****

9B19M106

Obisoft: Negotiating in ChinA

Stephen Grainger and Per Hintze wrote this case solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

This publication may not be transmitted, photocopied, digitized, or otherwise reproduced in any form or by any means without the permission of the copyright holder. Reproduction of this material is not covered under authorization by any reproduction rights organization. To order copies or request permission to reproduce materials, contact Ivey Publishing, Ivey Business School, Western University, London, Ontario, Canada, N6G 0N1; (t) 519.661.3208; (e) cases@ivey.ca; www.iveycases.com. Our goal is to publish materials of the highest quality; submit any errata to publishcases@ivey.ca. i1v2e5y5pubs

Copyright © 2019, Ivey Business School Foundation Version: 2019-11-22

In 2015, a Shanghai businessman, Ling Chong, contacted the director of US-based ObiSoft, Mike Herfken, to request becoming ObiSoft’s representative in China. Ling and Herfken developed their partnership over the next two years to grow ObiSoft’s business in China. After making significant sales in China, Ling became a ObiSoft partner and master reseller. Ling then proposed moving the company’s software research and development (R&D) to China. In August 2018, a board meeting was called to decide whether ObiSoft should make this change to target this huge market or remain in North America.

Background

In 2015, Ling was a software professional in Shanghai, China, when he approached a young American software company, ObiSoft, with a request to become ObiSoft’s partner in China. ObiSoft’s partner manager for Asia, Mike Herfken, received the call. He was surprised and stopped to consider this confident request. Herfken couldn’t speak Mandarin but knew that China was a huge market for software, and at that time, ObiSoft had no presence there. He believed the challenge with the Chinese market concerned language and culture, and he knew about the importance of relationships to get things done in China.

Ling had won a scholarship from the Chinese government in 2012 to study Western business practices and learned English while completing his master’s degree in business administration at the University of Notre Dame in Fremantle, Australia. After graduating in 2014, he received an offer from an Australian software company to return to China to work with the company’s international division in Shanghai. Over the next two years, Ling became an expert at selling software and developed relationships with many Chinese customers on behalf of his employer. After two years, he was confident enough to start his own business and apply all his knowledge and understanding of Western and Chinese business culture to his personal advantage.

While working in Shanghai, Ling discovered and monitored ObiSoft, a dynamic information technology (IT) company based in the United States, and saw it as a potential conduit to introduce new software to the Chinese market. He wanted to work with the company, and by chance met ObiSoft’s regional manager, Herfken, at an IT conference in Singapore. They established a good rapport and at the closing of the conference, Ling contacted Herfken to suggest ObiSoft should enter the Chinese market.

After discussing this idea with the ObiSoft senior management back in the United States, Herfken and his team agreed. As a result, many calls and emails were exchanged in the months following to discuss details, opportunities, and possibilities. Ling wanted to work for ObiSoft, and could see the company’s potential in China. As a result, Ling invited Herfken and his wife to visit him in Shanghai. After three days together of sightseeing, *yum cha,*[[1]](#footnote-1) dinner, and discussion, their relationship was established. Two months later, Ling and ObiSoft signed a partnership agreement. Herfken was cautiously optimistic and impressed with Ling’s motivation, his English-language capability, and his knowledge of the software industry both internationally and in China.[[2]](#footnote-2)

Becoming the Master Reseller for China

Ling explained to Herfken that he wanted to develop the Chinese market for ObiSoft and highlighted the immediate short-term challenge of developing a Chinese version of the existing ObiSoft software. Ling offered to translate the existing English-based software into simplified Chinese and to generously give the intellectual property for this translation to ObiSoft. Herfken was cautious but impressed. Ling’s goal was to become the master reseller for ObiSoft software in China, and by offering this translation favour, he was building his product base while enhancing his *guanxi*[[3]](#footnote-3) with Herfken. He needed to develop trust to help grow the company and realize its full potential.

After convincing Herfken, Ling translated the software into simplified Chinese at his own expense and, using this new version, soon managed to close several deals with his Shanghai customers. To win sales, he would offer potential new customers a price discount to switch from their existing software product and provider to ObiSoft. In sales discussions with potential customers, he emphasized the importance of using the latest technology, which he could provide, to maximize their benefits.

