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# DETERMINANTS OF LOCAL RESPONSIVENESS OF FMNCs IN MAINLAND CHINA

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Recent regulations, associated with China's accession to the World Trade Organisation (WTO), specifically Decree 113 and Decree 114, have largely changed the situation for foreign multinational construction companies (FMNCs) operating in mainland China. A field investigation has identified that local responsiveness is critical for FMNCs to survive and develop in the complicated and uncertain Chinese construction industry. Government policy, China-specific construction industrial factors and increasing competition intensity imposed by local competitors are recognized as the major determinants driving local responsiveness of FMNCs. This study has also examined that localisation of internal resources, establishment of local networks and cooperation or strategic alliances with local contractors and design institutes are the key local adaptation strategies for FMNCs operating in mainland China.

Keywords: local responsiveness, international construction, emerging market, MNCs.

## INTRODUCTION

Since China introduced its 'open door' policy in 1978, many multinational contractors and engineering consultancy companies have entered the mainland China market. The Chinese construction industry has witnessed unprecedented growth during last decade. It has become one of the largest construction markets in the world and still offers a large growth potential due to a huge demand for infrastructure and buildings. The Chinese construction industry remains lucrative and represents an important strategic position for multinational construction companies in their global landscape according to its large capacity and potential.

The Chinese construction industry presents certain China-specific factors which foreign participants may find hard to adapt to. It is an emerging market within a transitional economy, with massive number of state-owned and collective-owned native construction companies. Recent regulations, specifically Decree 113 and Decree 114, have launched a licensing and qualification regime for companies undertaking design and construction work in mainland China. Most foreign multinational construction companies (FMNCs, including both contractors and engineering consultants) have found themselves being largely restrained by these new regulations. Local adaptation is perceived by FMNCs subsidiary managers as one of the most crucial factors needed to succeed in the complicated and turbulent Chinese construction market.

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This study has identified the major determinants propelling local responsiveness of FMNCs in mainland China construction market. Three local adaptation strategies that FMNCs employed are also explored. As part of a broader research program, grounded theory is the adopted research methodology. Different from traditional deductive methods, grounded theory strategy starts from field investigation rather than theories. Based on findings from field study, a theoretical model is generated and it empirically validates some existing theories regarding local responsiveness in dynamic emerging markets.

## LOCAL RESPONSIVENESS THEORIES AND FRAMEWORKS

The global integration-local responsiveness (I-R) model proposed by Prahalad and Doz (1987) is one of the most influential theories concerning international business management and strategy of multinational corporations (MNCs). It argues that managing international business MNCs are required to balance two demands – global integration of activities and responsiveness to local conditions. Integration refers to the centralised management of geographically dispersed activities and resources in an attempt to build efficient operation networks and achieve maximum benefit from similarities across locations. Local responsiveness refers to resource commitment decisions taken autonomously by subsidiaries in an attempt to respond to specific local demands and differences. Bartlett and Ghoshal (1989) have applied this approach to identify three basic types of strategies for MNCs doing international businesses – global strategy (an integration strategy), multi-domestic strategy (a locally responsive strategy) and transnational strategy (a multifocal strategy), illustrated in Figure 1.

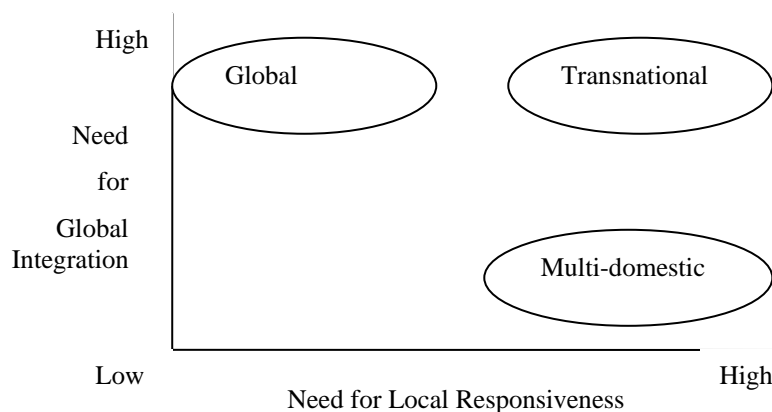


Figure 1: Integration-Responsiveness Grid (sources: Hurt, 2007; Prahalad and Doz, 1987; Bartlett and Ghoshal, 1989)

