Volkswagen Group China: Driven, but not Managed by Locals

Managing the MNCs in China

Term Paper

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Outline

1. Localization of Management in China: An Overview

Executives in China-based subsidiaries of western multinational companies (MNCs) face difficult decisions with regards to the question of whether to employ expatriate, Chinese or local-hired foreign managers (expatriates are defined as international transferees from the parent company to the local subsidiaries). For western MNCs, it may be especially attractive to assign expatriates to China due to the large cultural distance, which increases the perceived risk of losing coordination and control by filling key positions with Chinese nationals. One of the key reasons for expatriate assignments is related to the function of expatriates in the successful implementation and attainment of global business strategies, i.e. through knowledge transfer, coordination and control of foreign operations as well as the development of human resources (Reiche & Harzing, 2011). On the contrary, the costs and deficiencies (e.g., high expatriate allowances and expatriate failure in the form of premature return) related to expatriate assignments are known to be of significance in the case of China (Selma, 2003) and many MNCs have reported a reduction of these assignments in the course of cost-cutting programs (Grainger & Nankervis, 2001; Hewitt Associates, 2007). In particular, the "localization" of management -generally referring to the replacement of expatriate managers with managers recruited from the local labor market- has become an important issue for western MNCs in China (Wong & Law, 1999).

Different arguments can be offered to justify the preference for local Chinese managers: First of all, the network of social relationships (*guanxi*) in which local managers are embedded allows them to build lasting and trustful business relationships more effectively than expatriates (Graham & Lam, 2003; Hutchings, 2005). Secondly, employing local managers initially or localizing management positions can contribute to better work morale and effectiveness among Chinese employees through a common language and cultural background (Hailey, 1996). Moreover, the managerial and technical skills of Chinese employees have improved substantially over the recent years. Hence, there is no longer a short supply of highly skilled and experienced local employees within the Chinese labor market (Kuehlmann & Hutchings, 2010). Finally, localization could raise satisfaction and commitment of Chinese managers, for which the lack of visible career paths and discontent with the offered opportunities for growth and career advancement are a widespread concern and a major reason to resign from a job (Groenewald, 2008; Wong & Law, 1999).

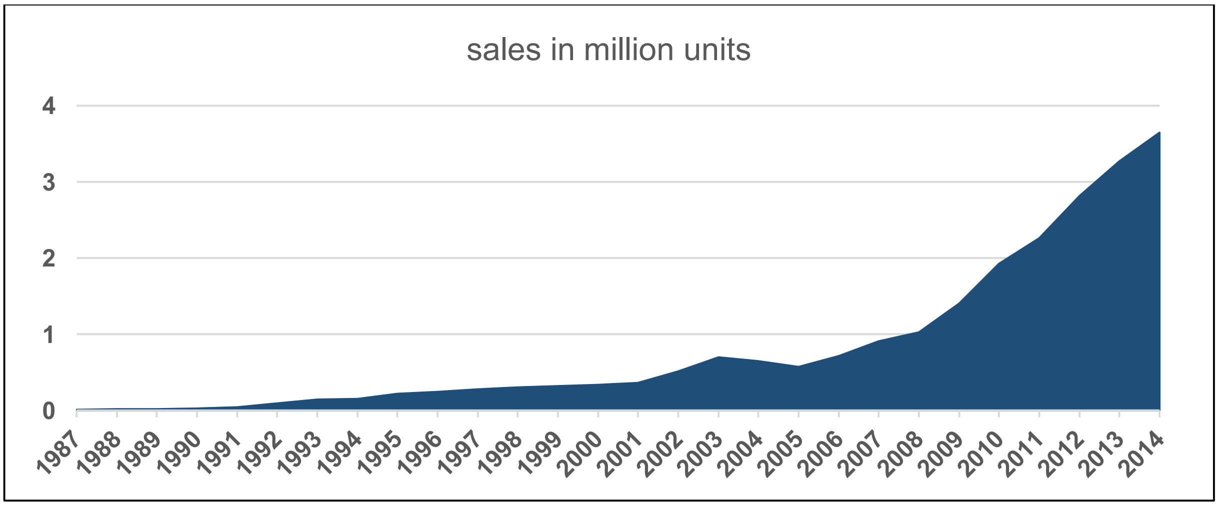
Nevertheless, there remain some disadvantages regarding the employment of local managers in China. While they are familiar with the Chinese culture and business environment, this might not be the case with respect to the values and norms of western MNCs, which could lead to frictions between the Chinese subsidiaries and headquarters (HQ). The high turnover rate among local Chinese managers is a further barrier to localization, since many local managers quit their job shortly after gaining employment in order to join another company which offers a more attractive payment or better opportunities for career advancement (Wang & Chan, 2006). Domestic firms sometimes offer dramatic pay increases to raid experienced executives and technical talent from western MNCs (Schmidt, 2011). Some western MNCs have begun to hire foreign managers who live in China, to capitalize on the relative advantages of both expatriate and local managers. Local-hired foreign managers are familiar with western corporate culture and management styles and they can leverage their pre-established social networks as well as experience in China when employed (Hutchings, 2003). However, replacing expatriate managers with Chinese or local-hired foreign managers is putting the effectiveness of personal control mechanisms in the MNCs' China operations at risk and the high turnover rate of Chinese managers could affect organizational stability. Furthermore, non-expatriates are unfamiliar with the HQ's corporate culture and lack networks in the parent company. Another drawback is that the parent company as well as the subsidiary have only asymmetrical knowledge about the commitment of local Chinese managers or local-hired foreign managers to the goals of the parent company (Harvey et al., 2001).

