firms. However there is a growing number of local providers who continue to increase the competence level, introducing more sophisticated services end directly competing with foreign companies. What makes the situation even harder for foreign 3PL providers the competition in China is often unfair, chaotic and illegal practices are not uncommon. In such case domestic providers have an

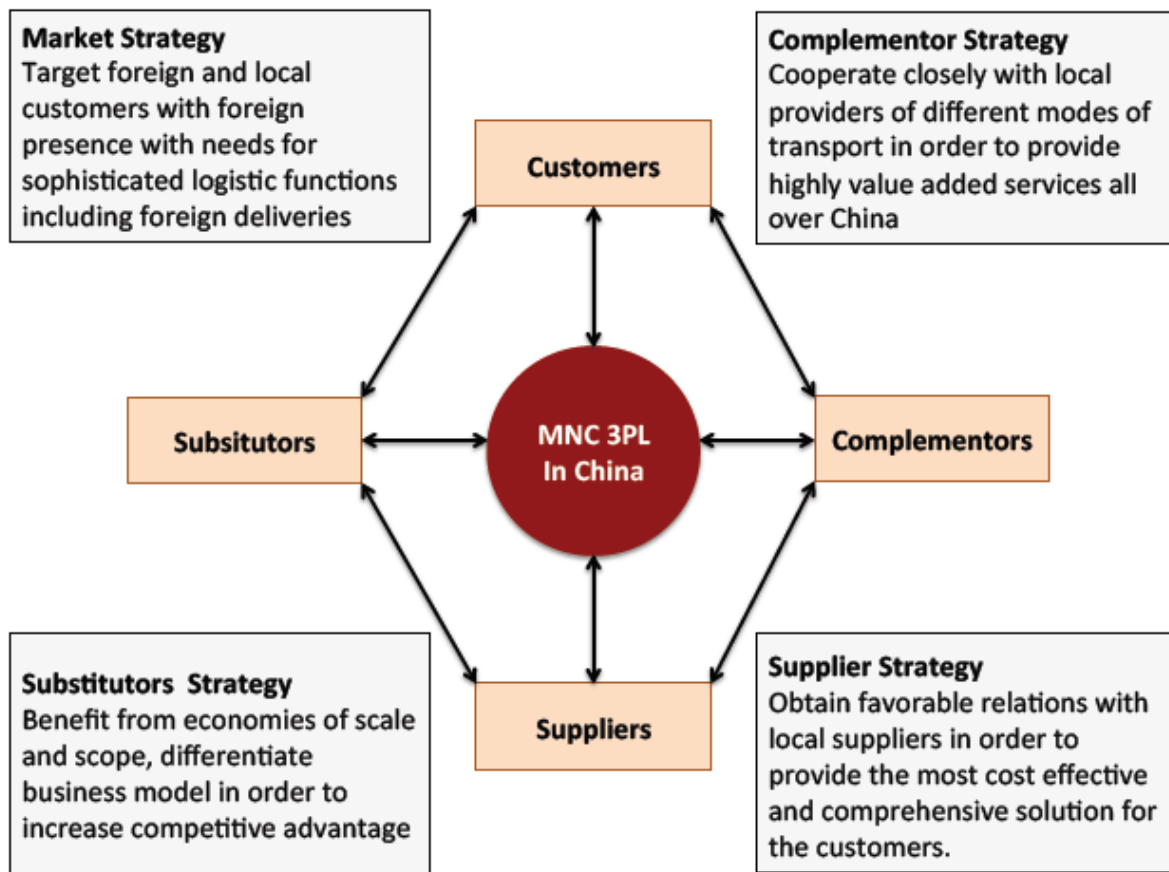
obvious advantage stemming from both higher better understanding of business environment as well as favorable relations with central or local administration. Those difficulties can be partially overcome by successful merger or acquisition of local entity. However, reality proves that many of M&A ends in a failure mostly due to incompetent integration process especially in human resources aspect. Therefore, due to the specifics of China market it is very important for foreign entrants to adjust M&A strategy, not only copy experiences from other markets.



