L.E.K.

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Do you Speak Chinese? (and Other Misperceptions About Supply Chain Success Inside the Great Wall)

The roaring Chinese economy has many Western executives focused on how to use this region to improve their global manufacturing operations and expand their footprint in the dynamic Asian market. But this allure has been tempered by headlines of dramatic Chinese wage increases, product quality problems and other factors that erode the bottom line. These concerns are often exacerbated because many companies fail to grasp the nuances of Chinese business or the impact of its dramatic regional differences.

Although these issues have some validity they don't provide a complete picture of China's business climate, such as the country's natural resources, skilled labor and infrastructure relative to other low cost countries (LCCs). L.E.K. Consulting believes that there are still advantages to using China as a component of your manufacturing strategy to reach consumers in this growing country, throughout Asia and globally. To that end, we have outlined six important insights to help corporate leaders gain a better understanding of this market – and in some cases, dispel misperceptions about business in China.

1: Despite Rising Wages, Manufacturing is Still a Good Bet

You could be forgiven for thinking that some U.S. companies are shying away from China. Last year, for example, Coach announced that it would shift up to 50% of its manufacturing from China to other LCCs in response to rising labor rates. Based on Coach and other examples, we regularly hear broad, presumptive statements from executives regarding high labor costs in China. But Chinese provinces can vary greatly by culture, dialect and economics.

Coastal regions and metropolitan centers such as Shanghai may observe higher wages but there are certainly many areas where wages remain much lower, particularly inland. This is especially advantageous for companies that don't need to pay premiums for coastal manufacturing sites – such as companies that are supplying other manufacturers in China or targeting consumers in China or other markets that can be reached by ground (e.g., Central and Eastern Europe, Thailand, Vietnam, etc.). As an example, a fashion manufacturer that serves Chinese consumers and produces goods for Western brands recently decided to relocate production from Guangdong to Sichuan to reduce labor costs by approximately 40%.

Multinational corporations (MNCs) are also being drawn inland by tax incentives and the continued expansion of physical infrastructure. Today, 40% of Fortune 500 companies have settled in Chengdu and Chongqing in the southwest (Sichuan Province area). And the city of Wuhan has used lower wages and an educated workforce in Central China's Hubei Province to become a viable alternative to established manufacturing hubs like Shenzhen (see Figures 1 and 2).

Do you Speak Chinese? (and Other Misperceptions About Supply Chain Success Inside the Great Wall) was written by **Paul Matthews**, a Vice President and Head of the Operations practice at L.E.K. Consulting in Boston; **Helen Chen**, a Partner and Co-Head of the China practice in Shanghai; and **Michel Brekelmans**, a Partner and Co-Head of the China practice in Shanghai. Please contact us at operations@lek.com for additional information.

Figure 1

Snapshot of Average Manufacturing Employee Wages by Province

Region	Province (and Capital City)	2009 Avg Annual Wage ($USD)	2010 Avg Annual Wage ($USD)	Percent Wage Increase
Northern China	Beijing (direct controlled municipality)	$6,600	$7,600	16.1%
Northern China	Shanghai	$7,401	$8,274	11.8%
Northern China	Tianjin	$5,790	$6,740	16.4%
Central China	Chongqing	$4,405	$5,059	14.9%
Central China	Hubei (Wuhan)	$3,995	$4,868	21.9%
Southwest China	Sichuan (Chengdu)	$3,878	$4,533	16.9%

Source: China statistic yearbook 2010/2011

Wuhan is home to manufacturers that produce products for Apple, Dell and other innovative companies. And Pfizer draws from a deep pool of university graduates in the area to staff its Wuhan R&D center, which supports clinical drug development projects in multiple geographies around the clock.

Comparing Chinese Manufacturing Costs with Other LCCs

Employee wages are only one factor to consider when evaluating where a company's manufacturing operations will be the most effective. Other important elements to consider include design and production capabilities, and a host of important variables around supplier networks (access to raw materials and componentry, integration capabilities among supply partners, planning and forecasting capabilities, etc.).

To determine the overall value of manufacturing operations in China compared to other countries, L.E.K. analyzed the economics of LCCs as well as cost of goods sold (COGS) by product and geography.

