leading IDEAS

strategy+business

Betting on China

by Ronald Haddock and Brenda Lei Foster

03/17/2009

a strategy+business exclusive

booz&co.

Betting on China

Even in the face of the economic downturn, a survey finds that multinationals in China are upgrading their mainland operations and encouraging the government to improve the education and productivity of Chinese workers.

by Ronald Haddock and Brenda Lei Foster

Although China is projected to eke out approximately 8 percent annual GDP growth in 2009 (even in the global economic downturn), it faces difficult decisions about the future of its manufacturing sector. Before the collapse of worldwide consumer demand, multinational manufacturers in China were largely focused on taking advantage of low-cost labor to make inexpensive products primarily for Western markets. At the same time, China's leadership was engaged in a determined effort to push domestic industrial capabilities into higher-end production by establishing protections for intellectual property rights, making it easier for foreign companies to set up shop in China, and enhancing the manufacturing skills and productivity of Chinese workers. The aim was to both expand the growing middle class in China and make the nation's consumer markets more desirable to global manufacturers.

But the landscape has changed remarkably. As exports tumble, a large number of mainland factories serving overseas consumers are closing, millions of Chinese are losing their jobs or job opportunities, and the domestic market is fast becoming one of the few, if minimal, growth engines in the short term for both home-grown companies and multinationals. In this new reality, will the Chinese leadership give in to short-term pressures and curtail its campaign to raise the skills of its workers and the quality of their output in favor of easing cost pressures on local manufacturers? Or will it take the bolder path, continuing to reform the manufacturing base at some economic and political expense to ensure a sustainable industrial sector and rising living standards in the long term?

These questions and the critical decisions surrounding them formed the backdrop to the second annual China Manufacturing Competitiveness study, prepared by the American Chamber of Commerce in Shanghai in cooperation with Booz & Company and supported by nine international chambers of commerce in China. Conducted between September and December 2008, the survey asked 108 manufacturing companies doing business in China — 82 percent were wholly owned by foreigners and 11 percent were joint ventures between multinationals and Chinese partners — a series of questions designed to paint a portrait of how these manufacturers perceive China as a market and as an export platform.

Although many respondents agreed that the Chinese government has made noticeable progress in modernizing the nation's manufacturing environment, clear majorities said that strengthening the education and productivity of Chinese workers, stimulating domestic demand, enforcing intellectual property pro-

Ronald Haddock
(ronald.haddock@booz.com) is a partner with Booz & Company based in Zurich. He has been with the firm since 1994, including 10 years in the China, India, and Korea offices. During his recent assignment in Shanghai, he led the auto and industrials practice in Greater China.

Brenda Lei Foster
(president@amcham-shanghai.org) has been president of the American Chamber of Commerce in Shanghai since 2005. She has more than 30 years of experience working on Asian and Chinese global concerns, and is a member of the Council on Foreign Relations.

tection, increasing quality and safety standards for products made in China, and welcoming foreign investment were "important" or "very important" to their company's business operations there. In other words, multinationals are hoping that the Chinese government maintains its zeal to reform and to improve the nation's ability to meet global manufacturing and trade benchmarks.

It's natural that Chinese leaders might be tempted, as worldwide demand falters and factories sit idle, to postpone their agenda of expanding the middle class. But such an agenda is more imperative now than ever as the slowing global economy creates thorny internal social problems. Among the concerns, a growing number of college graduates are unable to find jobs. China has thus far continued to strongly encourage job creation and the migration of domestic industrial capabilities into higher-end production through emphasis on worker development, despite short-term costs.

This year's survey found that manufacturing in China continues to evolve steadily, with more companies implementing sophisticated production techniques and technologies and integrating their Chinese operations into their global supply chains. On average, 39 percent of companies have adopted some aspect of best practices, up from 27 percent last year.

But this number is still far too low. Particularly with global economic conditions teetering, the more forward-thinking multinationals have a unique opportunity to benefit from one of the few growth areas that will almost certainly lead the eventual worldwide recovery. To be poised to profit from sales in China, more manufacturers must rapidly upgrade their production models in China to develop and capture economies of scale and scope. They should view China less as a low-cost country and more as a competitive manufacturing and sales environment, the hub for an Asian growth strategy. Indeed, the survey found that multinationals that had adopted such best practices were rewarded with gross profit margins that were, on average, 4 percent higher than those of companies that hadn't.

Historically, the most profitable multinationals in China have harnessed the duality of China as both an export and domestic market, compared with companies that have pursued the narrower objectives of either taking advantage of the country's low-cost labor to make inexpensive products or parts for Western markets, or importing products into China for sale in the growing domestic market. Companies that make a play on China's dual markets are better positioned and have more motivation to implement best practices, because to succeed they must devise factory footprints in China that produce large volumes of products but delay the moment at which those products have to be customized for Chinese and non-Chinese markets. They must do so in globally connected supply chains that are lean and highly responsive.

In this year's survey, the concept of China as a duality play continued to gain prominence: 57 percent of companies described this approach as their primary motive for establishing and growing their presence in China, versus 47 percent last year. At the same time, the percentage of respondents that identified labor or material cost savings as their primary reason for being in China without also citing local market access as a motive dropped by half, from 22 percent to 11 percent.

