

# Whose design is it?

How to protect your IP in China

Dr Tim Moore

**SAGENTIA**

## Executive Summary

**Many companies in the West outsource manufacturing to 'third world' countries in order to cut costs. Now they are looking to obtain further cost benefits by also outsourcing product development and design.**

This is not without its problems – and chief among these is the difficulty of protecting intellectual property (IP).

China offers not just low cost manufacturing and product development but also, because of the legal and cultural framework in Hong Kong, a more secure IP environment than most non-Western countries. Hong Kong therefore represents the best 'route into China' for Western businesses.

Risks of IP theft do still remain, however, and companies should take sensible precautions.

In our experience, many IP problems which Western companies experience in China come from a poor understanding of exactly what they are buying when they enter into a relationship with a Chinese firm. It is easy to hand over increasing responsibility for design and development, as well as for production, only to find that you have helped to establish a new competitor.

There are not just legal but also cultural barriers to be overcome in ensuring that your IP remains secure. We believe it is therefore important that your IP should be protected by a series of practical measures rather than relying simply on the law. Good IT security and dividing work between firms, for example, will help to prevent IP theft.

Selecting the right business partners is also crucial to success and this is not always easy. Building relationships in

China can be a lengthy process and in our experience it is useful to have the understanding and introductions that can only come from people – either native or expatriate – who are immersed in the local business culture.

With these measures in place, there are considerable benefits to be obtained from undertaking not just manufacturing but also design and development in China. These benefits extend beyond costs into areas such as better innovation and faster time-to-market.

## Introduction

Driving down costs to permit competitive pricing with acceptable profit margins has become key to the corporate strategy – even to the corporate survival – of many businesses.

As a consequence, companies in the West are outsourcing activities to countries where costs are lower than in their home markets. Initially, these companies turned to ‘third world’ countries for cheap manufacturing. Many of them are now seeking to gain further cost benefits by also outsourcing product development and design. However, along with the cost benefits have come a number of problems. The difficulty most frequently cited by Western firms is the protection of their intellectual property (IP) – preventing their designs and other trade secrets being copied for the benefit of unscrupulous competitors.

## Doing business in China

China is a popular choice of overseas location for outsourced design, development and manufacturing activities. This is not just because the Chinese government has actively sought this type of inward investment but also because the country has some unique attributes which help with IP protection. Chief among these is the ‘one country, two systems’ philosophy which has arisen from China’s recent history.

In mainland China, the years of communist rule since the 1940s engendered a culture where individuals could not own ideas; they were handed over and subsequently became the property of the state. Knowledge, it was considered, was better shared for the greater good of the country. It became natural for people to share ideas and the concept of IP as a valuable asset was unknown. Although the Chinese government is now following a much more market-oriented social and economic policy, and has introduced legislation for the protection of IP, we believe it will take much longer to change the culture than it did to change the law.

By contrast, what is now the Special Administrative Region of Hong Kong was ruled by Britain for more than 150 years until it was ‘handed back’ to China in 1997. Although now part of the Chinese state, it retains a separate legal system largely based on the British model – including laws for the protection of IP. Equally importantly, it shares a Western cultural understanding of the nature and value of IP. We have found that this unique heritage allows businesses to gain the ‘best of both worlds’ in cutting costs whilst also protecting their IP. It makes China the ideal location for outsourcing not just manufacturing but also design and development.

## The extent of the risk

What about this risk of IP theft? How worried should Western companies be about the theft of their ideas or designs?

Although we work with clients to ensure that more barriers to IP theft are put in place when working in China than we would probably feel necessary in a Western country, it is easy to overstate the extent of the risk. The reality is that most IP theft takes place at the lower end of the value chain. Music CDs and movie DVDs are by far the most commonly ‘pirated’ items – just as they are in most Western countries. The theft of IP in high-value, high-technology products is far less prevalent.

This is partly simply because of the practical difficulties of this type of piracy. Even given a complete set of plans for a high-tech consumer device, the costs of producing tooling, establishing production facilities and developing a marketing infrastructure are considerable barriers which the IP thief must overcome. Increasingly, too, the Chinese government is policing its new IP laws in mainland China as rigorously as in Hong Kong. Although taking legal action in China still remains a lengthy and expensive business for foreign firms, it is clear that there is a cultural shift taking place.

### Whose design is it anyway?

In our experience, part of the perception of China as a place where IP is under threat comes from a poor understanding by Western companies of exactly what they are buying when they enter into a relationship with a Chinese firm. We view Chinese manufacturers as falling broadly into three categories – OEM, ODM and OBM.

OEMs (original equipment manufacturers) are the 'traditional' outsourced manufacturing facility. They will produce your product to your design and make no contribution to product development. There is limited risk to your IP if you select the right OEM, with a business which depends upon securing outsourcing contracts from Western firms, and if you put in place the right systems and procedures for IP protection.

Original design manufacturers (ODMs) will not only manufacture your product but also assist with your product design and development. This service often appears to be 'free' and it is easy to hand over increasing responsibility to the ODM. However, if you have not specifically paid for the design and development work and have not protected 'your' IP with appropriate contractual arrangements, the IP is not yours at all – it belongs to the ODM.