3.2 Value net model

In order to analyze strategies of foreign 3PL in China and provide useful suggestions for the future value net model created Adam Brandenburger and Barry Nalebuff is used.

Figure 3 - 2 Value net of a foreign 3PL in China



3.2.1 Background information

Key information about the selected 3PL multinational will be provided in order to facilitate understanding of the analysis.

- one of the 5 leading global 3PL companies according to Supply Chain Asia in 2011

- operates more in more than 1000 location and its global network extends across over 150 countries or regions
- revenue in 2011 topped 9 bln USD after 25% growth yoy
- entered Chinese market in 1988, current revenue in the country reached 1 bln USD, accounting for more than 10% of its global sales with main customers including:, BMW AG, Johnson & Johnson Services Inc and General Electric Co.
- operates warehouses in 88 locations in Greater China combining 1,4 mln sq meters of storage space
- hiring over 14000 employees in the region
- offices in more than 100 locations around Greater China

3.2.2 PARTS model

The value net of the selected 3PL provider is examined with the help of the PARTS model with key findings summarized in this section.

- Key players included in the analysis are introduced below
 1. Customer: the customers of selected 3pl consist mainly of middle sized or large enterprises, both domestic and international that choose to outsource majority of their logistics activities such as warehousing or ground services. It mostly caters to manufacturing sector, with particular focus in automotive sector that accounts for 25% of its revenues.
 2. Supplier: the key suppliers of a 3PL company consist of utility, facilities and equipment providers.

3. Substitutor: substitutors of selected 3PL enterprise are mainly other 3PL multinationals or local providers as well as companies who choose to perform logistics activities in house
 4. Complementor: Complementors of selected 3PL multinational are providing services, outside of foreign entrants core competence. They can be divided into two groups. First are small sized companies providing simple services such as package delivery, often operating on a regional basis. Second are bigger providers in areas requiring substantial capital expenditures, such as sea or air freight.
- Added value created by this industry is analyzed in the model below.
 1. Customers mainly consist of companies that don't perceive logistics as main source of their competitive advantage and decide to outsource related activities to third party providers in order to focus on strengthening their core competence. The added value to the customers stems mainly from economics of scale and scope that arise from operating on a global level.
 2. Major suppliers of analyzed 3PL are mostly providers of utilities facilities or required equipment. They enable multinational to both lower fixed capital investments by renting warehouses or other necessary equipment as well as extend 3PL's scope of services at a lower costs by hiring contractors in regions not served by internal network.
 3. Complementors mainly consist of firms providing services that enable multinationals to offer integrated logistics solution for their customers.

Considering the size diversity between different regions of China and its specific business environment complementors are able provide added value if only they are properly into 3PL's network.

4. Local competitors possess significant cost advantages stemming from better understanding of local environment that enables them to play by different rules. They pose a threat to multinational by price competition especially in domestic service, therefore providing additional value for their customers.
- Rules determining the value creating of the industry are analyzed below.
 1. Relations with suppliers and complementators are often short, many of those companies are small sized and more focused on short term results than long term relationship. They often choose to switch customers based on better price offer.
 2. In general customers tend to cooperate with suppliers they are familiar with, therefore preferring long term relationship. It is especially true for more sophisticated services in case which significant switching cost apply. However, recent years of fast growth resulted in emergence of many reliable providers which customers can choose from. Moreover, western practices are more and more common in the market and some customers choose than supplier through tenders instead of relying on personal relationships like in the past.
 3. Despite of increasing popularity of practices accepted in the west the concept of *guanxi* is still very crucial for conducting business in China. Since it is very difficult for a foreign entrant to possess such skills

entering the market through M&A with a local partner may be a solution to this obstacle.