Based on the interview with a senior finance director from the Volkswagen China Investment Company (VCIC), this term paper discusses the challenge of management localization in terms of Chinese managers and the development of local talent for the Volkswagen Group China (VGC). After introducing the company and its China operations, the challenge that VGC faces with respect to the localization of management is described in more detail. Some suggestions to improve the localization of management at Volkswagen in China are laid out and discussed. This term paper then ends with concluding remarks.

2. The Volkswagen Group China

VGC is a division of the German automaker Volkswagen Group in China, and is responsible for supervising the Chinese associated companies and the set-up of new business segments. The Volkswagen Group ventured into China in 1984 as one of the first international automakers. The company has two joint venture partners for automobile manufacturing in China, Shanghai Automotive Industry Corporation and First Automobile Works. Its joint ventures, Shanghai Volkswagen and FAW-Volkswagen, have been extremely successful in supplying products to one of the major markets of the group. The operations of VGC include the production, sales and services of cars, parts and components, transmission systems and engines as well as the sales and service of imported cars. Volkswagen has delivered over 20 million cars of its different brands to Chinese customers since its market entry and has the highest market share in the passenger vehicle market in China. Figure 1 illustrates the annual sales volumes of the group form 1987 until 2014, underlining Volkswagen's success in the Chinese automobile market.

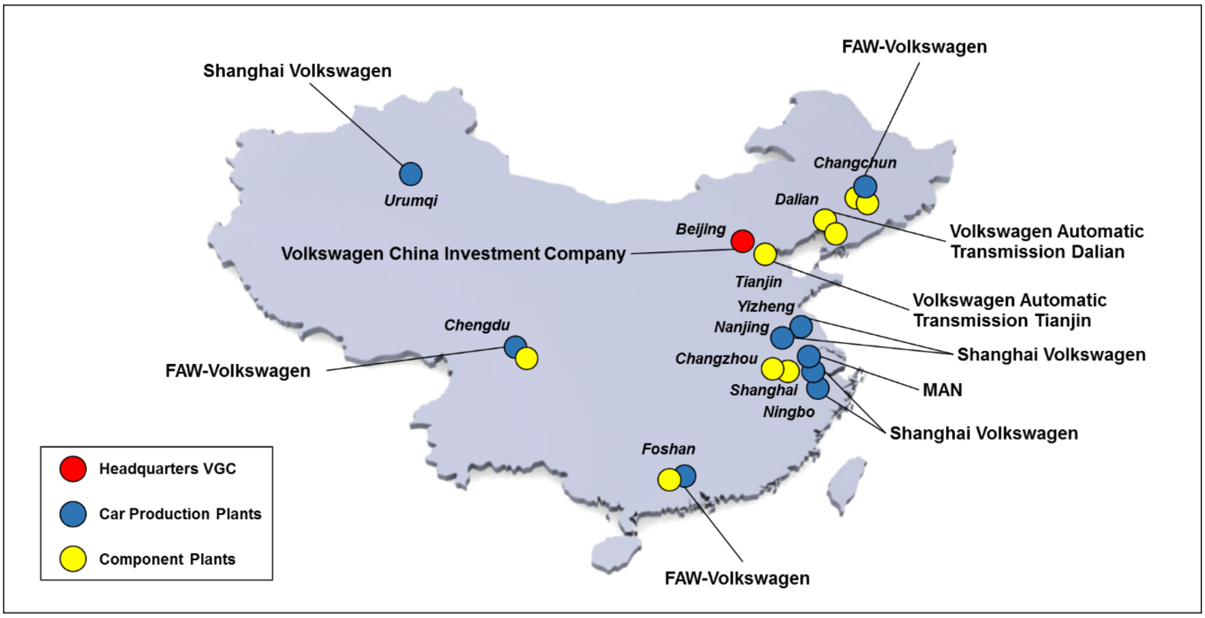
Figure 1: Annual sales volumes of Volkswagen in China



