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China's Shifting Competitive Equation

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Multinational companies must respond to China's rising costs by bringing their own global best practices to its shores.

by Christoph Alexander Bliss, Ronald Haddock, and Kaj Grichnik

The world's largest corporations have poured billions of dollars — and virtually every other type of currency — into China in pursuit of two basic objectives: First, to use the nation's low-cost labor to make and export relatively inexpensive products to markets around the world, and second, to build manufacturing, sales, and distribution networks that can feed China's hungry market of 1.3 billion people.

But many companies have generally pursued these twin aims without any real attempt to marry the two operations and harness manufacturing efficiency and economies of scale. In a rush to exploit China's seemingly endless market potential, companies have neglected to import the best ideas from their operations elsewhere in the world or to develop new ones in China — and as a result they are missing out on opportunities to create additional value for their shareholders.

That is one intriguing conclusion from a recent study conducted by the American Chamber of Commerce (AmCham) in Shanghai and Booz Allen Hamilton. This study, "China Manufacturing Competitiveness 2007–2008," surveyed 66 manufacturers in such industries as consumer, industrial, health care, and materials. Eighty-one percent were wholly owned by foreigners and 10 percent were joint ventures between multinationals and Chinese partners; 9 percent of the respondents chose to identify themselves as "other." About one-third of the respondents had an additional major presence in China beyond their manufacturing footprints: More than 50 percent had representative offices and roughly one-third had regional or global headquarters in China. The study found that three out of four companies lack fundamental best practices in their China operations and more than half — 57 percent — have failed to integrate the dual functions of export platforms and operations that support production for the domestic market.

This is particularly problematic because the economic fundamentals in China are shifting rapidly. China's fortunes are rising as it continues to attract capital investment externally and internally in high-tech industries such as aerospace, electronics, biotechnology, and environmental and alternative energy technologies. This means, however, that it is losing its long-standing status as a premier source of an abundant, cheap labor force that companies could count on to consistently deliver big returns. Indeed, China's operating environment is becoming more expensive as costs increase and the currency strengthens, a fact lost on few manufacturers. More than half of the surveyed companies — 54 percent — agreed with the statement that "China is losing its competitiveness to other low-cost countries in manufacturing." One of every two respondents said that India, Thailand, and Vietnam are chal-

Christoph Alexander Bliss, a principal with Booz Allen Hamilton, passed away prior to the final publication of this article. Booz Allen recognizes with gratitude his numerous and significant contributions to the firm's knowledge and practice of operations strategy and globalization.

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lenging China's low-cost position. Nearly one in five (17 percent) have already made the decision to move at least some China-based operations to other low-cost countries. Other organizations have produced similar findings. The Federation of Hong Kong Industries estimates that 10 percent of the 60,000 to 70,000 Hong Kong–owned factories in the Pearl River Delta region (broadly defined as Guangdong province, Hong Kong, and Macao) will be shuttered this year because of costs, likely the highest closure rate in 20 years.

Companies can avoid falling victim to China's shifting economic realities — and benefit from the nation's large and productive labor pool and its vast market of consumers — by becoming what we call *global supply chain integrators*. This involves linking factories, materials purchasing, and sales operations into a tightly knit unit. China should be seen as part of an international web of capabilities, including manufacturing, innovation, new business models, logistics, and talent development. In making China a critical component of their global operations, rather than just another satellite market, companies can create a global strategy that leverages China's size and dynamism.

Indeed, according to the AmCham/Booz Allen survey, companies that have successfully integrated their Chinese export-oriented activities with their Chinese market operations are achieving higher levels of profitability: They report gross profit margins of 29.6 percent compared with 17.9 percent for those that have not achieved integration.

Integrated from the Ground Up

Developing the mind-set that global integration is imperative is the starting point for companies in becoming a global supply chain integrator. In putting global integration into practice, one key step is to create manufacturing systems that produce large volumes of products but delay the moment at which those products have to be customized for specific Chinese and non-Chinese markets. There may be an infinite number of ways to assemble a personal computer, for example, but few of those ways make economic sense until and unless the company knows who the final customer is. This concept is called *postponement*, and, of course, there are different ways of achieving it depending on the type of product being manufactured. Hewlett-Packard Company engages in light postponement, making universal printers with the same labeling and packaging for all orders but including power supplies and language-specific manuals at the last moment. Motorola Inc. engages in more advanced postponement for its radio products by waiting until specific orders are received and then adding customized labeling and packaging.

Companies that are successful at postponement also typically create what we call *tailored business streams*. These companies take advantage of China's capacity for large-scale, cost-efficient manufacturing yet retain high levels of differentiation throughout the assembly process for both Chinese and global markets. At their heart, tailored business streams segregate the manufacturing of products with similar needs into parallel tracks. A PC manufacturer such as Dell Inc., for instance, identifies the common elements that unite 80 percent of its output, while reserving 15 percent of capacity for somewhat predictable demand conditions and 5 percent for opportunities that simply cannot be forecast.

It is only after adopting this philosophy and applying these practices in China that companies should engage in footprint and network modeling or specific planning for sales. In layman's terms, that means determining how many plants they should have, where those facilities should be located, and what their focus and mission should be, after considering customer and market requirements and weighing the economics of different options.

The next crucial step is sales and operations planning, a systematic approach to coordination between those two departments, calling for planned rather than ad hoc decision making. It requires robust communication among product managers, sales executives, and processing center leaders to answer key questions and determine where along the spectrum of customer needs a particular order falls. Does the customer want 10,000 very specific personal computers in two days? Does he or she want a more generic order in a week or 10 days? What is the customer willing to pay to expedite the order? Better communication of customer needs allows companies to make more informed decisions about where last-minute customization should be performed and where inventory should be held across supply chains that can span the globe.

After a manufacturer goes through these specific steps it is in an excellent position to apply lean practices, originally pioneered by the Toyota Motor Corporation but now widely practiced by manufacturers everywhere. Many manufacturers start at precisely the wrong point in China by trying to create lean operations because they don't understand the sequencing of the building blocks of a successful operations strategy. We estimate that fewer than 5 percent of the companies in the world are able to fully deploy lean practices, and the percentage is much lower in China.

To be sure, there are huge opportunities to use lean practices to improve existing operations. Too few companies, for example, are well integrated with their suppliers, and point-of-usage deliveries, which are commonplace in the developed world, are not widespread in China.

We believe — and the study confirms — that it is time for a fundamental rethinking of manufacturing strategies in China. In previous decades, it seemed that virtually any plant built in China could become profitable because costs were so low. And virtually any kind of sales channel could reap double-digit gains in growth every year because of China's huge population. But now the challenge is for companies to take a more systematic, global view of their Chinese operations and integrate these operations with their global supply chains. The realities on the ground have changed and that should, and must, shape the strategy of successful manufacturers. +

Resources

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