4. Illegal practices such as bribery or corruption are still very common way of acquiring customers in China.
- Tactics implemented by selected 3PL and other main players in the industry are summarized below.
 1. Major customers often tend to purchase services from more than one provider. Therefore, they can increase their bargaining power by creating a state of competition between the suppliers. Moreover, in case when one of them breaches the contract or lower the quality of services, they can easily outsource more activities to the other one with lower switching costs comparing to the situation when a totally new provider is being hired.
 2. Selected company focuses on providing integrated supply chain solutions for foreign multinationals or Chinese companies with global presence. It also takes part in forward integration of local companies forming joint-venture, mainly with firms operating in automotive sector.
 3. Majority of local competitors are unable to compete on global or national level focusing on serving local customers, mostly SME.
 - The scope of the game includes
 - Currently the analyzed 3PL provider focuses on manufacturing companies requiring high value added logistics solutions. However future strategy includes expansion into perspective consumer retail segment.

3.2.3 The Role of "Guanxi"

Analyzing the cases of foreign 3PL providers in China shows that they share one common feature. Representatives of many companies admit that "guanxi" is considered to be one of the most important factors shaping the development and management of their business in China. The huge reliance on "guanxi" stems mainly from absence of a strong institutional infrastructure as well as the characteristics of Chinese culture. Even though some believe that the prospected development of the Chinese economy should lower its significance, it is clear that in the near future properly managing "guanxi" is still a crucial factor determining company's operations.

Possessing "guanxi" doesn't automatically give certain competitive advantages when conducting business in China. It is often necessary to barely enable them. For example such many essential procedure for conducting logistic business such as customs clearance may become very difficult without possessing certain relationships with people working there. Therefore through acquisition of a local entity foreign company gains access to employees having favorable "guanxi" with the customs officer. Also during the contacts with the government officials or tax officers having positive relations can facilitate many administration procedures, since the rules are very vague and flexible. On the other hand lack of "guanxi" may result in very strict attitude and law enforcement towards the foreign entity including continuous tax controls. Similar situation occurs when it comes to land purchase. Since majority of the land rights belong to the government, having positive relations may result in lowering the cost of land acquisitions or give access to more convenient locations. Moreover, relations with the customers are also often based on "guanxi", that are very hard to attain for outsiders, especially for foreigners. Furthermore, their building up requires time, through M&A foreign entrants are able to acquire them in a shorter period of time.

3.3 Motives and drivers of logistics M&A in China

3.3.1 Characteristics of logistics M&A in China

After the reforms commenced by the government in 1980 foreign companies were allowed to operate in Chinese market. Their inflow may be divided into three main stages. Between 1980 and 1994 multinational companies such as Fedex, UPS, DHL focused on market research or providing international express service to support trade activities with foreign countries. During the second stage, between 1995 and 2004, the government relaxed its restrictions and opened 8 regions (Zhejiang Province, Jiangsu Province, Guangdong Province, Shenzhen, Beijing, Shanghai, Tianjin and Chongqing) for foreign investors treating them as an experiment before extending the policy countrywide. Third stage began in 2005 with further relaxing of restriction as stipulated in the WTO accession agreement and resulted in increased flow of foreign investments and mergers and acquisitions in 3PL sector.

Main M&A target - private companies and International Express sector.

During the last decade foreign entities have conducted acquisitions of various types of logistics companies including Sino - foreign joint -ventures, wholly owned foreign enterprises or private domestic entities being the most common acquisition target. Out of 10 major M&A cases during the 2005 - 2009 period six were involving private Chinese companies. When considering the field, majority of deals were made in International Express sector, into which foreign entities expanded first. Second most important type of logistics companies when M&A occurred was Freight Forwarding including key global players like Schenker, KUEHNE&NAGEL, PANALPINA,SDV⁵¹.

⁵¹ The Effects of Foreign Capital's Entrance into China's Logistics Industry, WU Yue, LIANG Chen and WEN Wei-juan (Beijing Wuzi University, Beijing 101149, China)

Equity merger and asset acquisition as a main form of M&A.