When considering fully loaded manufacturing costs, China today is substantially lower than developed countries such as the U.S. and is comparable to other LCCs (see Figure 3). Even with double-digit wage increases forecast during the next five years, China is only projected to become slightly more expensive than other LCCs, and continues to be below U.S. labor rates. Moreover, wages represent only 20-30% of fully loaded

Figure 2

Chinese Provinces and Primary Cities

Source: iStockphoto image 18841977

manufacturing costs, and do not alone drive total product cost increases. And as we'll examine in the next section, the growth of China's skilled workforce will continue to play an important role as companies evaluate their manufacturing options.

Overall, China's established position as one of the world leaders in manufacturing gives it a significant advantage over other LCCs that are still developing their manufacturing infrastructure. China has built a reputation for its ability to manufacture products for global innovators such as Apple who are turning to this country to manufacture some of their newest products.

Joint partnerships are also increasingly attractive for some MNCs. Visteon Corporation and its automotive joint venture in China, FAWER Visteon Climate Control Systems, draws on its world-class manufacturing capability and localized design services to supply heating and cooling products and systems to a wide range of automakers in China and globally. The company expanded its Changchun operations in 2011 to meet growing demand.

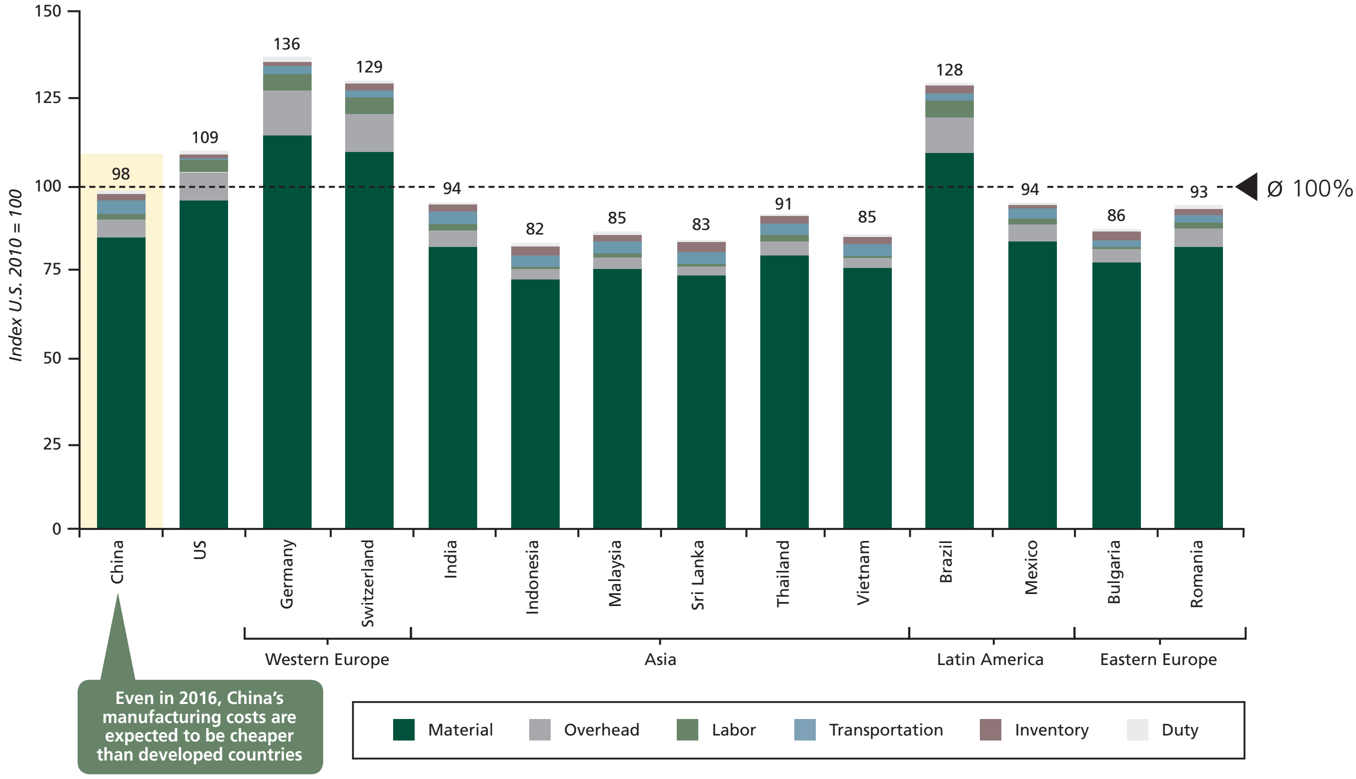
(Please note that companies will need to conduct individual research to identify strategies and recommendations that address their specific business requirements.)