Ling developed many regular mainland Chinese customers, and the ObiSoft board soon realized the importance of owning the copyright to the Chinese version of the software. This copyright was increasing in significance as a market for the software was quickly developing in Taiwan, Macao, and Hong Kong. In addition, ObiSoft was obligated to provide technical support for the software, which was not possible if customers used an unauthorized version of the software.

Ling was happy to grant the copyright for the Chinese version of the software to ObiSoft; in return, ObiSoft’s senior management made him the company’s master reseller across mainland China. It was a win–win outcome, and Ling had achieved his first goal. As master reseller, he became the sole point of contact for the Chinese market and was also granted the power to appoint sub-resellers and to conduct product marketing in co-operation with Herfken. As master reseller, he gained a partner commission of 50 per cent on sales instead of the typical 20–30 per cent. Thus, Ling could now offer up to a 50 per cent discount to his Chinese customers, and any higher price he could negotiate became his direct profit.

Using deadlines to get discounts

Ling understood from his previous experience that the pricing of enterprise software was a complicated matter. It was based on a price list whereby the user bought the perpetual rights to use the software. The challenge for pricing was that the marginal cost of generating an additional licence was close to zero,[[4]](#footnote-4) as the purchased software was simply downloaded from a server to the user’s machine. Thus, the negotiated price could be highly flexible, which smart buyers could exploit to their advantage.

Ling had also observed Western companies’ practice of focusing on quarterly and yearly results that directly aligned with the stock market’s reporting cycles. He noticed that when a listed company, such as ObiSoft, did not reach its forecasted level of sales, its share price might drop.

To take advantage of this situation, Ling placed buy orders close to the end of the quarter to help Herfken fulfil his quota prior to the closing deadline. Ling sometimes placed these “ghost” orders without having received any actual orders from customers for the licences, and he took advantage of the approaching deadline to negotiate cheaper prices from ObiSoft’s own sales department. He knew that gaining these allocations at such a low price would enable him to later offer bigger discounts to his mainland Chinese customers, which would generate trust, goodwill and *guanxi*. He knew these favours would be remembered and returned, as this long-term reciprocity, a component of *guanxi,* was a cornerstone of China’s business culture.

Ling understood that ObiSoft’s annual sales budget was ambitious, and that it was often a struggle for even the top sellers to consistently achieve their sales targets. Sales accounting rules also differed for partners and direct customers. For a partner, orders were booked based on a simple order slip completed by the partner without requiring the customer’s signature. As a master seller, Ling booked sales in advance without requiring the customer’s signature, while sales made by sales staff were required to have a contract that included the customer’s signature and their personal official stamp.

Herfken’s portfolio made him responsible for all ObiSoft’s sales in Asia, which meant he travelled frequently. Because of the number of countries in his portfolio, he was usually able to visit the major China hubs of Shanghai, Beijing, and Shenzhen only once a month. When visiting Ling, their meetings with potential customers often started at 8 a.m., and five to eight meetings were scheduled per day. The last meeting would usually include dinner, followed by karaoke with the clients. Herfken understood little Mandarin, so when attending meetings with Ling, he basically played the role of a figurehead for ObiSoft. The conversations at these meetings were often fast and completely in Mandarin (or a dialect), and he was able to follow only the disjointed translations that Ling provided from time to time. Consequently, Herfken was only vaguely aware of what was happening in the negotiations and of the details that were being discussed. In contrast, Ling was in total control, as he was usually the only person in the room who spoke both Mandarin and English fluently, and hence he was the only person who understood both sides of the conversations taking place.

During the last four months of 2017, Ling introduced Herfken to several large government prospects, including the Hospital Administration Board of Shanghai and the Federal Police of China. These organizations needed thousands of licences, and a contract with them could be worth millions of US dollars. These new prospects excited the ObiSoft corporate sales management team. As a result, they constantly asked Herfken for details of these possible deals, the configurations, the number of users, and decision-makers for these companies. Ling happily provided some of this information; however, it was difficult for Herfken or ObiSoft to double-check the information he provided, due to all of the details on the sales document being in Mandarin.