Majority of 3PL Logistics M&A in China is conducted in form of equity merger or asset acquisition. Each of them has different pros and cons. Equity merger method is relatively uncomplicated and allows tax deduction, whereas asset acquisition involves bureaucracy procedures such as asset reporting etc. However, when conducting asset acquisition buyer is not liable for debts of purchased company, which is the case when choosing equity merger form. In order to mitigate this risk enterprises deciding on equity acquisition often do it in the form of equity transfer. Major examples of equity acquisitions in China 3PL sector are FedEx acquisition of Tianjin Da Tian (天津大田), UPS deal with Sinotrans (中外運) and TNT investment in Huayu Logistics (华宇物流). Whereas Schindler National deal with Baoyun and Menlo Worldwide investment in Shanghai CHIC are representative for asset acquisition method. Sometimes, such as in the case of FedEx and Da Tian W. Group combination of both was used⁵².

3.3.2 Acquisition of customer portfolio

Main reason explaining preference of acquiring private companies among foreign entities is gaining access to wide customer portfolio. Acquiring and maintaining mutually beneficial relations with customers is a key success factor for any corporation. This rule is especially important in East Asia where personal connections, built up through years of cooperation, are essential in business environment, often more important than contracts signed concerning poor efficiency of Chinese courts. Therefore, acquisition of private companies is a quick and efficient method of acquiring customers. According to China Federation of Logistics and Purchasing more than 80% private domestic companies had foreign entities as

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their clients. More successful ones often maintained successful relations with big MNC's, for example China Baoyun Logistics which was one of the 30 biggest private logistics companies before acquisition by Schneider National had served such customers like P&G, Phillips, Electrolux, Siemens, Nestle, Watson's, Samsung, LG, AkzoNobel or Delphi⁵³.

3.3.3 Increase of market expansion speed

Another crucial factor supporting mergers and acquisitions as mode of market entry is quick access to domestic logistics network of the acquired company. Foreign enterprises by leveraging know - how and resources of local partner can significantly shorten the time of setting up its Chinese operations. Moreover, in case when foreign investor has a sizeable global network, the synergy coming from combining capabilities in China and abroad would lead to better financial results required to cover the premium often paid for acquired companies. Acquisition of HOAU Logistics (华宇物流) by TNT is a distinctive example of such conduct. Before the merger the company was one of the biggest providers of ground logistics services in China. Its network comprised of 1100 operating locations with over 3000 vehicles in all 30 provinces and direct-controlled municipalities. Through acquisition of Huayu Logistics TNT not only purchased a comprehensive road transport network but also obtained a portfolio of 180 000 customers, providing the company with resources supporting expansion into mid-range market.

3.3.4 Overcoming restrictions towards foreign entities

Moreover, through M&A global players gain access to areas restricted by government for fully owned foreign enterprises. For example multinationals are allowed to operate in

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international express sector, however still can't provide domestic express delivery services. Therefore in 2006, one of the four key players in the sector, American FedEx, decided to acquire stake in its partner Da Tian W. Group. As a result foreign giant gained access to domestic express network in major Chinese cities. Acquiring local partner enabled FedEx to extend its services scope and gain first mover advantage over its major rivals In 2009 German DHL completed a 300 mln RMB worth acquisition of Shanghai based private company A Plus Express which now provides domestic express delivery services for DHL. Main competitors such as UPS and Dutch TNT, are still in the stage of application for permission to provide express delivery services.