This is often where Western companies find that they run into difficulties, as designs and ideas which they thought they 'owned' are used by the ODM on its own account. An OBM (own brand manufacturer) is often a spin-out from an ODM. It will produce and market products under its own brand, sometimes basing the design on what the ODM has developed for Western customers.

Chinese OBMs are a growing force in the world economy. Many are now buying Western companies in order swiftly to obtain brands and market presence that it might otherwise take years to establish. Western companies doing business in China need to be very aware of the danger of gradually handing over more

and more of their product knowledge to Chinese suppliers with the potential to become OBMs – because these may well be future competitors.

### What are the benefits?

Given the potential risks – and the practical difficulties arising from a different culture, different language, different legal system, eight hours time difference from the UK and minimum 11 hours flight time – do the cost benefits justify Western companies continuing to do business in China?

The booming Chinese economy has led to an erosion of the cost differentials between China and Western nations. Wages have risen substantially in recent years and continue to rise. However, factory wages in China are still only around 10 per cent of those in the West. We believe that the potential for cost saving through outsourcing production to China remains huge. When it comes to design and development work, wage rates for skilled engineers and designers in China are around one-third of those in the West.

More important than the cost differential, however, is the benefit to be obtained from more closely linking design and manufacturing than is possible if the design department is in the West and the factory in China. Moving from design concept to prototype to pre-production - and then into full scale manufacture - is much easier if all the people involved speak the same language and are in the same time zone.

*“Chinese OBMs are a growing force in the world economy”*

The easier collaboration which this permits gives benefits in many ways. The quality of design and innovation is improved by having concept designers and manufacturers working closely together. Errors and misunderstandings can be significantly reduced, saving not just cost but also time, allowing new products to be brought more swiftly to market.

Undertaking design and development work in China can have problems of its own, however – mostly related to cultural differences between Chinese and Western markets. For example, domestic kitchens in China are rather different to those in the UK, reflecting differences not just in menu but in family life. So a kitchen appliance manufacturer undertaking development in China must ensure that designers have a complete understanding of the way in which the product is to be used. Otherwise the end result may not truly match Western consumer needs.

### Protecting your IP

There are many practical and legal steps which you can take to ensure that you get all the benefits of Chinese outsourcing without being exposed to undue risks of IP theft.

For example, you can outsource manufacture of components to a number of different companies in mainland China, ensuring that none of the manufacturing companies has access to enough of the total product to permit them to copy the overall design. You can then assemble the completed product in Hong Kong, where the culture and the legal system provide stronger protection.

Further protection can be provided by manufacturing in Hong Kong any key components in which there is a particularly high level of IP. Even in Hong Kong, however, our experience suggests that erecting practical barriers to IP theft is more effective than relying solely on the legal system to provide protection. Good IT security and a system for dividing work between firms or departments - to ensure few people have access to a complete product design - are sensible precautions which you should expect your supplier to have in place.

Keeping design and manufacturing separate, whilst encouraging close collaboration during prototyping and pre-production phases, helps to protect against knowledge 'leakage' as well as outright IP theft. You will inevitably be training Chinese workers not just in your technology but also your markets. You need to be sure you are not training a future competitor.

For this reason it is important to choose the right business partners. There are a growing number of companies - not just in Hong Kong but also now in mainland China - whose core activity is assisting Western firms with manufacture, design and development. These companies simply cannot afford the loss of business which would flow from a reputation for lack of IP security and they therefore actively manage that risk.

*“The booming Chinese economy has led to an erosion of the cost differentials between China and Western nations”*

We have seen that in many of these companies the approach to IP protection extends beyond organisational and physical security into tackling the cultural approach to IP. Staff are taught about the values and culture of their customers so that they understand not just what needs to be done but why it needs to be done.

Identifying the right partner is not always easy. Building relationships in China can be a lengthy process and it is useful to have the understanding and introductions that can only come from people – either native or expatriate – who are immersed in the local business culture. We ourselves have taken the route of establishing a joint venture with a major Chinese manufacturer to help us facilitate outsourcing for clients.

## Conclusion

There are considerable benefits to be obtained from outsourcing not just manufacture but also design and development to low-cost, non-Western countries. However, along with these benefits there come risks of IP theft.

China is one location where the benefits can be realised whilst risks are minimised. Obtaining this balance, however, requires good planning, the choice of the right partners in China, and sensible precautions to protect your intellectual property.

Dr Tim Moore is a director of Sagentia SGAI Ltd - a first-of-a-kind joint venture between a western high-tech consultancy and Eastern manufacturer, offering design and build services.

For more information email [info@sagentia.com](mailto:info@sagentia.com)



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[www.sagentia.com](http://www.sagentia.com)  
info@sagentia.com



### Sagentia Ltd

Harston Mill  
Harston  
Cambridge  
CB22 7GG  
UK

T. +44 1223 875200

### Sagentia GmbH

Westend Carree  
Grüneburgweg 18  
D-60322 Frankfurt  
Germany

T. +49 69 9550 4500

### Sagentia Inc

8161 Maple Lawn Boulevard  
Suite 475  
Fulton, MD 20759  
USA

T. +1 240 547 6600

### Sagentia SGAI Ltd

Unit 6-7, 13/F  
Wah Wai Industrial Centre  
38-40 Au Pui Wan Street  
Fotan  
Hong Kong

T. +852 2866 8701

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