Foreign subsidiaries of MNCs should possess necessary flexibility to adapt to a particular local environment while maintaining a system of integration and internalization. The demand for local responsiveness often arises when local markets contain significant differences in customer needs and/or distribution channels, or where products are required to be locally competitive especially when the local industry is fragmented (Prahalad and Doz, 1987). A complex and dynamic host

market with socio-political and macroeconomic sophistication also propels local responsiveness (Morrison and Roth, 1992). Foreign subsidiaries have to consider local responsiveness in managerial practices and human resources adaptation in response to host country context and industry structure (Hurt, 2007).

Yadong Luo (2001) has proposed a model identifying major determinants of local responsiveness in an emerging market with three levels of factors – national environmental, industry structural and organizational (shown in Figure 2). National environment refers to the macroeconomic, political/legal and socio-cultural environments of a host country. Major environmental factors that may elevate local responsiveness include environment complexity, specificity and cultural distance between home and host countries. Many emerging markets' economies are in transition which generates dynamics requiring companies to develop a superior ability to respond quickly to environmental changes. Each emerging market is shaped by unique business and commercial practices ascribed to historical, social and economic reasons (Luo and Peng, 1999; Xin and Pearce, 1996). Such institutional contextual impediments can hinder information transfer and technology and management skill diffusion in cross-border operation or within the local market (Doz and Prahalad, 1991; Mueller, 1994; Sorge, 1991). They also increase the liability of foreignness and adaptation costs (Dunning, 1981). Therefore, in order to build up sustainable competitive position, foreign subsidiaries have to respond to local conditions efficiently and effectively.