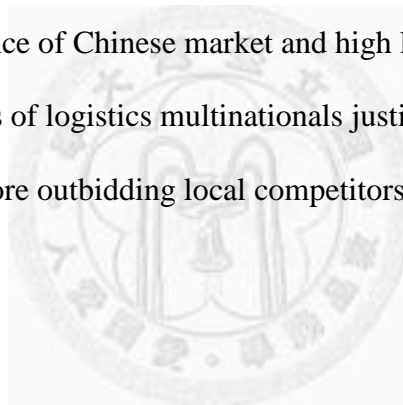
3.3.5 Global strategy purposes

Third Party Logistics is one of the fastest globalizing sectors in world's economy. According to Hout, Porter and Rudden (1982)⁵⁴, in a global industry competitive advantages of an enterprise in one country are affected by its market position in other region. Moreover, based on Kim and Mauborgne (1988) research⁵⁵, global strategy has significant impact on choice of market entry by multinational enterprises. Through M&A foreign companies are mainly seeking to increase its global market share and synergies stemming from operating on a global scale. By acquiring local partners multinationals increase their level of control and prevent emergence of potential competitors. Recent expansion of TNT is a distinctive example of such conduct. Its acquisition of HOAU Logistics (华宇物流) was a part of company's global strategy that pursued increase of global market share in consolidating industry. In recent years TNT engaged in many similar deals in such countries like Vietnam, Thailand, Singapore or Malaysia to secure its position in perspective Asian market. According

⁵⁴ Hout, Thomas, Michael E. Porter & Eileen Rudden. How global companies win out[J]. Harvard Business Review, 1982(60):98-108.

⁵⁵ Kim, W. Chan & Renee A. Mauborgne. Becoming an effective global competitor[J]. The Journal of Business Strategy, 1988(1):33-37.

to Kim, Hwang and Burgers research global scope of operation allow companies to benefit from synergy effects⁵⁶. They may be observed in many aspects of entities operations, such as R&D or marketing. In case of logistics enterprises such synergy comes mainly from network integration, that enables multinationals to provide high value added, one stop shopping service for its customers. Acquisitions conducted by Menlo Worldwide can be a good example of such strategy. In 2007 this leading American supply chain management services supplier acquired Shanghai CHIC (上海熙可控股公司) and Singapore based Cougar Express Logistics. As a result of this acquisitions gained access to one of the most comprehensive logistics network in East Asia. Menlo Worldwide expansion in this fast growing region enabled its parent company Conway Holdings to offer integrated services for its customers in America and Europe. Importance of Chinese market and high level of synergy between domestic and global operations of logistics multinationals justifies paying high premium for Chinese companies and therefore outbidding local competitors unable to benefit from such significant synergy effects.



⁵⁶ Kim, W. Chan, Peter Hwang & W.P. Burgers.. Global diversification strategy and corporate profit performance[J]. Strategic Management Journal, January-February, 1989,10(1):45-57

Figure 3 - 3 Main M&A's of foreign 3pl companies in China

2005.01	Malaysian based Kerry Logistics acquires 70% stake in Datong International for 380 million RMB.
2005.03	Meridian IQ, a subsidiary of leading provider of transportation and global logistics services YRC Worldwide Inc acquires Shanghai-based GPS Logistics Group.
2006.01	FedEx acquired 50 percent share of the FedEx-DTW International Priority express joint venture from DTW Group and DTW Group's domestic express network in China for US\$ 400 million.
2006.09	American YRC Worldwide purchased a 50% stake in JHJ International Transportation Co. Ltd.
2007.03	03 Dutch TNT acquired Chinese largest cargo and parcel transporter, Heilongjiang-based HOAU Logistics Group for 135 million USD.
2007.09	Schneider National acquired BaoYun Logistics one of the top 30 private owned logistics companies in China.
2007.09	Menlo Worldwide acquired Shanghai based 3PL CHIC in a deal worth for 60 million USD.
2008.05	Agility Logistics, Kuwait based giant with has acquired Cosa Freight, a full service ocean freight forwarder with offices in six key locations in China.
2008.08	YRC Worldwide bought a 65 percent share of Chinese Shanghai Jiayu Logistics Co for 45 million USD
2009.01	German DHL together with its partner Sinotrans acquired Apex100 for 300 million RMB.
2009.03	American ProLogis acquired assets in order to expand its platform at one of its largest industrial parks located in Suzhou, China in a deal worth 1,5 billion RMB
2010.01	Sagawa Global Logistics acquired 100% of the shares in Silox Shanghai and Qingdao Silox, two China based logistics companies from Silver Ox Inc and established them as subsidiary companies.
2011.07	Kerry Logistics acquired controlling interest in two companies in 3PL sector in China; Shanghai Wisdom Group and Shanghai Huicheng Logistics.

