



strategis partners

White Paper

Learning to Love China's Uncertainty

The role of scenario planning in developing
your China strategy

Learning to Love China's Uncertainty

Today, business initiatives for China have to be designed and delivered in an environment of uncertainty—driven by shifting customer and market opportunities, political and regulatory imperatives, and rapid technological and economic change. Scenario Planning is a framework for making decisions now—but with the medium and long-term risks and opportunities in mind.

By Jay Horton

INTRODUCTION

It is truly a pleasure to be here with you this morning in Hong Kong at *a-connect's* Business Briefing. I was invited to explain how scenario planning can help you design your China business initiatives. The other thing I was asked to do was to be brief, so I will constrain my comments on this big topic to about 30 minutes. And then we will open the meeting for questions and comments.

My presentation has three aims: firstly, to discuss the challenges of dealing with China's uncertainty, secondly to explain how scenario planning works, and thirdly, to show how you can create better strategies using scenarios.

So what are scenarios? Scenarios are plausible, pertinent stories about the future. They are tools for communicating and learning, aids for strategic thinking, and challenges to conventional wisdom. To paraphrase George Bernard Shaw, the best scenarios emerge in discussions first as jokes and fancies, then as blasphemies and treason, then as questions open to discussion, and finally as established truths.

Scenarios are plausible, pertinent stories about the future. They are tools for communicating and learning, aids for strategic thinking, and challenges to conventional wisdom

My message this morning is that Corporations embarking on their China initiatives can benefit from methods and tools that deal with uncertainty. Scenarios provide such a framework. Our natural inclination in business is to work from what we know. Scenarios force us to look at what we don't know, what we can't control. More important, they make us think about the larger picture. They aim to stretch our thinking and question our assumptions. In so doing they help us overcome failures of imagination and so develop more innovative strategies. ¹

Peter Drucker, the management writer provides a good illustration of the quandaries in imagining the future:

*"When a new venture does succeed, more often than not it is in a market other than the one it was originally intended to serve, with products and services not quite those with which it had set out, bought in large part by customers it did not even think of when it started, and used for a host of purposes besides the ones for which the products were first designed."*²

1. CHINA'S UNCERTAINTIES AND OUR DECISION BIASES

China is perhaps the greatest uncertainty in global business today. We need look no further for a measure of uncertainty than China's stratospheric household savings rate. At 20 percent of GDP it is much higher than most other Asian countries.

Uncertainty drivers in China

"The test of a first-rate intelligence is the ability to hold two opposed ideas in mind at the same time and still retain the ability to function," F. Scott Fitzgerald once wrote. He might well have been describing the future of China—the land of dreams but also of disillusionment. It is going through dramatic pains with transition, and now it stands somewhere between a failed bureaucratic system and a modern economy.

There are two deep-seated views about this country's future.

On one side is the view that China will become the world's largest economy; by 2040 according to Goldman Sachs. It is already the fastest growing, averaging a 9 percent GDP increase annually over the past 20 years. Edward Tse ³ says there are five forces driving China's future success:

- The intensity of Chinese entrepreneurialism is propelling many companies beyond a role as producers of low-cost commodities
- China's emphasis on rapid research and development makes it a seedbed for original products and services in the future
- The ability to attract executives from around the world is providing a higher level of competence for China's enterprises
- Increasingly, high-quality management and governance structures are being put in place
- The country is taking on a role as a catalyst of sustained economic growth in the developing world.

Sceptics respond that its growth is bound to falter, soon, amid the growing environmental, social, and political problems brought on by rapid expansion. Mixin Pei, author and Senior Associate with the Carnegie Endowment for International Peace casts pessimism on China's growth strategy⁴. He argues that China is falling into a "transition trap" due to its partial economic and political reforms.

A provocative thesis in this age of China worship Pei argues that because the Communist Party must retain significant economic control to ensure its political survival, gradualism in political and economic reform will ultimately fail.

Examples of dysfunction abound. The banking system is riddled with debts; the central and local authorities still interfere arbitrarily in business; corruption is rampant; the legal system is weak; property rights are uncertain; the regulatory system is incomplete; and there is widening inequality. Forget progress, China's future is decay under this scenario.