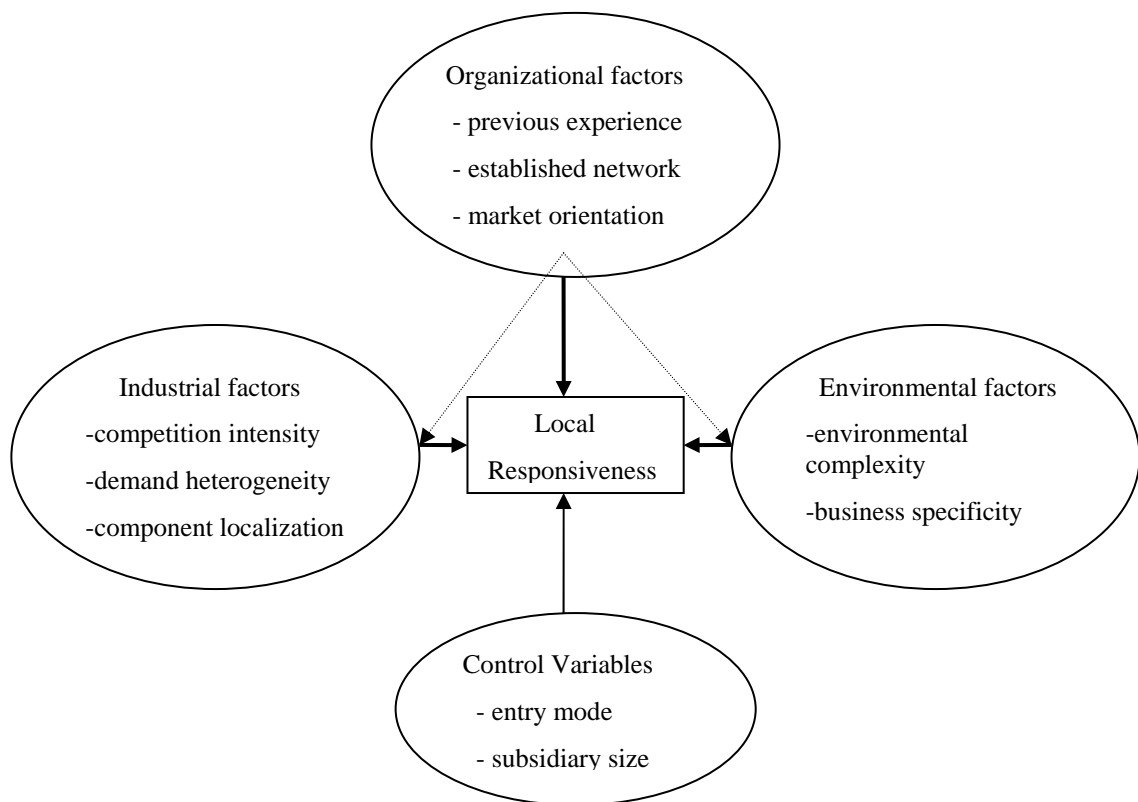


Figure 2: Determinants of local responsiveness (source: Lou, 2001)

According to industrial organizational (IO) theories, industry structural forces determine the strategies and activities of firms embedded in the industry (Porter, 1980; Schere and Ross, 1990; etc.). The degree of local responsiveness is largely influenced by industry structure (Chang and Singh, 2000). Luo (2001) has identified that competition intensity, customer demand heterogeneity, and demand on component localization are the major industrial factors that propel local responsiveness. Competitive intensity among existing rivalry and threats generated from new entrants and substitutes may force foreign subsidiaries to exploit new competitive advantages through local adaptation. In an economically dynamic and culturally diversified economy, market demand may vary. Local focus and adaptation is necessary. In emerging markets, government may often enforce localization and thus some components of the supply chain may be required to be localized.

Even embedded in the same national and industrial context, firms behave differently. Market orientation (locally oriented vs. major exporting) of a MNC largely determines its degree of local adaptation. Export-seeking subsidiaries are less dependent on indigenous environment and therefore require little responsiveness. Previous experience about host environment is important for mitigating the liability of foreignness (Erramilli, 1991). A subsidiary which is more familiar with the market is more likely to commit resources and investment to local operations (Chang, 1995). Establishing relationships with local suppliers, buyers, distributors, competitors and government is a social investment that foreign subsidiaries can use to their benefit. Firms that have well cultivated local networks are more likely to seek economic rents by utilizing such commitment.

## **RESEARCH METHODOLOGY**

This study of local responsiveness of foreign multinational construction companies (FMNCs) operating in mainland China is part of an ongoing research program exploring strategic management of large and medium sized FMNCs competing in China. Grounded theory was adopted to investigate and discover the nature of competition within the Chinese construction market and the strategic behaviour of FMNCs in this arena. An inductive research methodology is selected due to several reasons. Firstly, there is a lack of comprehensive and well known theoretical frameworks focusing on individual units and subsidiaries within the MNC and most studies on international business management and strategy are concerned with the MNC as a whole (Birkinshaw, 2001). There is a paucity of literature on business strategies of foreign subsidiaries in emerging markets.

Secondly, most of international business theories are developed from studies of MNCs in manufacturing industries. However, the construction industry is different from traditional manufacturing industries; the products of construction involve not only physical buildings but also services (Hillerbrandt, 1984). As construction skills develop and diversification is expanded, more and more service products are developed and provided by contractors, such as design and build (D&B), management contracting, design, build, operation and transfer (DBOT), financing, operation and maintenance, etc. (Seymour, 1989; Enderwick, 1987; Langford & Male, 2001). Thus, there arises the concern whether those theories built upon studies of manufacturing

industries are applicable to construction industry where services are the major products.