Key Actions:

Companies must look beyond just wages when considering the overall value of manufacturing in China. Many other Asian countries that also offer low wages may have limitations in transportation or other supply chain variables that could drive up overall costs and increase risk.

Figure 3

Product Cost Index by Country (2016F)*



CAGR% (2010–16F)

China	US	Germany	Switzer-land	India	Indone-sia	Malaysia	Sri Lanka	Thailand	Vietnam	Brazil	Mexico	Bulgaria	Romania
2.5	1.5	1.2	0.5	1.7	1.4	1.5	1.3	1.5	1.2	2.2	1.5	1.4	2.0

Note: * Based on a weighted average of representative product groups
Source: EIU, World Bank, searates.com, freght-calculator.com, L.E.K. analysis

2: China's Workforce is Increasingly Skilled

The Chinese government is very cognizant of the power of its talent capital. China is now the world's second-largest spender on research and development (R&D), and is heavily investing R&D dollars in key sectors such as alternative energy, biotech and nanotechnology. And logically, China is expanding its base of skilled workers to bring new innovations to market.

For example, Chinese supply chain leaders tend to take more of an active role in corporate strategy than their Western counterparts, and are involved in decisions that include growth opportunities and risk management. It is also more common for the top supply chain executive to report to the CEO or president of a company in China than in the U.S. (87% of the time versus 61%). Some MNCs are already working to further promote supply chain expertise in this region. In 2009, the Cisco-Fudan-Stanford (CFS) Supply Chain Leadership Institute was created to offer advanced supply chain management training to executives at Chinese companies. Additionally, a growing number of foreign-educated Chinese nationals are returning home to play leadership roles in a variety of industries.

The capabilities of a highly skilled workforce must also be considered when calculating the true value of transferring labor costs to another region. But the value of these important skills are not always quantified with the same rigorous cost-benefit analysis of other direct costs.

Key Actions:

As China's leaders grow stronger and more talented, MNCs will need to recruit and leverage top Chinese talent to remain competitive. As the competition for top talent heats up, Chinese enterprises are snapping up a greater share of the top talent pool globally by offering higher compensation, better long-term career development opportunities and other benefits. China's workforce can play a pivotal role in accelerating production times, reducing material costs and playing a role in R&D and operational improvements. MNCs would be well-served to tap into this growing pool of human capital to help reach their business goals.

3: Despite Weak Links, the Supply Chain is Effective

With a limited physical and technological infrastructure Chinese supply chains are required to "do more with less" many manufacturing facilities have antiquated information technology (IT) systems and operational procedures, making it difficult to track factory performance metrics. And MNCs frequently have challenges integrating their legacy enterprise resource planning (ERP) systems with the IT infrastructure of their Chinese partners. The frustration caused by these IT integration hurdles could be managed better if MNCs took the time to better understand the supply chains of their Chinese counterparts.

As an example, one retailer's North American operations leveraged radio-frequency identification (RFID) and mobile technology, boasted real-time visibility of its products and componentry from suppliers to end customers while using advance analytics on its point of sale (POS) data for optimizing its planning and forecasting. The company recently entered China to take advantage of its raw materials and potentially tap a new market for its products. When L.E.K. reviewed the company's three-year implementation strategy, it found that many projections related to transfer of practices, realization and timing of benefits were based on assumptions that were incorrect due to a misunderstanding of its Chinese partner's infrastructure and its ability to provide real-time reporting. We are now working with company executives to quickly achieve short-term integration "wins" while honing its longer-term integration strategy.

That said, Chinese supply chains are surprisingly effective at doing so much with so little compared to other countries. If a supply chain can prosper in its current environment today, imagine how much more productive it could be with advanced infrastructure.

And that's why cloud computing could be so important to China. Cloud technology provides data connectivity and information sharing as a service, which enables organizations to collaborate without requiring significant investments in new technologies or the time-consuming integration to make systems throughout the supply chain compatible. Unlike supply chains in the developed world that are often saddled with legacy IT infrastructure and terabytes of data, many Chinese supply chains are starting from virtually a blank slate, and could use cloud computing to "leapfrog" the traditional learning curve evolution and increase operational agility very quickly. During the 12th Five Year Plan period (2011-2015), China plans to invest more than one trillion RMB in the information industry, with cloud computing being one of the main investment areas.