Source: Own elaboration based on company documents.

As of 2014, more than 89,000 employees work for Volkswagen in China and roughly 360,000 employees work within the VGC dealer network. Over the years, the number of entities that represent VGC has risen to more than 40. Figure 2 gives an overview over the Volkswagen production facilities in China (excluding detailed descriptions for different component plants).

Figure 2: Production facilities of Volkswagen in China



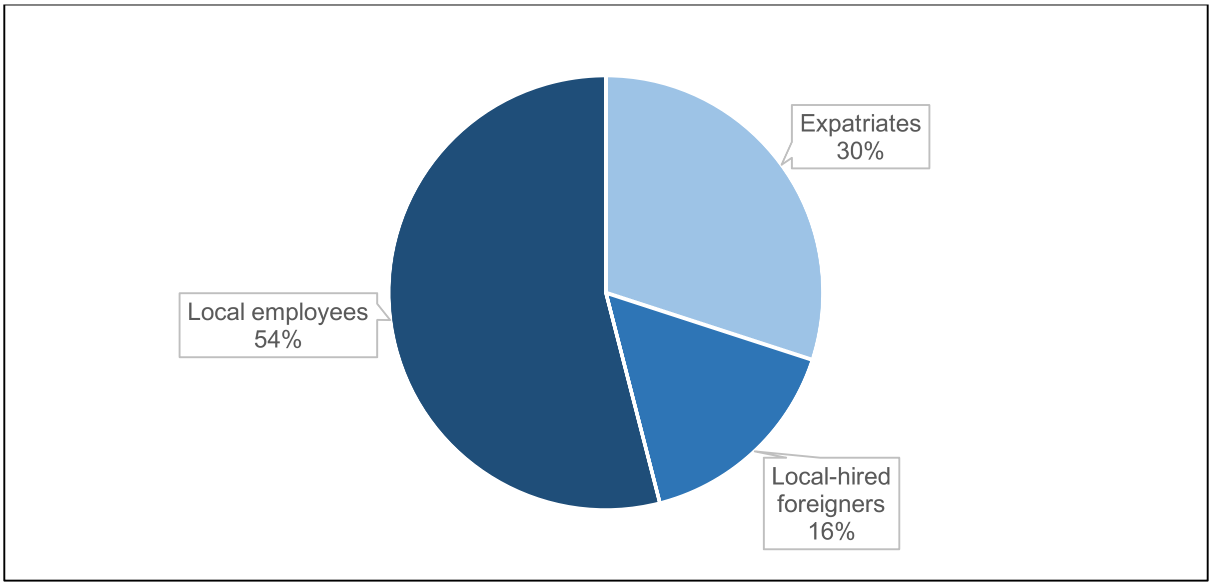
Source: Own elaboration based on company documents.

These have grown in number and not only include production facilities of the joint ventures but also wholly owned subsidiaries like the Volkswagen Automatic Transmission Dalian. VCIC is a wholly owned affiliate that serves as a holding company and HQ to VGC. While Volkswagen understands the importance of China, both locally and globally, and has established well-oiled operations in this market, the company faces an important challenge: the local employees who are driving the success of the company often do not take part in its management.

3. The Challenge of Localization at the Volkswagen Group China

The interview revealed that the fraction of expatriate managers and local-hired foreign managers remains very high at Volkswagen's entities in China compared to the number of local Chinese managers, even though the Volkswagen Group has been operating in China for more than 30 years. Expatriates still make up the majority of top executives. It is not unusual that certain positions, like that of the chief financial officer, are filled with expatriate managers (Harzing, 2001). But even in functions that are usually rather localized in other markets of the Volkswagen Group, such as human resources and purchasing, top management and senior management consist almost exclusively of expatriates and local-hired foreign managers. In addition, VGC also employs many expatriates and local-hired foreign employees on non-managerial levels. As an illustration, Figure 3 shows the breakdown of expatriates, local-hired foreigners, and local employees for VCIC (all employees and not just management). Local employees only account for roughly half of staff, while expatriates account for 30% and local-hired foreign employees for 16%.