This research focuses on FMNCs from North America, Europe and Australia listed in the ENR 'Top 225 International Contractors (2006)' and 'Top 200 International Design Firms (2006)' who have operations in mainland China. There are 81 FMNCs in this grouping. Besides those FMNCs from North America, Europe and Australia, within the ENR lists there are other foreign players from Japan, South Korea, and Singapore. However, these participants mostly serve only clients from their home country and they are different in nature to the business management and organization culture with western FMNCs.

A six months field investigation was undertaken in mainland China to collect data on strategic management of targeted FMNCs. Interviews with senior managers and project managers of these FMNCs and documentation analysis were the major research methods employed. Fourteen interviews were completed with eight wholly foreign owned FMNCs. Data collected are analyzed through 'line-by-line analysis' and 'categorizing' methods designed and developed by scholars (Strauss and Corbin, 1998; Bryman and Bell, 2003) studying inductive research methodologies. A qualitative data analysis software 'NVivo7' was used to facilitate data analysis and improve accuracy. A report together with a questionnaire presenting major findings from field investigation was generated after data analysis. It was sent to previous interviewees for data verification and to other FMNCs that have not been involved in interviews for validation. Major results concerning local responsiveness of large and medium sized western FMNCs are discussed in the following section.

## **DISCUSSION**

Following the field investigation, local adaptation was identified as one of the most important critical success factors for FMNCs to compete in the Chinese construction industry. It is largely driven by the specific nature of the Chinese construction environment. Major determinants of local responsiveness of FMNCs are examined.

### **Policy-driven environment**

Historically, governmental restrictions have posed a significant obstacle for foreign construction companies wishing to enter the Chinese construction industry. Regulatory changes are viewed as one of the most significant threats for FMNCs operating in China. Since China's open door policy in 1978, regulations concerning foreign participation in activities such as design and contracting have been changed and adjusted regularly (e.g. in 1986, 1992, 1994, 1995, 2002 and 2004).

With China's accession to the WTO, the regulatory environment for foreign participation has been largely changed. The promulgation of Decree 113 in the construction works sector and Decree 114 in the engineering and design sector issued by the Minister of Commerce and Minister of Construction has changed the environment. Decree 113 and Decree 114 have mainly restrained FMNCs from

undertaking construction, design and engineering work by setting extremely high requirements on registered capital for establishing a local entity and implementing a complicated licensing and qualification regime.

Driven by Decree 113, FMNCs that previously undertook construction work in China were forced to make quick strategic responses: 1) whether to continue construction contracting despite the high costs, or provide consultancy services only and avoid risks; and 2) in what form to enter the market – as a wholly foreign owned company or Sino-foreign joint venture or acquisition. The Chinese government gave only two years for the transformation and FMNCs had to adapt to the regulation changes efficiently. The investigation indicated that only 7 out of the 81 targeted FMNCs have obtained construction licences since Decree 113 was promulgated at the end of 2002. Many multinational contractors have chosen to remain in China with representative offices and wait for opportunities to enter the market due to the high entry barriers and risks. Confronted with the difficulties of obtaining construction and design and engineering licences, FMNCs have to establish strategic alliances or cooperative relationships with local construction companies and Design Institutes in order to participate on projects.

Moreover, market demands for FMNCs in China are largely driven by China's inbound foreign direct investment (FDI) policies. According to Decree 113 and Decree 114, wholly foreign owned construction related companies are allowed to undertake only four types of projects:

- Construction projects that are fully foreign funded or granted
- Construction projects that are awarded through international tendering and founded by international financial organizations
- Sino-foreign joint venture construction projects that are funded at least 50% by foreign investment or Sino-foreign joint venture construction projects that are funded less than 50% by foreign investment but are technically difficult for Chinese construction enterprises to complete independently
- China founded construction projects that are technically difficult for Chinese construction enterprises to complete independently

The field study also indicated that more than 95% of clients of most FMNCs working in mainland China were international clients. Thus market demand for FMNCs is largely influenced by inbound FDI policies such as the "Catalogue for the Guidance of Foreign Investment Industries" issued by the Minister of Commerce annually which describes the governmental encouragement or discouragement of FDI in many sectors of each industry.

