L.E.K.

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Changes, Challenges and Champions: China's Industry Outlook in the Midst of Global Uncertainty

With the weakening US economy and Eurozone debt problems fuelling concerns about the global economy double-dipping, many company executives have turned to China for growth. After all, the emerging market led the world out of the global financial crisis in 2009. However, all is not rosy as worries about the health of the domestic Chinese economy pile up and cracks in the investment-led growth story appear.

With rising inflation, prospect of a property bubble and concerns about the quality and quantity of local debt making headlines, corporate executives have been increasingly pessimistic about operating conditions in China. The headline Chinese Purchasing Manager's Index (PMI) has declined for 10 continuous months from November 2010 to August 2011 and has, since July this year, remained in negative territory, indicating a contraction in factory output. Corporate executives widely point to increases in raw material costs, reduced demand due to the global economic turmoil, increase in wages and Chinese renminbi (RMB) appreciation as key challenges in their business in China.

What does this mean for the outlook for the Chinese industry? Are all sectors equally affected and what are strategies that companies deploy to face the changes and challenges ahead?

In our view, there are eight key drivers that are most relevant in determining business performance in China in the coming years:

- **Extent of economic growth in China:** After three decades of high growth, China's GDP growth is expected to slow down to ~7-9% per annum as the Chinese government shifts the economy towards consumption-led growth. While there are concerns about the Chinese economy headed for a hard landing, the consensus is that the Chinese economy will continue to grow at a slower rate, driven by domestic consumption, strategic emerging industries and industrial restructuring policies

- **Impact of global markets:** As the "factory of the world," China enjoyed double-digit export growth over the last decade. However, many of China's major export destinations are currently facing possible recession, creating substantial short term risks for sectors which are export-based

- **Movement in raw material and oil prices:** Prices of raw material in China have increased at ~10-15% per annum in recent years, creating substantial cost pressure on manufacturing businesses in China. This trend is expected to continue in the future with manufacturers affected to varying degrees depending on their ability to pass on the price increase downwards in the supply chain

Michel Brekelmans is a Partner with L.E.K. Consulting and based in L.E.K.'s Shanghai office. He has 15 years' experience in strategy consulting with L.E.K. Consulting, of which 10 years is in Asia. We have developed a more detailed discussion document that we would be happy to discuss with you if you are interested. Please contact us at industrial@lek.com for additional report information or related information.

- **Extent of RMB appreciation:** The Chinese government's official stance is that the RMB will be allowed to gradually appreciate against the U.S. dollar with the USD/CNY exchange rate falling to 6.1 by 2015. This will continue to impact the profitability of export-heavy sectors, with manufacturers of lower-value goods facing more difficulty passing on the impact of currency appreciation to their global customers

- **Extent of labour cost increase:** China's labour cost has increased at ~15% per annum over the last 10 years. Labour intensive sectors have been particularly impacted, with some moving manufacturing operations inland or to lower cost countries, or reducing their dependency on manual labour. Labour cost is expected to continue increasing in the mid-term

- **Speed of improvement in operational efficiency:** Supported by rapid technological advancement, China's manufacturing industry production efficiency improved at ~25% per annum from 2006-09, during which wages grew by ~16%. As such, compared to workers in low-cost countries of Vietnam, Indian and Sri Lanka, Chinese industrial workers continue to be more productive. Going forward, operational efficiency is expected to continue to increase as the Chinese government continues its industrial upgrading initiatives