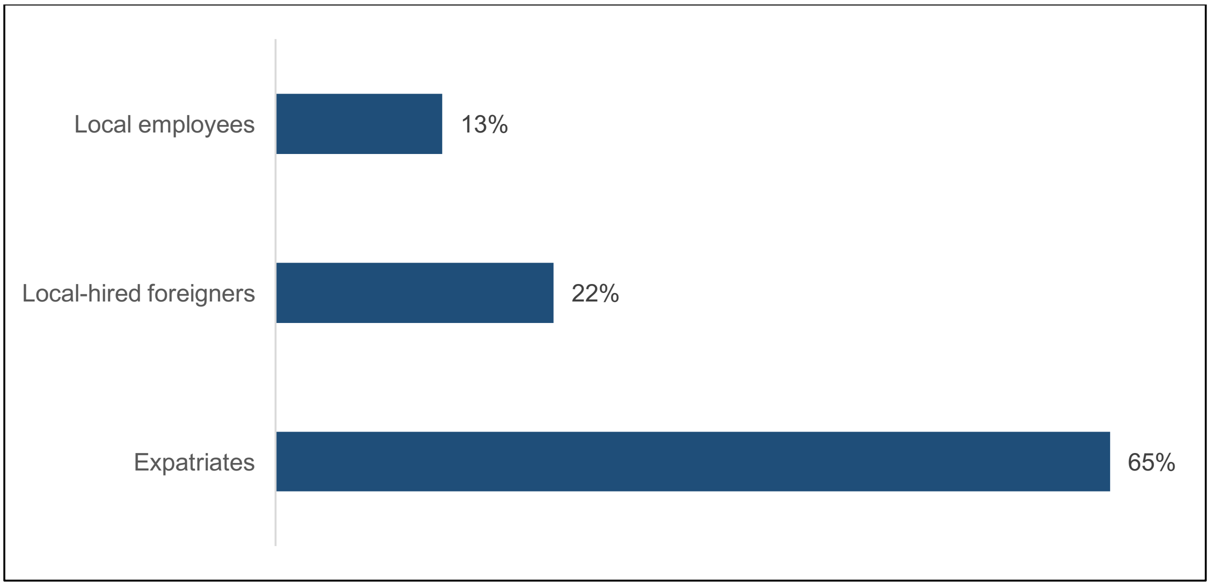
Figure 3: Breakdown of different staffing options at VCIC



Source: Own elaboration based on company documents.

From a financial perspective, this situation is no longer sustainable due to the cost burden expatriate managers and local-hired foreign managers impose on the company. The cost of transferring managers to China and supporting them and their families is expensive. Main cost drivers are housing allowances, school fees for the expatriates' children and yearly bonus payments. In addition, local-hired foreign managers also receive housing allowances as well as higher salaries than their Chinese colleagues. These differences in payment might lead to resentment or less commitment on the part of the Chinese employees if the value-for-money of expatriates and local-hired foreigners is not apparent. Figure 4 depicts the cost burden that the different staffing options impose on VCIC (no absolute numbers due to confidentiality). The costs of the 30% expatriates at VCIC are roughly four to five times the costs of the 54% local employees and three times the costs of the 16% local-hired employees. The costs of the 16% local-hired foreign employees are almost twice as high as for local employees.

Figure 4: Costs of different staffing options at VCIC



Source: Own elaboration based on company documents.

In order to cut these costs, Volkswagen would have to increase the localization of talent and management in the company's China operations. For instance, the interviewed senior director mentioned the possibility of hiring more Chinese employees who had been educated abroad or those who have already been exposed to western cultures and working styles. They could subsequently assume management positions after being trained within Volkswagen. The finance department of VCIC already employs many Chinese who have graduated from German universities, have prior work experience in Germany and are proficient in the language, which also enables them to bridge disparities between the Chinese subsidiaries and the German HQ.