China is also too vast and varied to be considered as a single market. There are also very different cultural, economic construction environments in different regions. Different provinces have different regulations related to foreign construction activities, different requirements on contracting procedures and different taxation policies. FMNCs must be aware of these regional diversities and accumulate specific

local knowledge in each region. This may come through localisation employment policies.

### **Relationship-oriented contracting culture**

China is an emerging market during transition. The business environment in the construction industry is largely relationship oriented and socially embedded. Relationship-based contracting is common. Managerial and personal relationships are very important for exploiting new opportunities. FMNCs have to establish solid relationships with their clients, suppliers, local partners, local construction related institutions, central and local government. The study indicated that many FMNCs, especially large sized FMNCs, have established departments in each of their local offices in China for developing relationships with local clients and government. FMNCs also require local employees to help establish local networks by using their local knowledge and personal relationships.

### **Specific contracting system**

Although China has been 'open door' for thirty years, the construction system is still different from international norms. China has applied its special design codes and standards which are very different from international ones. FMNCs must learn to cope with them. Tendering systems and bidding procedures in China still have differences with international models that FMNCs are familiar with. In order to succeed in the Chinese market, foreign players must understand the Chinese way of doing construction. In addition, the Chinese construction industry has its specific problems such as, interference by government especially on large state-owned projects, project payment in arrears, and lack of transparency for tendering and project delivery. In order to deal with these issues, local employees with sufficient local knowledge are essential. The top management team also need to prepare to accept and adapt to these China-specific factors.

### **Growing threats from local competitors**

There are three main categories of Chinese construction enterprises: state-owned units (including government agencies), collective owned units (or co-operatives), and private owned entities. State-owned construction companies are playing a dominant role in the market. They are usually on a much larger scale in terms of production and employment than the others. During last two decades the Chinese construction companies have developed fast.

FMNCs come to the Chinese construction market with high technology and management skills. However, local companies provide lower prices and are relatively efficient. The huge Chinese market provides domestic construction companies with the best chance to practise and improve. Knowledge transfer through Sino-foreign joint ventures also accelerates improvement. Increased overseas participation has helped Chinese construction companies develop their technologies and improve quality of production to meet international standards. They have also built up better brand identity and become important players in the global market.



Local companies have other advantages comparing to FMNCs: 1) better supporting infrastructure for exploiting new opportunities, 2) developed local logistics system, 3) well established business and social networks with key construction-related parties, 4) licences required for construction, design and engineering work which are hard to obtain for FMNCs, and 5) protection by central and local government through regulations and policies.

Confronted with growing threats from local construction companies, FMNCs are forced to increase local adaptation. As local companies continue to move up the value chain, cost pressure on FMNCs is rising up. Localisation of key internal resources especially key human resources, e.g. engineers and project managers, is crucial for FMNCs to cutting costs. The field investigation has shown that the annual costs of a western project manager in FMNCs in China are usually five times higher than the costs of a local project manager.

The key findings concerning major determinants of local responsiveness of FMNCs operating in mainland China are summarized into a model illustrated in Figure 3. Three categories of factors are identified as the major determinants driving local adaptation of FMNCs. Government forces through regulations and policies are influential. Although China has entered the WTO, the Chinese construction industry is not completely open for foreign participations. High entry barriers have been set and local protectionism is strong. The Chinese construction industry has specific factors (relationship-oriented contracting, unique construction systems and culture that are different from international norms), which require adaptation from FMNCs. Growing threats imposed by local competitors force FMNCs into localisation as a cost cutting strategy.

