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Reality tempers tech firms' dreams for China

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Just how promising is China's high-tech market?

A growing number of tech companies are looking at China as the next huge business frontier, both as a way of tapping into its growing consumer market and for manufacturing goods at cheaper costs.

Some recent data, particularly in the semiconductor industry, have supported that optimism.

In the Semiconductor Industry Association's monthly worldwide chip sales report released last week, Asia Pacific was the only region that saw chip revenue climb compared with the same month last year. Asia Pacific includes China, Singapore, South Korea and Taiwan. China's growth is by far the most robust, according to the association.

Chip sales to the Asia Pacific region rose 22.4 percent to \$4.16 billion in May while sales in the Americas, Europe and Japan fell 21 percent, 20.6 percent and 25.9 percent, respectively.

In a semiannual forecast luncheon last month, the association predicted that semiconductor consumption will rise 27 percent in the Asia Pacific region this year, while the other three regions will likely face declines.

Some high-tech giants such as Silicon Valley's Applied Materials and Intel Corp. view China as an opportunity that's too good to pass up, and recently invested hefty amounts of money there.

But all that glitters may not be gold.

While thoughts of selling goods to this vast country and the potential to tap into its low-cost manufacturing base are attractive to many executives, some experts warn that China's gold mine is still full of pitfalls.

In fact, if the past is any indication of what lies ahead, companies must take prudent steps in engaging the Chinese market -- or the results could be disastrous, experts say.

Usha Haley, an associate professor specializing in international business at the University of Tennessee at Knoxville, said most companies that have set up shop in China to sell their products domestically have not been profitable.

The story was different if the firms' strategy was to take advantage of lower manufacturing costs in China and export their products abroad, she said.

Haley's research involved a wide range of industries. She studied companies such as TRW Inc., 3M and Bayer.

What's interesting is that despite the lack of success in China's domestic markets, most of the firms are still planning to expand there, Haley said.

Nick Hope, former director of the World Bank's lending program in China, agreed.

"I have anecdotal evidence that for a lot of bigger companies, their profits have not been sensational or (they) have not been there at all," said Hope, now acting director of the Center for Research on Economic Development and Policy Reform at Stanford University.

"The question is, are you investing for profits in the next three or four years, or down the line?"

And gauging China's true market potential is very difficult, whether it involves high-tech gear or other domestic products, Haley said.

"The thing about China is that a lot of it is 'guesstimate.' Everything is market potential, but the markets today are not that large," she said. "A lot of it depends on how the dice falls in the future."

China's entry into the World Trade Organization last year definitely was a milestone, and forces the Middle Kingdom to open its markets and subscribe to free trade.

The details are still to be worked out, and there are many remaining issues, such as the country's two-tiered value-added tax system, in which rates on imports are much higher than rates on goods produced in China.

"It's something that they put in place last year to try and encourage (semiconductor) investment in China," said Daryl Hatano, the semiconductor association's vice president of public policy. "But you cannot have a discriminatory approach like that."

Two weeks ago, Hatano was in China meeting with Chinese officials to talk about such issues.

"I think they understand it in a general sense. You have to keep in mind that their industry right now is still relatively small, but growing rapidly," he said.

Domestically produced chips only satisfy about 20 percent of demand in China, Hatano said. That's one reason several big chipmakers have expanded to China in recent months.

Anticipating the rise in the number of semiconductor factories in China, chip manufacturing equipment-maker Applied Materials opened a huge sales and marketing office in October at the Pudong Zhangjiang High-Tech Park in Shanghai. The Santa Clara company then promptly announced it signed a \$200 million deal with Grace Semiconductor Manufacturing, which is based in Shanghai.

Intel Corp., the world's largest chipmaker, said it invested \$500 million in China last year. The Santa Clara firm said in May that it will assemble and test its Pentium 4 microprocessors at the Waigaoqiao Free Trade Zone in Pudong.

The site employs 1,200 workers, and the company plans to expand to 3,000 workers by 2004.

"It used to be that most companies would set up joint ventures in China. Now the trend is much more toward wholly owned facilities," said James Jarrett, who served as president of Intel China Ltd. in Beijing from 1996 to 2000. He is now the firm's vice president of legal and government affairs and director of worldwide government affairs.

"You've got to go in and build your network up and take care of the customers and go from there," he said. "It's a question of really trying to take full advantage of the opportunities that are there."

Smaller tech players also have joined the mix.

Kingston Technology, a Fountain Valley (Orange County) firm that makes memory sticks for PCs, opened a manufacturing plant last year at the free

trade zone in Pudong in a joint venture with Great Wall, a Chinese computer company.

Business conditions have vastly improved since the 1990s, said Stephen Rodriguez, Kingston's director of strategic marketing.

"The fact that they desperately want to join the WTO, they're being much more flexible and reasonable," he said.

Still, navigating through China's economic waters and dealing with sometimes conflicting bureaucracies is difficult, Haley said.

And for high-tech companies, issues such as intellectual property protection are still elusive concepts in China.

"China remains the No. 1 violator of copyright and patent protection for multinationals," Haley said.

Also, while the central government is more open to the ideals of the WTO, regional government officials may not see things eye to eye with multinational companies, Haley said.

But even if all those concerns are addressed, companies moving into the market must account for their competitors, Hope added.

He said that one reason foreign automakers haven't found success in China is that there are too many of them competing for a relatively small domestic market.

"You can't afford to walk in blindly. There is a need to assess the situation," said Hope.

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