Faced with two competing bodies of evidence concerning China's future, decision makers may reject or misinterpret one body of evidence in favour of the other. In addition, they may seek out the company of others whose views support their own. This bias spells danger for strategy development.

There are two deep-seated views about this country's future—the land of dreams but also of disillusionment

Decision making bias in the face of uncertainty

Our individual and organizational decision making bias runs deep and it can lead to faulty strategies. For example there are five other reasons why individuals and organizations may fail to deal effectively with uncertainty.

We are overconfident. We are often blind to the limits of our expertise.

We escalate commitment. We invest additional resources even when all indicators point to failure of continued investment

We anchor in the status quo. Our tendency is to adjust insufficiently from an initial position

We are risk averse. Our professional pride is tied up in being right. Employees are often rewarded for good decisions and penalized for failures, so they spend a great deal of energy trying not to make mistakes.

We assume feedback is reliable. Decision researcher Robin Hogarth distinguishes between “kind” environments, which offer reliable feedback, and “wicked” ones, in which feedback is lacking or misleading.⁵

In China business, wicked environments are common. To take one example Jacques Herzog the Swiss architect for the National Stadium in Beijing explains: “you have no clue what really happens, what are the dynamics really are.” Both government bureaucrats, who respond to social and political pressures, and the newly ascendant capitalists, who try to anticipate market conditions, make sudden and seemingly capricious decisions. Their explanations are often incomplete and unconvincing. At any moment up to the start of construction, their project could have slipped through their fingers and smash or vanish without their ever knowing why.⁶

Scenarios help us to deal with uncertainty and decision bias in three ways

Firstly, scenarios provide a framework and process for thinking about change, uncertainty and opportunity that lies over the horizon. It's an “outside in” approach of understanding the business environment. The scenario planning process enables a diversity of perspectives to be introduced in a structured way. It's also a way to introduce outside expertise into the planning process to overcome decision biases.

Secondly, by educating decision makers about the alternative ways in which the future might unfold, it can help them to better prepare the organisation to respond and adapt. It's possible to challenge conventional wisdom constructively, and enable the organisation to consider a variety of possible futures.

Thirdly since we cannot predict the future with certainty, scenarios help leaders adjust course in the light of events. The better the scenarios, the less frequent these surprises will be and the more successful the strategy.

Scenarios provide a framework and process for thinking about change, uncertainty and opportunity

2. MASTERING THE LOGIC OF SCENARIO PLANNING

The core of the scenario process is that you research key drivers of change. You determine which are predictable and which are uncertain. You decide which uncertainties are most influential, and base the scenarios of the future on those uncertainties. Finally you spend time exploring the implications of those scenarios.

The building blocks of scenario planning

When developing scenarios, it is important to begin with a specific decision or issue that the organisation will need to think hard about. Here are some examples of focal issues:

- Can we survive as an independent player in China?
- What should our next generation products for China look like?
- How should we prepare our managers for the disruptive changes ahead in our industry?

Frames of reference

Scenario thinking exercises begin with a rigorous fact-finding phase. However, rather than conducting research on how a company is performing, or what the future is likely to be, the research focuses on uncovering the framework of assumptions that the management team has about the future.

A frame of reference is an overarching idea or a “mental model” that organizes our perception of issues. It may sound like an abstract concept but it has a very real impact. Deng Xiaoping may not actually have used the phrase attributed to him—“it is glorious to be rich”—but that new frame of reference took off like wild fire in China a quarter of a century ago.

While mental models can help us to understand what is going on around us, they also simplify and filter what we see in ways that can obscure opportunities or threats. This is a problem if the model is not well suited to the emerging business environment.

As an example of the importance of framing, in the early 1980s IBM held its critical planning meeting to decide their PC strategy. A key focus of the meeting was the ten year forecast for the PC market, estimated to be 275,000 units p.a. by the end of the decade. In fact, actual PC industry sales turned out to be 60 million units p.a. IBM missed out on a potential \$250 billion of wealth creation! So what went wrong? It was a matter of framing. IBM's Frame of Reference was that people merely wanted “CPU power”. But in reality, people wanted “control” through desktop computing to overcome the rigidities of mainframe computing. The lesson here is that the wrong mental maps were driving decisions and actions.