Source: YUAN Ping-hong, Logistics Sci - Tech, No 8. 2009, The Influence of Foreign M&A on the Private Logistice Enterprise of China, Anhui University of Finance & Economics, Bengbu 233041, China

3.4 Impact of M&A on Chinese 3PL sector

By entering the market through mergers and acquisitions of Chinese 3PL providers Multinationals had significant impact on logistics sector as a whole. Within a short period of time foreign entrants had significantly contributed to the process of increasing concentration of fragmented logistics industry in China. Due to implementing most recent know-how and technologies global players also played a crucial role in raising efficiency within the industry. By providing world class services foreign entrants played a significant role in facilitating

growth of trade between china and abroad, and as a result contributed to acceleration of GDP growth. However, from Chinese point of view, raising level of foreign ownership in such a key sector as logistics may become an obstacle for local players to grow due to high level of competition from better positioned overseas companies⁵⁷.

3.4.1 Contribution to economy growth

At the beginning of M&A wave Chinese logistics industry was still in its infancy. Government by opening the market hoped that entrance of foreign enterprises will not only help to develop logistic industry, but also provide services that enable growth of other sectors. Nowadays majority of key global players already established their operations in China. They provided Chinese logistics industry not only with capital, but also more important assets such as technology and experience gained through years of global operations. Therefore significantly raising sophistication level of services offered in the market and bringing better growth perspectives for the whole economy.

3.4.2 Increased market concentration levels

China logistics sector has a very low concentration level by international standards with many locally operating companies often consisting of one self-employed owner. Exceptionally low levels of concentration often lead to inefficient allocation of assets and unnecessary multiple performing of many activities. Small companies by engaging in stiff competition often waste significant amount of resources which don't result in increase in efficiency of industry as a whole. Mergers and acquisitions in the industry have a positive impact by increasing the concentration levels and bringing better quality services even to the less developed areas of the country.

⁵⁷ Research on Transnational logistics Corporation Mergers in China
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3.4.3 Increasing competition

Local 3PL providers are still far behind global players in such aspects as market share, customer portfolio, marketing activities or brand recognition. According to research conducted by Mercer⁵⁸ vast majority of the companies operating in the industry belong to SME⁵⁹. As a proof of this thesis, not a single company included in the research has exceeded level of 2% market share. Multinational supported by global logistics network and extensive capital had gained a significant part of the higher value added market such as 50% of export and 60% of import related services⁶⁰.

Chinese logistics industry is still relatively immature. Low concentration is combined with low entry barriers, especially in case of less sophisticated services. Low entry barriers lead to very high levels of often destructive competition. Entry of foreign players increased its levels even further. Overall, M&A of multinational enterprises had more positive than negative impact on the industry development exposing bottlenecks affecting the sector and providing it with most recent know-how and services⁶¹.

⁵⁸ Research on Transnational logistics Corporation Mergers in China

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⁵⁹ according to Chinese classification yearly revenue has to remain below 50 mln RMB

⁶⁰ The Effects of Foreign Capital's Entrance into

China's Logistics Industry WU Yue , LIANG Chen and WEN Wei-juan(Beijing Wuzi University , Beijing101149 , China)

⁶¹ Tactics of Transnational Logistics Corporations in China and the Revelation

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Chapter 4: Conclusion

4.1 Main Findings

This research reviewed current situation as well as future prospects of China's 3PL market applying the viewpoint of foreign companies operating in the industry. Moreover the analysis of market entry modes and competitive strategies has been conducted with focus of M&A activities of foreign multinationals. Moreover, recommendations for further growth strategies of 3PL providers are provided.

According to the research, the logistics industry as a whole has very good prospects and growth potential, with majority of expansion to occur in domestic market services. Main reasons for such growth distribution is the Chinese government policy targeting domestic market demand expansion, as well as slowing growth of international trade flows between China and the world. Moreover, current low efficiency of logistics implies huge growth potential for the industry that will be supported by big-scale development of transport related infrastructure. The tendency of logistics activities outsourcing is clearly visible as companies choose to focus on enhancing their core competences. Also rising competitive advantages of Chinese enterprises and, as a consequence, gradual globalization of their activities will be a huge market opportunity, particularly for foreign 3PL providers.