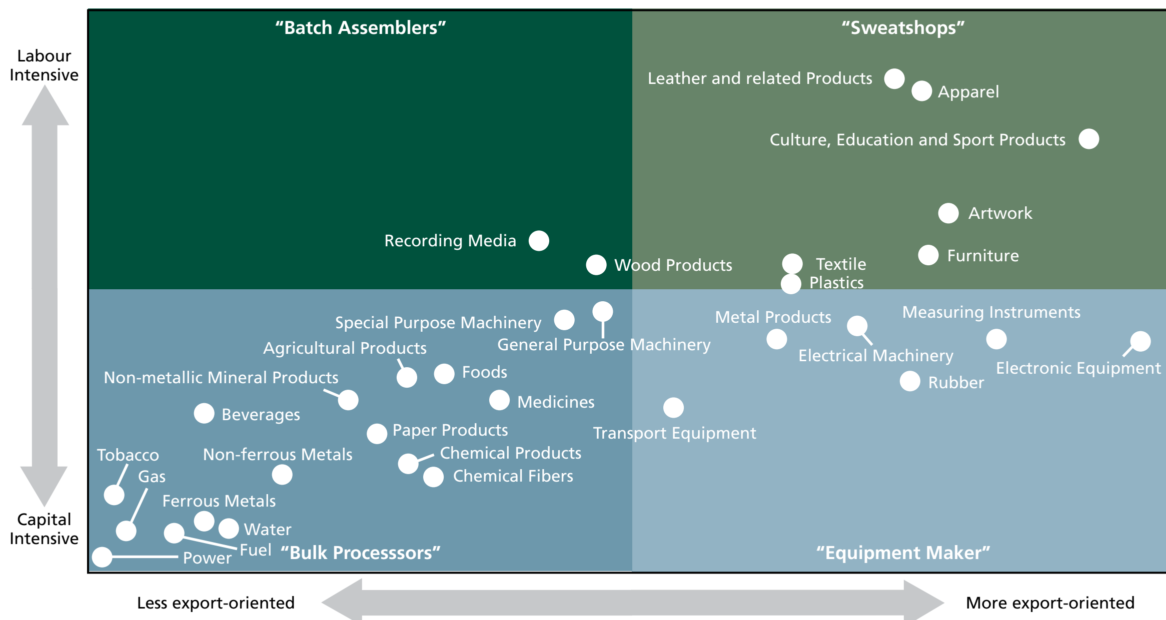
- **Strategic alignment with national industrial policy:** Continuing a policy started in 2006, the Chinese government put in place a series of guidelines as part of the 12th FYP to shift the country's manufacturing focus towards technology-intensive and environmentally-friendly industries. As a result, high-tech manufacturing and "new energy" or "green" industries enjoy more favourable credit terms, tax incentives and preferential treatment in land use

- **Strategic alignment with national taxes & VAT policy:** In conjunction with national industrial policy, the current export VAT rebate and corporate tax rate systems favour high value and high-tech industries and disfavour high energy consumption, high polluting and commodities industries

All the above trends are critical in determining a business's outlook in China. However, what do these trends mean for different industries within the Chinese economy? How will different companies be impacted? It is likely that an export oriented apparel manufacturer will face different challenges from a medical device manufacturer targeting sales at tier 3 and 4 cities in China's vast hinterland. L.E.K. has developed a detailed analytical framework for assessing the outlook of different industry sectors by assessing each sector's labour/capital intensity and

Figure 1

China's Industries by Category (2010)



Source: China Statistical Yearbook 2010, L.E.K. Analysis

its import/export mix to understand the impact of each of the 8 fundamental industry trends. The premise underlying our model is that these trends will affect each category of companies in different ways. For example, industries that are heavily export oriented like electronic equipment manufacturers are more exposed to movement of the global markets and exchange rate changes whereas industries that are labour intensive like apparel, artwork and furniture producers are very sensitive to labour cost change and operational efficiency improvement.

In our model, industries are grouped into 4 categories (Figure 1):