In the 1990s, IBM recognized the importance of framing. They brought in open-source revolutionary Richard Stallman to speak to its researchers at a time when its software business was built around the traditional proprietary software models. IBM has now built a successful business around the idea of open-source software.

While mental models can help us to understand what is going on around us, they also simplify and filter what we see in ways that can obscure opportunities or threats.

Uncovering the assumptions – the “Official Future”

The traditional approach to developing a strategy starts with a presumption: armed with sufficient rigour, companies can predict the path to the future from the experience of the present and the past. In this approach, planners make assumptions about trends in customer markets, funding requirements, technology, regulation, and so on. In effect they “assume away” most of the uncertainties. Unfortunately, the resulting plan can end up as an internally-driven reflection of what the company wants the future to look like.

A key role of scenario planning is to tease out the conventional wisdom; then ask: what if it's wrong? For example, the Official Future for some companies might be predicated upon crucial, but unexamined assumptions such as:

“We can safely add new capacity to our industry without affecting prices”

“We have an innovative edge over local companies”

“Customers need the ‘Gold Standard’ and will pay for it”

“There is no other competitive solution available”

“Our competitors would never do that.”

The Shell Company were able to rehearse a massive fall in the price of oil in the early 1980s when every other oil major thought the oil price was going to go up even more. Shell created valuable lead time in realising that one crucial assumption about the industry's Official Future could be wrong.

Conflicts and Dilemmas

Strategic change comes as a result of inherent conflicts and dilemmas in the existing models of production and distribution, and scenarios are a way of describing how such change might play out.

A key reason companies succeed these days is their ability to nurture disruptive innovations that lead to new products that are cheaper, better, and more convenient than their predecessors. They exploit contradictions in the *status quo* such as over-serviced customers, under-served markets, products with too much functionality or too little functionality.

The relative immaturity of many industries in China paves the way for sweeping change. Clayton Christensen's historical analysis of 20 markets that were created in the last 100 years shows that the creation of new markets is consistently accompanied by the same four events: ⁷

1. The haphazard (and at times accidental or lucky) development of a new “technology” (or new way of doing business)
2. A flood of companies entering the uncertain market opened by the development of this new technology
3. A slow initial uptake of the products and services associated with the new technology, followed by a huge explosion of customer interest when a dominant design is established
4. The death of most of the early entrants (and their products) once a design emerges as dominant.

Strategic change comes as a result of inherent conflicts and dilemmas in the existing models of production and distribution, and scenarios are a way of describing how such change might play out

Key drivers of change

To develop the scenario logics around the future of your China business, we then identify drivers of change such as the following:

- Chinese entrepreneurialism and growing emphasis on R&D
- Improvements in the quality of management and governance
- The ability to achieve a higher level of competence to run enterprises
- Growth in China's domestic consumer spending
- Shifts in centres of economic activity within China
- Structural weakness in China's financial system
- Continuing population growth pressures and population ageing
- Increasing demand for resources, and pressures on the environment
- Shifts in values. A long-term cultural values transition is occurring globally along two chief dimensions: from authority to individuation values that cultivate distinctiveness, and from physical security and economic growth toward quality of life and well-being values.

Next we identify those drivers of change which are more-or-less predetermined— and those which are fundamentally uncertain. Taking the critical uncertainties, we then identify the different paths in which they might lead, and select those which will most help us think about the future.

Building Scenarios

There is no one right way to develop scenarios. Different organizations and different industries may dictate the use of one or another of the approaches for setting the basic logics of a few scenarios. Scenarios should capture some real surprises, but they should also maintain plausibility.

Scenarios should capture some real surprises, but they should also maintain plausibility

Scenarios are not simply end-state descriptions of the world on some particular future date. It's important to see how we get from here to there. Each scenario plot should be different, yet relevant to the focal question. Christopher Booker has described the basic archetypal plot-lines which recur in many different contexts.⁸ Those relevant to your China scenarios might include the following:

Rags to Riches: Smart thinking, not money holds the key to future success for your company in China

Overcoming the Monster: Slowing growth generates crisis. Turmoil ensues. But a reformed industry finally emerges.