Acknowledging current and future importance of Chinese market majority of the key global players in the industry have entered China in 1980's and 1990's, long before the main period analyzed in the thesis. Due to government restrictions towards foreign entities they were operating mainly in form of joint-venture with local partners. Their main market focus was supporting foreign trade activities of both foreign and local companies.

According to the research M&A wave of multinational 3PL providers in China had been influenced by several key factors. Firstly, loosening of government policies enabled foreign companies to conduct business in China as a wholly owned enterprises instead of joint ventures with local partners. Therefore it allowed foreign enterprises to buy out their partners share. The main reason for such buyout wave were common arguments between the associates. Since the management often had different views stemming from very diverse cultural backgrounds the cooperation wasn't always very smooth. Therefore foreign companies preferred to take things in their hands and gain ability to make decisions independently, based solely on their own considerations. Since the majority of foreign players were much bigger in size then their Chinese cooperates, the deals were conducted as acquisitions rather than mergers.

Another factor determining the popularity of M&A was its speed a particularly crucial factor when considering strategies in such fast growing markets as China. When the restrictions were loosened, there were already many capable local players competing in the market. M&A was a method that enabled foreign companies to attain scale economy in a short period of time, instead of building up capabilities in house.

In spite of popularity of M&A, many of deals in the industry didn't bring expected results. Acquired companies either failed to create synergy with the parent enterprise, or the foreign players wrongly targeted low value added services in domestic market, where they weren't able to compete with local companies possessing various competitive advantages on the local market. Therefore, many M&A transactions ended in failure and in extreme cases foreign multinationals have decided to sell entities acquired before.

4.2 Recommendations

Several recommendations are made after analysis of foreign 3PL providers expansion in China:

Customer focus:

- Foreign multinationals should focus to serve customers whose logistics operations are characterized with at least some level of sophistication, in the low value added market services local providers have competitive advantages stemming from better understanding of Chinese business environment.
- In order to success in cost oriented customer segment the companies should thoroughly analyze their supply chain cost structure and try to provide more effective solutions based on their know-how, technological advantages. Inefficiency of logistics industry as a whole implies that there is a lot of room for improvement in this matter.
- Educate customers, emphasize added value creation and savings due to implementation of more efficient logistics operations. Spending more money on logistics services can still provide big savings by decreasing inventory cycles and working capital needs.
- Closely cooperate with key customers, if necessary take part in joint-ventures responsible for forward integration of their logistics activities

Leverage complementors, suppliers and capabilities of parent company:

- Due to big fragmentation of the market foreign 3PL should act as integrators, leveraging competences of local suppliers and complementors, providing complete supply chain solutions.
- Leverage economy of scale and focus on high value added services such as multi-modal transport, supply chain management or international logistics.
- Improve efficiency by implementing know-how and management skills of parent company
- Pursue vertical integration with top performing complementors through M&A, through purchasing minority stake multinationals can gain better access and first hand information from the market. Moreover they will also gain better position to persuade management of benefits brought by long term win - win cooperation.
- While conducting M&A foreign entrants should focus on the human side of mergers. In Chinese business environment personal connections of key managers in the company are one of the key competences determining competitive advantage of a company. Therefore their remuneration should be closely bonded with company's results, providing strong incentives for better performance.

4.3 Research limitation and further research suggestions

Since not all data included in the research are the most recent one, some inconsistency may occur, especially during comparisons. Moreover, since the companies are unwilling to provide detailed data about their business to prevent their competitors from obtaining confident information, many constrains occurred during the analysis of operations of selected 3PL provider operations.

Due to very specific Chinese social cultural environment a further analysis determining the methods that foreign enterprises apply to overcome its "foreignness" disadvantages. The analysis should be made with special focus on Japanese entities since bad sentiment towards this country is still very common among common Chinese citizens.





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