Another problem with assigning many expatriate managers to China is the usually high turnover rate. Volkswagen assigns expatriates to China for a period of approximately three years and then transfers them. This is a cumbersome approach to managing China operations because the expatriates are leaving China at just about the time they have gained enough experience to do their jobs well. On the other hand, the frequent change of expatriate managers leads to a loss of know-how and tacit knowledge when they receive another international assignment or are repatriated. This might hinder the transfer of knowledge between HQ and the China subsidiaries. From the interview it becomes clear that the strategy of rotating people in on a short-term basis is no longer appropriate for VGC. Instead, a reduction of the overall number of expatriate managers that stay in China for a three years period is necessary. Volkswagen needs expatriates or local-hired foreign managers who have a commitment to being in China for longer periods and are willing to link their future career opportunities entirely to the growth of the company's China operations. Since Volkswagen has mature operations in China, which have become very large and complex over the years, the company must necessarily rely more on local teams of managers, while a lower number of expatriate managers has to ensure a certain level of coordination and control.

The major obstacle of management localization at VGC is the lack of trust in local Chinese employees. This is also a reason why, as mentioned above, there are almost only expatriate managers in senior and top management positions of certain functions such as human resources. In the case of human resources there is a perceived risk that Chinese managers might favor personal connections in the recruitment process. Additionally, employees at the group's HQ at times feel uncomfortable to contact their Chinese colleagues due to language barriers and a lack of trust in their abilities. A group-wide ethnocentric mindset has led to an organizational structure which is characterized by mostly German born employees in senior, and top management positions. Currently, Volkswagen does not fully utilize the potential of local employees because the company only provides limited career development opportunities for local talent. There is a "glass ceiling" for Chinese employees, that limits their chances to reach a management position. In some instances, other original equipment manufacturers (OEMs) have hired local potentials who have previously been trained and employed within Volkswagen but did not have the chance to become a manager or to assume a senior management position. These local talents, who lack visible career paths and are unsatisfied with the offered opportunities for growth and career advancement, subsequently look for opportunities outside of Volkswagen. In return, the loss of these talents leads to high replacement costs for the company and information spillover to other OEMs.

While there is the chance to provide special career development solutions to some local employees, this process is not well organized across functions and has to be driven personally by the respective superior. For instance, the finance department of VCIC has established an exchange program where two local employees are trained for a period of two years at HQ and then take on more senior or management functions either on group-level or in one of the production plants in China. Recently, new visa regulations, which demand at least two years overseas work experience for foreigners who want to obtain a working visa, are forcing Volkswagen to hire Chinese interns. This has been stressed in the interview as a great opportunity to attract talented candidates and to create a local talent pool, since many of the Chinese interns study abroad and possess profound inter-cultural as well as international experience. To ensure the sustained competitiveness of the company's China operations in the course of the fast-paced development of the Chinese market, a strategy for the localization of management has to be formulated and implemented. Thus, the next section lays out some suggestions for successful localization of management at VGC as derived from the interview.

4. Suggestions for a Successful Localization of Management

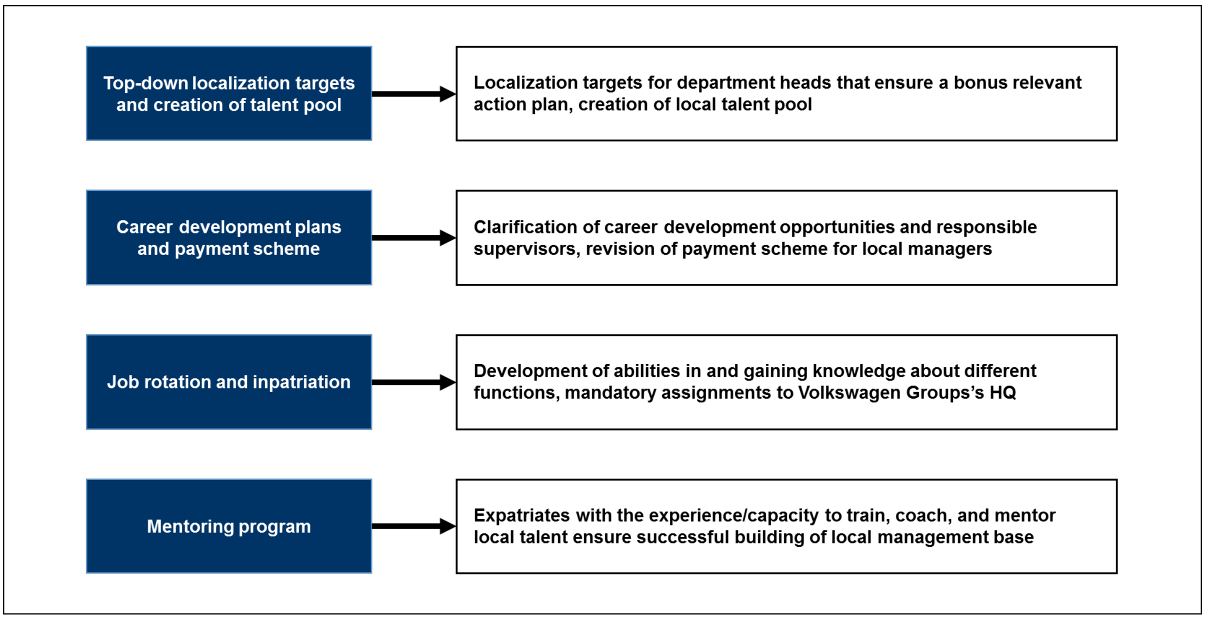
The initiative for management localization and a change in mindset has to come from the top management in the form of top-down localization targets. This includes targets for department heads to which these have to commit themselves and against which they are subsequently evaluated. In addition, these targets have to be relevant for bonus payments in order to assure commitment of the management. The departments have to provide an action plan to improve the development of local talent, taking into account possible functional differences with regards to the speed of implementation of such localization targets. Furthermore, in light of the new visa regulations, the human resource department has to set up a local talent pool in the mid-term and put in place the respective corporate structures to facilitate its development at VGC. This talent pool might then provide potential candidates for a local management team, which could lead Volkswagen's China operations in the long-term.