The Quest: The hazardous journey towards the goal; the economy grows and industry reform continues in fits and starts over the next decade

Escape from Death: How major business risks and uncertainties play out, and are dealt with

Voyage and Return: Travels into new market or technological territory eventually pay-off but only after disruptive innovation succeeds

Other plotlines can be used in scenarios such as:

Tectonic Change: Structural alterations which produce dramatic flare-ups, which cause major discontinuities; for example the break-up of China.

Unbounded Possibility: The seductive idea that continued growth in China will occur over the very long-term, and so enabling your company's sights to be set higher than before.

Using Scenarios

Exploring scenarios involves addressing three inter-related questions:

- What is the essence of the underlying formula for the organisation's success, given the range of scenarios?
- What portfolio of initiatives should we be pursuing?
- What are the early indicators for each scenario?

A core policy to deal with uncertainty is to take a portfolio approach. The portfolio of initiatives represent where, how, and when your company will create value in the face of divergent future scenarios. These initiatives are a set of actions implemented over different time frames - short term, medium term, long term. These actions might include: placing strategic bets; investing in real options; introducing new organisation capabilities and picking the right people; developing initiatives to increase speed and flexibility; fostering organisational cultural change; forming alliances and partnerships to share risk; and changing the nature of the dialogue with key stakeholders.

The portfolio of initiatives represent where, how, and when your company will create value in the face of divergent future scenarios

Consider making intentional mistakes as part of your portfolio of initiatives. When you suspect that one or two of your implicit assumptions are wrong, you can achieve progress more quickly by deliberately making errors, rather than by considering only data that support the assumptions. Mistakes—done right—are a powerful way to accelerate learning and increase long term success.

Investing in real options

Real option thinking can be very useful for developing your portfolio of initiatives. Real option thinking recognises not only that the future is uncertain but also that an essential element of value in strategic initiatives is their inherent flexibility. Such value is created through identifying, creating, owning, managing, and exercising options such as:

- The option to continue a development path or exit after the pilot phase
- The option to scale up faster in response to better than expected results
- The option to alter the implementation strategy.

Real option thinking advises us to pursue multiple paths, but fail fast when it's become clear that one option is not bearing fruit. An implication of real option of course is that the organisational leadership supports failures, not just successes.

Those failures should be studied. As Mark Twain said:

*"We should be careful to get out of an experience only the wisdom that is in it—and stop there; lest we be like the cat that sits down on a hot stove lid. She will never sit down on a hot stove lid again—and that is well; but also she will never sit down on a cold one."*⁹

3. CREATING SUCCESSFUL STRATEGIES THROUGH SCENARIOS

Key success factors for scenario planning

There are two key success factors for scenario planning. First, a structured process of facilitated workshops is vital for team learning and developing the scenarios. Second, the people selected to participate are critical to a successful outcome.

Pierre Wack the pioneer of scenario planning at Shell during the 1960s and 1970s stressed the importance of what he called “remarkable people”.¹⁰ This phrase in French means not so much gifted or eccentric people, but people with unconventional insights about the world around them. Wack and the Shell scenario planners cultivated their own network of remarkable people.

The scenario planning process involves the following activities:

- Decide on the Focal Issue, and selecting the key participants
- Conduct interviews and gather information to address the focal issues
- Through a series of workshops, identify the frames of reference, the drivers of change, conflicts and dilemmas, and the key uncertainties
- Craft the logic for each scenario, and develop the scenario narratives that describe how key uncertainties play out
- Explore the implications - so what should we be doing?

The scenario planning project is designed around key workshops

The work of developing and using scenarios is centred on two major workshops. These would involve up to 15-20 internal and external participants. The task of developing a set of scenarios starts in the first workshop. Once the narratives have been drafted, the objective of the second workshop is to assess the findings, and explore the implications.

Scenarios can be narrowly or broadly focused, for example around:

- Corporate strategy and public policy issues such as development of the high level agenda, review of corporate structure, country risk and opportunity assessment, and industry futures
- Innovation such as development of the agenda for R&D and market research, and new product and service development
- Business decisions such as capital investment, acquisitions, competitive bidding for major projects, and outsourcing initiatives
- Alliance development and inter-firm collaboration.

There are two key success factors for scenario planning:

First, a structured process of facilitated workshops

Second, the people selected to participate are critical to a successful outcome.