A. Batch Assemblers (i.e. labour intensive/less export oriented sectors)

B. Sweatshops (i.e. labour intensive/more export oriented sectors)

C. Bulk Processers (i.e. capital intensive/less export oriented sectors)

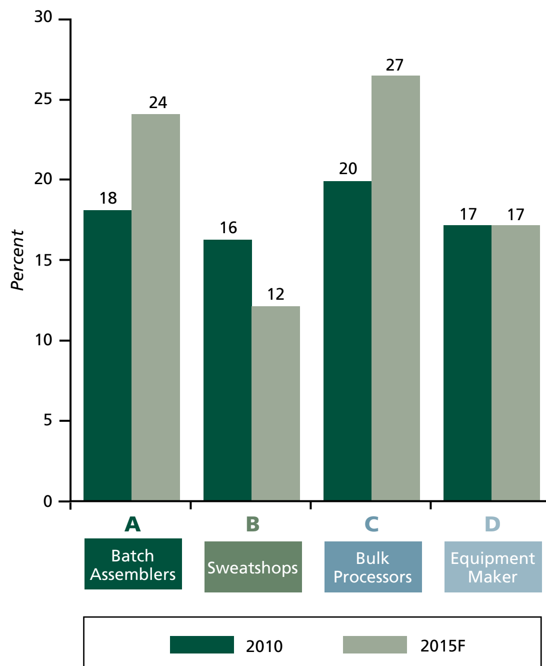
D. Equipment Maker (i.e. capital intensive/more export oriented sectors)

Our analysis shows that export oriented, labour intensive "Sweatshops" are the most negatively impacted in the coming years while domestic oriented, capital intensive "Bulk Processers" are the most positively impacted, with the potential of gross margins increasing by up to 7% (Figure 2).

Companies in "Sweatshop" industries are, to some extent, already a "victim" of some of the forces shaping China's business environment. Many footwear and apparel manufacturing companies in China have already ceased business or shifted production to low-cost production sites in Vietnam, Cambodia, Laos and Bangladesh, with the plight of failing shoe businesses in the Southeastern city of Wenzhou emblematic of the situation. In addition, the plastics industry has also been struggling, with many small and medium sized manufacturers caught by sudden slackness in orders from traditional western export markets and less-efficient firms going out of business. The Chairman of the Hong Kong Mould & Die Council has predicted that as many as 20-25% of the companies in Southern China's plastic tooling and moulding industry could close by early 2012, in particular those supplying electronics or housing appliances manufacturers.

Figure 2

Base Case Gross Margin by Company Type (2010 vs. 2015F)



Source: China Statistical Yearbook 2010, L.E.K. Analysis

Trend	Base Case Assumption	Rationale
Economic growth	7.0%	Average analyst forecast
Global market impact	1% annual price decrease due to global competition and 1% annual drop in export sales growth due to global economic slowdown	L.E.K. assumption based on possible global recession and low-cost countries wage increases and differentials
Raw material price increase/Oil price increase (affects transportation cost, etc.)	4% raw material price increase, 4% oil price increase (adjusted for ability to pass on 50% of the cost increase)	Based on average historical raw material price increase and average analyst forecast for oil prices
Exchange rate by 2015 (USD/RMB)	6.1	Average analyst forecast
China labor cost increase	15%	Based on historical wage increases and analyst forecasts
Operational efficiency increase per employee	12%	Based on historical operational efficiency increases
National industry policy	Additional 10% capital spending on national industry policy related requirements	Estimate based on national industry policy adjustment
Taxes/VAT	15% tax rate for high tech companies, 25% corporate tax for all others, individual VAT rate	China government laws and regulations

On the other hand, companies in "Bulk Processer" industries are likely to thrive. The outlook for the pharmaceutical industry is bright – it looks to enjoy strong domestic demand from the country's emerging middle class and benefit from alignment with governmental policies while being relatively shielded from the impact of the global economy downturn as well as increase in labour costs. Likewise, the energy (power) and specialized machinery sectors look to perform well as the Chinese government enacts policies to reach the country's environmental and industrial upgrading goals.

Based on our analysis, future industry winners are likely to be "Bulk Processors" or "Batch Assemblers". Besides pharmaceutical manufacturers, this includes companies producing consumer products such as food and beverage, paper, products, agricultural products, providers of special purpose machinery and providers of basic industrial products including certain chemicals, oil & gas and metal products. Companies in these sectors are generally faced with a much more favorable business climate, particularly when compared to "Sweatshop" industries.

We expect that "Equipment Maker" including manufacturers of electrical, transport and measurement equipment continue to face an attractive environment in China although those businesses with a higher exposure to export markets will have to develop the right strategies to remain competitive, vis-a-vis increasing threat from other low-cost countries, and protect its position in a more turbulent environment.