Connected to top-down localization targets is the clarification of career development opportunities. Top and senior management have to "walk their talk" in that they actively assume their roles in supervising the career advancement of local managers and are committed to personal development. This would also create a mindset where employees look toward longer term benefits in their careers. Research has shown that high potential talent in China is attracted to companies that offer such attractive long-term career paths (Schmidt, 2011). Volkswagen has to abolish the "glass ceiling" that the history of rotating high-potential western employees into senior positions has created if the company wants to exploit localization advantages of long-term career paths for Chinese employees. Besides, with the growth in the Chinese market and the battle for China's talent, remunerations levels have increased over time (Yang & Hukins, 2012). Thus, the payment scheme for local managers has to be revised in order to better represent the value-for-money of local managers. A decrease in the salary gap between expatriate and local managers would give Volkswagen a more favorable position in retention challenges and increase the commitment of Chinese managers.

To mitigate the risks introduced by the potential lack of western business expertise (perceived as a lack of abilities) or organizational commitment, it is important to comprehensively socialize the local employees into the corporate culture, to increase their learning about the Volkswagen Group's wider global pattern of products, markets, and strategies. These development processes can take place through seminars, on-the-job-training, and multinational project groups. Hence, job rotations should become an integral part of VGC's local career development so that local managers can show their strengths in several areas and projects. However, mandatory inpatriate assignments to HQ can be expected to also have a great impact on overcoming the above mentioned obstacles, since it allows local managers to build up their own network within the group. This would increase the level of trust in local Chinese managers and break down cultural barriers between HQ and the Chinese subsidiaries.

Moreover, there is a need for VGC to consider how training and development can be pursued more effectively between locals and expatriates. An important part of the work of expatriate managers at VGC should be to identify and develop potential local successors. This entails not only on-the-job-training but also mentoring to local managers in areas such as organizational strategy and culture. As a result, expatriates should not only be chosen because of technological or managerial expertise but also on the basis of their experience in, or capacity to train, coach, and mentor local managers in Volkswagen's China operations. Given that expatriates are committed to such training and development, this may increase their value-added for the group as well as their value-for-money in the eyes of Chinese employees. Figure 5 depicts the above mentioned suggestions for successful localization of management at VGC.

Figure 5: Components for a successful localization of management



5. Conclusion

Similar to many other western MNCs, Volkswagen faces the challenge of management localization in China. Until now, the company relied predominantly on expatriate managers to run its mature operations. The high cost burden of expatriate managers as well as local-hired foreign managers, the cumbersome practice of rotating high-potential western employees in on a short-term basis, and the very large and complex China operations of the Volkswagen Group make it necessary to increase the localization of management. Educated, experienced Chinese managers are, like good managers anywhere, worth their weight in gold. The war for Chinese talent, especially managers who have worked for several years for western companies, is waged vigorously. In order to be competitive in talent recruitment as well as retention, Volkswagen should formulate and implement a thorough localization strategy for the group's China operations. Some suggestions for such a strategy have been outlined in this term paper.

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