CONCLUSION

Uncertainty is the condition of all business endeavours in China today. So the ability to anticipate the unexpected is not just a valuable add-on to corporate planning practice, but potentially the single most important factor for its success.

For you personally scenario thinking is a valuable aid to build support for your China business strategy:

- Scenarios can help communicate with your peers and with top management and the Board how China's risks and uncertainties may play out, and can be dealt with
- They can help secure the commitment to a longer-term strategy in the midst of short-term setbacks
- Within your own team, scenarios can foster open-mindedness to new ideas and different perspectives, and can help re-shape core assumptions before they become outdated or just plain wrong.

Scenarios create a dialogue between risk and opportunity

Thirty years ago it was commonplace for product-development activity to be housed in silos insulated from sales and marketing groups. How could we have been so misguided? Yet many businesses replicate this error today by separating the functions of risk management from business innovation and development. Both activities are at the forefront of exploring uncertainty. Great opportunity can be found in the most "risky" areas, while new risks emerge from every innovative corporate endeavour.

Scenario planning opens up a range of possibilities, much broader and wider than traditional tools that strive for a single right answer. Scenario planning helps us to entertain worst-case scenarios, as business leaders must. Upside scenarios can raise the sights of an organization to a higher level of sustained performance.

As Charles Darwin said:

"It is not the strongest of the species that survive, nor the most intelligent; rather it is those most responsive to change."

The ability to anticipate the unexpected is not just a valuable add-on to corporate practice, but the single most important factor for its success

REFERENCES

¹ The description *failure of imagination* was used by the US Government 9/11 Commission to describe part of why intelligence agencies such as the CIA and the FBI failed to foresee and prevent the events of September 11, 2001. Al Qaeda's new brand of terrorism presented challenges to US institutions that they were not well-designed to meet.

² Peter Drucker, *Innovation and Entrepreneurship: Practice & Principles*. New York: Harper & Row, 1985.

³ Edward Tse, *China's Five Surprises*, Booz Allen Hamilton Inc., 2005.

⁴ Mixin Pei, *China's Trapped Transition*, Harvard University Press 2006.

⁵ Robin Hogarth, *Educating Intuition*, University of Chicago Press, 2001.

⁶ Arthur Lublow, "The China Syndrome", *New York Times*, May 21, 2006.

⁷ Clayton Christensen, *The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail*, Harvard Business School Press, 1997.

⁸ Booker, Christopher, 2004, *The Seven Basic Plots*, Continuum Books.

⁹ Twain, M. 1897. *Following the Equator: A Journey around the World*, American Publishing Co, Hartford, CT.

¹⁰ See Kleiner, Art 1996, *The Age of Heretics: Heroes, Outlaws, and the Forerunners of Corporate Change*. Doubleday: New York.



About the Author

Jay Horton, Founder of Strategis Partners, is recognised as a leading adviser to companies and Governments on a wide range of strategic business issues, including scenario planning, innovation, value chain strategy and organization.

During his twenty year management consulting career, he has worked with clients in Australia, Canada, China, Japan, Hong Kong, Indonesia, New Zealand and Singapore.

Jay has played a range of leadership roles:

Partner of PricewaterhouseCoopers, leading their Applied Decision Analysis practice in the Asia-Pacific

Founder and Managing Director of decision consulting firm ORG Pty Limited

McKinsey Consultant to top management in Australasia

Principal of Everest Group, international advisory firm on outsourcing

Australian Volunteer Abroad in South East Asia.

Jay's qualifications include Master of Economics from Australian National University and a Bachelor of Engineering from James Cook University. He is a Fellow of the A.I.C.D.

www.strategispartners.com.au
jay.horton@strategispartners.com.au
Tel: +61 (0)412 05 1379
Fax: +61 (0)2 9440 1789



strategis partners

Contact us

Level 57, MLC Centre
19-29 Martin Place
Sydney, NSW 2000
Australia

t. +612 9238 6886
f. +612 9238 6887

e. info@strategispartners.com.au

Level 19, Two IFC Tower
8 Finance Street, Central
Hong Kong

t. +852 2251 1625
f. +852 2251 1618

www.strategispartners.com