

APPROACHING CHINA WITH EYES WIDE OPEN

SUCCESS IN CHINA REQUIRES AN EYE FOR OPPORTUNITY
AND THE NEED TO DO YOUR HOMEWORK.

≡ BY STEVE MINTER

If you are a manufacturer deep into planning for the turnaround, now is a very good time to be thinking about your China strategy. Certainly, the Chinese economy has had its fair share of problems—exports down 20% in the first quarter, thousands of factories shuttered and more than 20 million migrant workers jobless. But May brought the third month of expansion in Chinese manufacturing. China's Purchasing Manager's Index stood at 53.1% in May, the third month it was above 50 and indicative of economic growth.

"Companies may want to be more proactive there earlier. People in [my] market are weaker so that gives me some opportunities. My competitors may be distracted with their own problems," says Steven Ganster, managing director, Technomic Asia, a division of Tompkins International. "If I have the balance sheet and the guts, it may be a good time for a disruptive strategy. At a minimum, we need to plan for recovery."

Observers such as Ganster say China's \$584 billion stimulus program has had a quick, visible impact on Chinese domestic spending. While much of the U.S. stimulus package will go to prop up weakened balance sheets, Ganster points out, the Chinese stimulus is going to infrastructure and the promotion of revenue growth.

"They cut taxes on small cars and literally the next month, you saw a sharp uptick in the sale of small cars. They offered discount coupons of approximately 13% on various home appliances and computers for the rural market. It gave a nice benefit to the rural market but it also helped to boost production and clear out inventory of suppliers on the east coast [of China]. There is also more traditional investment in roads and things of that kind."



Ganster adds that the Chinese stimulus investment has a long-term, strategic component aimed at promoting innovation and R&D. Similar to steps the government took at the beginning of the decade, he believes, this stimulus has the potential to take China to the next level of productivity and competitiveness.

TOTAL COST

Many U.S. companies came to China years ago because of lower wage costs and economic incentives for exporters. In 2000, the hourly wage was approximately 80 cents while it is \$1.70 to \$2.25 today. Duane Bolinger, a managing partner with BBK based in Shanghai, says China continues to enjoy other economic advantages such as the quality of the labor force, infrastructure and IT and a broad supply base. For very labor-intensive, low-margin industries such as shoes, says Bolinger, rising labor costs in China already have prompted companies to move production to lower-cost nations such as Vietnam or Malaysia.

But if companies came to China for cheap labor,

they are staying to participate in the country's huge domestic market and increasingly looking at selling their Chinese production in Asia. For more capital-intensive industries, recent data show more than 80% of multinationals have no plans to move any capacity outside China. Access to China's huge domestic market accounts for much of that, says Bolinger, but also multinationals have spent a lot of money to build supply chains in China and are not eager to duplicate that effort.

China experts say the country is encouraging the evolution to higher-value manufacturing through laws to improve labor conditions, tax increases and targeted tax incentives for "encouraged industries," typically cleaner, more technologically advanced industries.

These changes won't come without challenges. Bolinger charges that years of focus on sales growth and low labor costs has resulted in a failure to implement best practices in manufacturing or supply chain management. "Multinationals are in a better position than locals to do this in that they have the wherewithal within their own companies to assist them in those best practices," he says.

China also faces consolidation in its fragmented industries, says Bolinger. For example, he notes that the top 100 automotive component suppliers command less than 50% of market share. "An aluminum wheel supplier told me there are 100 wheel suppliers and if you added their capacity together, there is equivalent of 100 million vehicle capacity," he says. "There has to be consolidation." That provides even greater incentive to companies to make sure that they are doing business with suppliers that are financially viable in the face of this shakeout.

As the China market changes, experts say it is important for companies considering investment in China to appreciate the total cost of operating there. For example, a recent Grant Thornton analysis, "Is China in Your Future?," shows that factories in China earned a 50% median return on invested capital (ROIC) in 2007, compared to 18% in U.S. plants. "But if you look at average sales per employee, it is almost the same number. What that tells you is if the average return on investment is almost the same in China and the U.S.—about 32%—then some plants in the U.S. that are well-run can achieve as good ROI as China," says Wally Gruenes, managing partner of Grant Thornton's Consumer and Industrial Products Group.

Total cost, says Gruenes, includes items such as freight costs, duties, inventory carrying costs, travel costs and the additional cost of maintaining a midnight shift here in the U.S. because of the time difference.

Ganster urges companies to focus on "strategy before structure" before setting up operations in China. They should carefully consider what they need to do and how it fits into their global strategy. Also, he says it is critical that companies identify their "addressable market—that part of the market

where you can make money." In the past, foreign companies have owned the premium end of the market and Chinese companies have controlled the low end. "If you look at the macro view, every market is large and growing," he points out. "The question is whether my slice of the pie is growing and what is my structure to participate. That is where we have seen the power encounters between foreign companies that have localized and Chinese companies that have upgraded. Both are fighting for that large middle market."

QUALITY

Recent headlines about contaminated pet food and lead in toys continue to fuel concerns about the quality of Chinese goods. According to the Grant Thornton study, China has a median customer reject rate of 50,000 parts per million (ppm), compared to 100 ppm in the U.S. Chinese plants may be more willing to resolve quality issues, it notes, by using more labor, "reworking and redoing products until the outcomes are acceptable . . ."

China does stress quality, points out Gruenes, and there is a high focus on total quality management in Chinese plants. Yet, the Grant Thornton study found much less empowerment of Chinese workers than in the U.S. Empowered employees are more likely to identify quality issues and bring them to the attention of management or make corrections during a production run. Conversely, employees who are not empowered may allow hundreds or thousands of defective parts to be produced before the defect is identified at the end of a process, if it is identified at all.

Not all the onus for quality rests with Chinese suppliers, says BBK's Bolinger. Companies should have a good supply risk management process in place. Foreign companies must make sure that they are communicating effectively with their suppliers, doing both financial and operational due diligence to ensure that price pressures, for example, aren't leading to inappropriate steps to reduce costs. He pointed to data that 75% of multinational companies had targeted material price reductions in 2009. "I found that surprisingly high given that concern also with financial viability of these suppliers," he says.

Such issues help underscore a critical lesson Western companies must learn: an appreciation for the cultural differences attendant with operating in China. For example, Ganster says foreign companies fail to understand how relationship-oriented business is in China. Business relationships require repeated face-to-face meetings, as he notes, "before and after 5 p.m." Americans are direct, low-context communicators, and as a result can easily misunderstand communications with Chinese customers and suppliers. Ganster says Americans are prone to put great emphasis on contractual language when there is a problem, but in China, he maintains, "Trust and understanding trumps a contract. If there is trouble, a good relationship will save you." **IW**

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