By the beginning of December 2017, the Central Hospital Administration of Shanghai (CHAS) was negotiating a large contract with Ling that Ling was determined to close before the confirmation of sales deadline on December 31. He said CHAS was in the market for 2,500 licences for the total undiscounted price of US$2.5 million.[[5]](#footnote-5) Because he was now both a master reseller and partner, Ling was entitled to discount this ObiSoft price by 50 per cent, which meant that the sales price for him would be immediately reduced to $1.25 million. However, Ling knew the Bi-Tech system, and by mid-December he was confident that he could reduce this price further. He knew that China was a price-sensitive market, and to win big orders he needed to offer big discounts.

Leading up to the December 31 deadline, Ling had stayed in regular contact with Herfken to monitor how ObiSoft was progressing in achieving its annual sales target. Ling knew ObiSoft had been well below its target for the third quarter ending September 30 and by mid-December it was nearly 60 per cent below its target for the October 1–December 31 quarter. Ling knew ObiSoft needed to sell a lot of software to meet the fourth-quarter target, which created a buyer’s market with opportunities to negotiate a further reduction in the sale price with the ObiSoft corporate sales management team. In mid-December, he managed to negotiate an extra 25 per cent price reduction, in addition to his 50 per cent discount as both a partner and master seller, giving him a total discount of 75 per cent on the original listed price of $2.5 million. This meant ObiSoft’s corporate sales management team now expected the revenue from the CHAS sale would be $625,000, given the discount of $1,875,000.

Ling knew that it was in everyone’s interest to close the deal. If he could place an order before the end of the calendar year, all of the sales managers, including Herfken, would receive an extra sales bonus.

By December 20, as the deadline approached, Ling convinced Herfken and the corporate sales management team to approve an additional 10 per cent discount, which meant that the extra price discount was now 35 per cent. When added to the 50 per cent partner discount, the total discounts now represented 85 per cent of the original selling price. As December 31 approached, pressure was mounting on the CHAS sale to be realized, prompting daily communications between Ling, Herfken, and ObiSoft’s corporate sales management team. Herfken’s role was to explain corporate policy to Ling and to explain to the corporate sales management team how delicate and competitive this business was in China. Ling had control of the situation and was the only person who understood both the Western and Chinese markets and the resulting dialogues.

By December 30, the corporate sales management team was desperate to fulfil the company’s quarterly sales target. Ling knew this and requested an additional 5 per cent reduction to bring the total discount to 90 per cent. The deal was finally closed on December 31, at a net cost to Ling of $250,000 for an order with an original value of $2.5 million. The total savings amount on the transaction was $2,250,000, or 90 per cent. At the time, neither Herfken nor anyone else in the company, except Ling, knew whether the contract was real or a “ghost” sale—because the customer’s contract and signature were not required; the only requirement was Ling’s written approval as master reseller.

With this order, ObiSoft managed to reach its sales goal for the year, and all managers received their yearly bonus. Everyone on the ObiSoft team was pleased. In the end, it was Ling who best understood the business psychology of the Western company and who won the 90 per cent discount by using the principal’s sales quotas, targets, and reporting deadlines to his advantage.

Ling had actually sold a trail package of 1,000 licences to CHAS at a 50 per cent discount, which gave him a personal margin of 40 per cent profit on this deal. The remaining 1,500 licences were a “ghost” sale that he planned to sell to new customers at a 25 per cent discount from the list price, which would provide him with a profit margin of 65 per cent. Nobody knew the whole story except Ling.

The Next Step: Moving R&D to China

Six months later, Ling presented a new proposal to the ObiSoft board in June 2018: to move the R&D for new versions of ObiSoft’s software to China. He argued that this move was attractive, due to a new Chinese government policy of granting subsidies for up to 50 per cent of the establishment cost to foreign companies that relocated their R&D departments to China. He felt that other advantages were that software engineers in China were readily available, were paid salaries 35–60 per cent of the salaries in the West, and new software versions could automatically be adapted to the language and other requirements of the Chinese market.