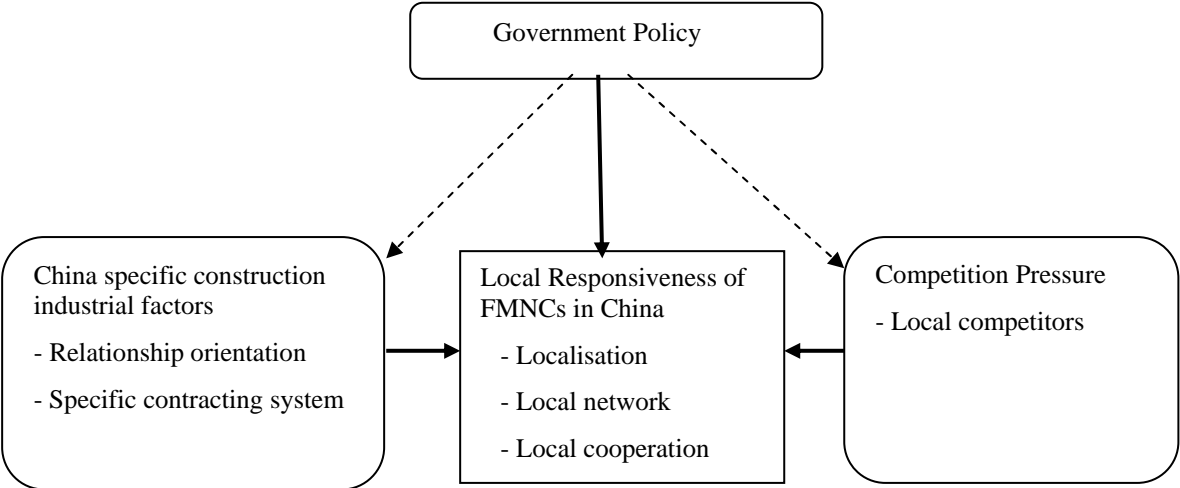


Figure 3: Major determinants of local responsiveness of FMNCs in China

Meanwhile, three major local adaptation strategies can be classified from FMNCs' responses: 1) continuous localisation of key company resources particularly human

resources; 2) establishing good relationships with local suppliers, partners, competitors, central and local government and other construction related institutions; 3) building up long term cooperation or establishing strategic alliances with local contractors and design institutes. Cost pressure imposed by growing threats from local competitors and the demand for local knowledge are the primary drivers for localisation. Relationship-oriented construction culture and unique Chinese contracting system call for the establishment of local networks. High entry barriers set through government regulations due to protectionism force Sino-foreign cooperation and alliances to be favoured by FMNCs.

## CONCLUSION

Given the complexity and uncertainty of the semi-open Chinese construction market and the growth of competitive threats from local competitors, ownership advantages transferred from home markets (e.g. advanced technology, management skills) are no longer sufficient to ensure success for FMNCs. They are forced to develop location-specific competitive advantages that enable them to adapt to local environment quickly. Localisation of internal resources is the best practice to cut down overheads and gain local knowledge. Establishing sustained and solid managerial and personal relationships with indigenous suppliers, clients, local contractors, design institutes, government and other institutions helps to create more competitive opportunities. Building good cooperation with domestic contractors and design institutes can alleviate the shortage of qualification licenses and enhance market opportunities. The demand for local responsiveness of FMNCs will continue as long as these major determinants of localisation still exist in the Chinese construction industry.

This study has empirically validated some issues proposed by Luo (2001) in his model of major determinants for local responsiveness in emerging market. For instance, the governmental influence identified in this study verifies Luo's (2001) 'legal/political environment complexity'. Relationship-based contracting identified in this study represents 'social-cultural complexity'. Local competitor threats of this study indicate 'competition intensity'. Government regulation encouraging Sino-foreign joint venture/cooperation entry mode confirms 'component localization under government pressure'. Further studies could focus more on the theoretical development of local responsiveness strategies for FMNCs competing in emerging markets and implementation of these strategies.

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