Cloud computing has the potential to transform manufacturing in China the same way that cellular technology has enabled developing countries in South America, Africa and elsewhere to implement widespread phone service quickly via mobile – virtually bypassing traditional landline phone service.

Key Actions:
As the cloud becomes more mainstream and operations infrastructure inevitably improves, China's productivity and attractiveness as a supply chain location only increases. Companies that continue to invest in Chinese supply chain infrastructure will likely see strong returns.

4: Optimize Production at Home, Replicate Abroad

Supply chain experts who have worked extensively on the ground in China observe that MNCs tend to increase specification standards by as much as 20-30% for outsourced suppliers vs. in-house suppliers in Asia. Some executives may perhaps be overcompensating for loss of control and lower perceived quality. If outsourced suppliers fail to meet the higher specifications, a company may blame the failure on overseas outsourcing and conclude that in-sourcing/repatriating operations is the best remedy.

This behavior seems to be largely subconscious as many executives seem to create or revise old specifications to what they should be rather than what they are. In an effort to include detailed production guidelines for manufacturing partners, product specifications become more complex and rigorous. Additionally, if new specifications have not been time tested in-house or with local suppliers, it is difficult to anticipate limitations to execution or anticipate problems. It is not reasonable to expect new levels of manufacturing performance without a significant commitment from MNC executives to work very closely with their manufacturing partners at all levels to achieve new benchmarks.

Key Actions:
MNCs need to ensure they review the expectations that they place on Chinese supply chains to ensure that they are reasonable and fair. Unless there is specific business rationale, expectations for overseas operations should generally be the same as those for in-house or local suppliers. In some cases, Chinese suppliers are visiting Western companies' manufacturing facilities to better understand requirements and operations in an effort to win contracts and ensure that there is consensus on all sides regarding service levels.

5: Rethink How You Forge Strategic Partnerships

MNCs often make the mistake of managing Chinese supply chains at arms-length from abroad. Senior managers may make a handful of annual trips to China, mostly limited to large metropolitan areas such as Shanghai or Beijing. Many MNCs assume that one partner in China is sufficient to represent the entire country. In reality, MNCs require multiple local relationships to be effective, and these local relationships are critical to success. Forging collaborative relationships, or "guanxi," throughout the supply chain takes effort and a true commitment by all parties. In-person business meetings can be effective in any culture and China is no exception, as the Chinese are much more likely to have successful business relationships with people that they know and trust.

Companies don't always to need to enter new partnerships with Chinese companies alone. MNCs like logistics supplier DHL, Cardinal Health and TAL Group are exploring how they can work with native Chinese companies and other MNCs to expand their services here. There are various partners available in China to support your organization throughout your expansion efforts. For example, you can hire an audit firm to collect sales data manually while your organization works to build and automate its distributor network.

Key Actions:
Whether it is through hiring local managers and employees or working through a partnership with firms that specialize in local supply chain infrastructure, MNC employees should be onsite to build strong local relationships.

6: Understand the Real Currency of Business

Tales of misunderstood contracts, production problems and distributors that don't follow clearly defined protocols can be an unfortunate part of business. And the impact of these issues can be amplified with companies trying to enter or expand their foothold in China (or any other country). Of the hundreds of international companies we've worked with on their China strategies, we've found that many of these issues are grounded in a deeper misunderstanding of Chinese business processes.

Medical device distribution can be a fitting example on how easy it is to misunderstand actions and incentives driving business behavior in China. In the United States and Europe, for example, many MedTech companies work either directly with hospitals on consignment or with their distributors on a credit basis. In the U.S. model, the distributor's capital costs are low because they only pay MedTech manufacturers once they've sold specific products to hospitals. U.S. distributors are also clearly incented in two ways. The first is to sell products already in their warehouse, and the second is to contact the manufacturer to order a product that they don't have in stock.

In China, however, local distributors can also be strong partners in helping with market access and navigating with local procurement and selling practices. Given the lengthy payment terms that hospitals typically have, distributors act as the manufacturer's bank: paying products with cash on delivery, and frequently not getting paid by hospitals for more than nine months after the products have been sold. With typical inventory of two-to-three months, a large distributor has a 12-month cash cycle, which for most international players would be clearly unacceptable.