This study was among the first to measure the impact of the financial downturn on multinational business operations in China. Uncertain about the global economic outlook and concerned about economic progress in low-cost markets that are usually seen as alternatives to China for manufacturing operations, fewer respondents this year said they have concrete plans to relocate or expand manufacturing capacity out of China in the next five years (10 percent in 2008 versus 17 percent in 2007). Also, more respondents this year (28 percent versus 13 percent) were neutral when asked to comment on whether China was losing its competitive edge to other low-cost countries, likely reflecting the slowdown in new manufacturing investments worldwide as well as the volatility in demand and supply in competing low-cost countries. Even with a worsening downturn, companies grew firmer in their desire to invest in China, with nearly half saying that they intend to "grow" or "grow significantly" their production capacity on the mainland in the next couple of years.

The global economic crisis has changed the assumptions about future business strategies for virtually every manufacturer operating in China. Before the recession, the biggest challenges were higher material and compensation costs as well as the appreciation of the renminbi; now, declining rates of domestic growth, falling demand for Chinese exports, global currency volatility, and tight credit are paramount concerns.

To navigate this increasingly difficult environment, multinationals in China should focus on a few key activities:

- Accelerating domestic market development beyond the premium segment and moving down the price/performance ladder for products and services to take advantage of the continuing growth of the middle class, while reducing dependence on export markets.
- Tailoring their product design to meet domestic demand by fine-tuning current offerings for local market conditions and preferences and developing new business models to support this initiative.
- Linking local Chinese manufacturing and purchasing activities with their global extended supply chains to build and capture economies of scale and scope, harnessing the duality of China in the process.
- Remaining vigilant and in fact seeking to identify potential discontinuities in supply and demand and being ready to act.

Every downturn creates opportunities for the fleet of foot, especially for strong companies with healthy balance sheets and the institutional capacity to act swiftly. +

Resources

American Chamber of Commerce in Shanghai in cooperation with Booz & Company, "China Manufacturing Competitiveness 2008–2009": The study on which this article is based. www.amcham-shanghai.org/AmChamPortal/MCMS/Presentation/Publication/PublicationCustomization/Content.aspx?Type=1&GUID=%7bF3CDAEBE-75CB-4010-8539-84F704637EE1%7d&tb_Name=PublicationCustomization

Christoph Bliss and Ronald Haddock, "Integrating China into Your Global Supply Chain: Lessons Learned from Global Supply Chain Integrators," Booz & Company white paper, March 2008: A new breed of companies — global supply chain integrators — recognize that China, India, Brazil, and Russia are more than just low-cost source markets or the mega-growth markets of our age; at a minimum, they are both. www.booz.com/global/home/what_we_think/reports_and_white_papers/ic-display/41901762

Christoph Bliss, Ronald Haddock, and Kaj Grichnik, "China's Shifting Competitive Equation," *s+b Leading Ideas Online*, 03/18/09: Analysis of the 2007–2008 China manufacturing study. www.strategy-business.com/li/leadingideas/li00067

Kaj Grichnik and Conrad Winkler, with Jeffrey Rothfeder, *Make or Break: How Manufacturers Can Leap from Decline to Revitalization* (McGraw Hill, 2008): An assessment of how manufacturing can be revived and what manufacturers can do to improve competitiveness. www.amazon.com/dp/0071508309/

Anil K. Gupta and Haiyan Wang, "The China and India Strategy," *s+b*, Spring 2009: For most Fortune 1000 companies, the right question to consider now is how best to pursue China and India together, not separately. www.strategy-business.com/press/article/09113

Ronald Haddock, "Achieving Operational Excellence in China: Strategic Need and Practical Solutions," Booz & Company white paper, April 2006: To fulfill the needs of growing industries, the role of operations must extend beyond cost savings and address the labor productivity gap, poor asset productivity, and the increased importance of quality. www.booz.com/global/home/what_we_think/reports_and_white_papers/ic-display/41901988

Ronald Haddock, Reid Wilk, and Michael Pfitzmann, "Lessons from China: The Importance of Knowledge-based Sourcing in Low-cost Countries," Booz & Company white paper, January 2009: Structural shifts in China's economy are forcing companies to adopt deeper and more personal strategies for supplier relationships. www.booz.com/global/home/what_we_think/reports_and_white_papers/ic-display/43460672

Edouard Samakh, Kaj Grichnik, and Ronald Haddock, "Unraveling the Chinese Puzzle: A Practical Approach for Manufacturers," Booz & Company white paper, January 2006: How manufacturers can assess the level of opportunity or threat from China. www.booz.com/global/home/what_we_think/reports_and_white_papers/ic-display/41945148

Conrad Winkler, Kaj Grichnik, and Arvind Kaushal, "Manufacturing: Diagnosing This Downturn," *s+b*, Spring 2009: An examination of the most effective approaches used by manufacturers in past downturns to survive and position themselves well for recovery. www.strategy-business.com/press/article/09104a?preview=1&psid=&ph=

strategy+business magazine
is published by Booz & Company Inc.
To subscribe, visit www.strategy-business.com
or call 1-877-829-9108.