This decision involved all ObiSoft departments and especially concerned the executives in sales, research and development, finance, and management. The advantages of moving ObiSoft’s R&D to China included the lowering of costs for employing professional personnel (see student spreadsheet, Ivey product number 7B19M106) and that future versions of the software would be adapted to target the largest IT market in the world. The disadvantages included the potential loss of jobs for ObiSoft employees in North America and the associated communication, trust, language, and cultural concerns associated with working with the Chinese workforce. In addition, China was well known for having weak intellectual property rights especially for a foreign company.

The decision was on the agenda for ObiSoft’s August 2018 board meeting. Herfken knew that many questions would be directed to him. He had 10 years’ experience in Asia as ObiSoft’s regional manager and knew that ObiSoft’s top management would be looking to him for advice on what to do. Should ObiSoft leave its R&D in North America, or shift the operations to China? What decision was best for ObiSoft’s management? Why?

1. Yum cha, also known as going for dim sum, was the [Cantonese](https://en.wikipedia.org/wiki/Cantonese_cuisine) tradition of going for [brunch](https://en.wikipedia.org/wiki/Brunch) to consume [Chinese tea](https://en.wikipedia.org/wiki/Chinese_tea) and [dim sum](https://en.wikipedia.org/wiki/Dim_sum)—small portions of [steamed](https://en.wikipedia.org/wiki/Steaming), [pan-fried](https://en.wikipedia.org/wiki/Pan-fried), and [deep-fried](https://en.wikipedia.org/wiki/Deep-fried) dishes served in [bamboo steamers](https://en.wikipedia.org/wiki/Bamboo_steamer). The practice was popular in [Cantonese](https://en.wikipedia.org/wiki/Cantonese_language)-speaking regions of the world and other areas with large Chinese communities. People often go for dim sum in large groups for family get-togethers and celebrations. [↑](#footnote-ref-1)
2. The four subsectors of the Chinese IT industry were telecommunications (telecom), hardware, software, and IT services. Telecom was a restricted industry, which meant that foreign participation was allowed only through joint ventures with dominant Chinese players—often large state-owned enterprises or private companies that had strong ties with the government. Hardware, which was considered a mature market, was not a restricted industry. The hardware market had small margins and was subject to constant pressure on its prices and profits. The software and IT services sectors were the two sectors where foreign companies were most active. [↑](#footnote-ref-2)
3. *Guanxi* referred to the establishment of a relationship between two individuals to enable a bilateral flow of personal favours or social transactions. Irene Y. M. Yeung and Rosalie L. Tung, “Achieving Business Success in Confucian Societies: The Importance of Guanxi (Connections),” *Organizational Dynamics* 25, no. 2 (1996): 54–65. [↑](#footnote-ref-3)
4. An example of zero marginal cost was freeware, which was software that could be freely downloaded and used, and was provided by a company that charged only for support. An example of freeware was the operating system Linux, which was originally developed for [personal computers](https://en.wikipedia.org/wiki/Personal_computer) based on the [Intel x86](https://en.wikipedia.org/wiki/Intel_x86) architecture, but had since been ex[ported](https://en.wikipedia.org/wiki/Porting) to more [platforms](https://en.wikipedia.org/wiki/Computer_hardware_platforms). Linux also ran on [embedded systems](https://en.wikipedia.org/wiki/Embedded_system) (i.e., devices with [operating system](https://en.wikipedia.org/wiki/Operating_system)s that were typically built into the [firmware](https://en.wikipedia.org/wiki/Firmware) and were highly tailored to the system). Devices with embedded systems included digital video recorders, network [routers](https://en.wikipedia.org/wiki/Router_(computing)), facility automation controls, television, [video game consoles](https://en.wikipedia.org/wiki/Video_game_console), and [smart watches](https://en.wikipedia.org/wiki/Smartwatch). [↑](#footnote-ref-4)
5. All currency amounts are in US$ unless otherwise specified. [↑](#footnote-ref-5)