However, this model comes with both higher costs and a different set of incentives than the manufacturers see in the U.S. or Europe. Distributors' margins can be significant in China (between 8% and 12% of the final selling price on average), which is difficult for most headquarters to understand because margins in the U.S. and Europe have historically been in the low single digits. In addition, distributors are clearly incentivized to purchase what sells best and in the shortest amount of time rather than showcasing new products that manufacturers want to promote but that currently lack market recognition.

Lastly, the distributors become, in effect, the face of the brand for the manufacturer. But without a clear business model that incentivizes distributors to be good shepherds of the brand, this may create issues for the manufacturer. This is a strategic and practical problem that most MNCs have only partially addressed so far, and as the market grows, it will become more important to ensure consistent service and brand experience.

Distribution channel problems may cause hospitals to have a negative manufacturer sentiment due to issues caused by their distributors. And because MedTech companies don't typically work directly with hospitals, this insight can be difficult to obtain.

MedTech distributors in China are central to MNC success because they understand local (provincial and city) practices and are inherently better at collecting debt from hospitals. While MNCs will have to work with distributors for the foreseeable future, there are ways that their role can be recast to ensure consistent service delivery, and recapture value that is currently left with the distribution chain.

Looking more broadly, what is automatically assumed to be important due to the American or European mindset may not be as important to Chinese companies. For example, many Western companies historically focus on "shareholder value," or bottom-line financial performance. Certainly Chinese companies (and their local governments) would like to be profitable as well, but many of them also focus on broader issues that could range from increasing employment, expanding local infrastructure and aligning corporate initiatives with government planning goals such as 12th Five Year Plan, which has statements around building larger companies. This approach is similar in spirit to Western corporate social responsibility initiatives, and companies that emphasize the "triple bottom line."

Key Actions:
Western companies must understand the business priorities and values of their Chinese counterparts to establish a foundation for a true partnership. A better understanding of the Chinese business perspective will help to establish a framework where all partners can reach their individual and collective goals.

Capitalizing on Market Opportunities in China

China is investing heavily in human talent, technology infrastructure and R&D. As it grows stronger and more competitive, MNCs will need to be active partners to successfully access local markets and/or source for international ones. We offer three key strategies for success:

1. Do Your Homework: China is a complex environment that requires detailed understanding of regional, political and cultural nuances. True knowledge of the country requires more than a few trips to large urban areas or desktop research. Dedicated staff either in China or the region is integral to establishing a successful process.

2. Rewrite the Playbook: Strategies that were successful in other countries may not work in China. Develop your own strategy that addresses the range of factors that enable successful operations. This includes educating your Chinese partners about your business process, understanding key considerations about their supply chain and requirements, and determining the best way to collaborate for a successful partnership.

3. Set Reasonable Goals: Instead of applying existing metrics wholesale, consider what metrics are appropriate and achievable given the local environment, infrastructure and other variables.

China offers tremendous potential for those who know where to look and how to serve specific market segments. Just as British, United States or Australian consumer don't all speak the same English, "American" or "Australian" (although some may beg to differ), there is no single "Chinese" language. But there is a burgeoning infrastructure that may strengthen the manufacturing capabilities of many MNCs efficiently and effectively. Supply chain operations in China may enable MNCs to reach a rapidly growing middle class with disposable income in this country, serve as a regional hub for expansion throughout Asia or to address added demand in other markets.

Six Insights for Business Success in China

To address some of the misperceptions about business opportunities for MNCs in China, L.E.K. has developed six keys to consider as you enter this dynamic market or expand your presence here:

1. Despite Rising Wages, Manufacturing is Still a Good Bet
2. China's Workforce is Increasingly Skilled
3. Despite Weak Links, the Supply Chain is Effective
4. Optimize Production at Home, Replicate Abroad
5. Rethink How You Forge Strategic Partnerships
6. Understand the Real Currency of Business

L.E.K.'s insights are developed based on hundreds of projects in this country, as well as feedback from our staff in China and senior L.E.K. executives across the globe who counsel MNCs on market strategies for this region.

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded nearly 30 years ago, L.E.K. employs more than 900 professionals in 20 offices across Europe, the Americas and Asia-Pacific. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns.

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