Working in a sector where the underlying industry drivers are pointing in the right direction helps, but does not guarantee success. In reality, we see many successful businesses operating in "Sweatshop" industries but adapting their business models to stay competitive, for instance by investing in automation or by relocating production to low cost locations in Western China. At the same time, there are plenty of examples of businesses that are not doing well, despite the fact that fundamental industry environment is still quite attractive.

To capitalise on the positive trends and mitigate the negative impacts of the eight key industry drivers, executives of and investors in companies in China can consider a variety of strategies, which can be broadly, divided into four categories and centred around growing revenue or increasing profitability:

1. We have seen an increasing trend whereby companies are looking to grow revenues organically through exploitation of *multi-brand strategies* that allow companies to better target customer groups and fulfil specific needs. In addition, companies can seek to *diversify their sources of revenues* and look at increasing revenue channels through addition of *value-added services or after-sale services*

2. Revenue can also be increased inorganically through *bolt-on acquisitions* designed to create and extract synergistic value while companies can look to other fast growing emerging markets outside of China for *international expansion opportunities*

3. Profitability can be increased through operational excellence through *value chain integration* either up or down stream, *operational efficiency* improvement through increasing automation, applying lean manufacturing techniques, and *industrial consolidation* to reap economies of scale

4. To increase profitability, companies can also look at optimising pricing, one of which is *premium pricing* or *value engineering* products. By offering more of a differentiated products, companies increase their ability to pass on the impact of raw material price increase to customers and seek to enhance a clear brand awareness and positioning as well as product attributes so as to differentiate themselves from competitors

Given that each strategy is targeted at achieving different outcomes, their specific suitability and applicability would depend on the business model adopted by the company in question (Figure 3). For instance, "Sweatshops" prioritised strategy should be to seek for ways to diversify its revenue channel and move up the value chain to increase its pricing power, "Equipment Maker" would do better to develop multi-brand strategies and pursue industrial consolidation.

Figure 3

Applicability of Strategies for Companies of Different Business Models (2011)

Strategy			"Batch Assemblers" Labor intensive/less export oriented	"Sweatshops" Labor intensive/more export oriented	"Bulk Processors" Capital intensive/less export oriented	"Equipment Maker" Capital intensive/ more export oriented
Growth	Organic	Multi-brand strategy			√	√
		Diversify revenues	√	√		
	Inorganic	Bolt-on acquisition	√	√	√	√
		International expansion		√		√
Profitability	Operational excellence	Improve operational efficiency	√	√	√	√
		Industrial consolidation			√	√
	Pricing	Premium pricing	√	√	√	√

Source: L.E.K. Analysis

With a multitude of uncertain factors, both external and internal looking, which could fundamentally affect business operations in the country, the road ahead for Chinese businesses is neither straight-forward or clear. Nevertheless, given that its large domestic market, integrated supply chain and well-established transport facilities and infrastructure, China remains a very attractive environment for many businesses, and should remain firmly on the radar screen by corporates decision makers and financial investors alike.

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For further information contact:

Bangkok
Suite 26/F Capital Towers
All Seasons Place 87/1 Wireless Road
Bangkok 10330
Thailand
Telephone: 66.2.654.3500
Facsimile: 66.2.654.3510

Beijing
Unit 1026, Floor 15
Yintai Office Tower No. 2
Jianguomenwai Avenue
Beijing 100022
China
Telephone: 86.10.6510.1075
Facsimile: 86.10.6510.1078

Shanghai
Floor 34, CITIC Square
1168 Nanjing Road West
Shanghai 200041
China
Telephone: 86.21.6122.3900
Facsimile: 86.21.6122.3988

Singapore
50 Raffles Place
Singapore Land Tower #32-01
Singapore 048623
Singapore
Telephone: 65.9241.3847

Tokyo
7th Floor, Glass City Shibuya
16-28 Nanpeidai-cho, Shibuya-ku
Tokyo 150-0036
Japan
Telephone: 81.3.4550.2640
Facsimile: 81.3.4550.2641

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