

Book Excerpt

Bringing **best practice** to China

As the country merges into the world economy, best practice in China will become best practice globally, products developed in China will become global products, and industrial processes developed in China will become global processes.

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How do your operations in China stack up, measure by operating measure, against what your company is doing in Europe, Japan, and the United States? This may be a more critical question than you realize: within a decade, if your organization in China isn't a star in your company's performance firmament, you may be in trouble—globally.

This question is also a very complex one to answer. Thousands of multinational companies of all sizes, including more than 460 Fortune 500 companies, now operate in China, and many are doing just fine. The American Chamber of Commerce in China conducts an annual business climate survey, and in its most recent one (which took place in 2006) 64 percent of the member companies reported that business in China was profitable or very profitable. One out of three said that their operations in China had higher margins than their worldwide organizations did, and another third reported margins on par with the global average.

But the conditions for success in China have been changing. Many multinational companies are expanding across the country to ever-smaller cities and towns, establishing positions to serve fast-growing segments of the Chinese middle class and small- and medium-sized businesses. In the process, they frequently incur greater sales, marketing, and distribution costs and take on new organizational challenges as they try to understand—and meet—the needs of customers in such markets. Moreover, they're encountering stiff competition from regional and national domestic Chinese rivals, which frequently know these customers better, have long-established business relationships in local markets, and compete relentlessly on price in places where consumers typically have much less money to spend than those in the big cities.

What's worse, today's sunny numbers mask underlying performance shortfalls. Because manufacturing-labor costs in China are a fifth of their levels in Europe and the United States, for instance, many multinationals have been running plants in China less efficiently than at home, and are still coming out way ahead. A recent McKinsey study of 30 multinational-owned factories in China found that waste reduced profits by 20 to 40 percent. Similarly, though several multinational retailers that source goods in China save as much as 20 percent compared with costs elsewhere, we've studied many of the goods they buy and found that they could realize far greater savings—often double what they achieve today—if they managed procurement processes as rigorously as they do in more established markets.

Managers don't underperform in China intentionally. Waste is endemic to manufacturing plants there partly because some multinationals have inherited, through partnerships or acquisitions, legacy processes, employee mind-sets, and manufacturing approaches. A chaotic environment, changing regulation, and a red-hot talent market all do not help either. Waste in production plants, inefficient distribution networks, underleveraged procurement processes, and lackluster market research are hard to change, and if margins are good and business is growing, managers focus on growth, not operational improvements. But "good-enough" execution isn't sufficient any more as businesses expand in China and competition stiffens. Companies such as Danfoss, GE, KFC, Johnson & Johnson, and Nokia are showing that execution counts in China. They took a different approach, with a far greater emphasis on high performance standards and operating rigor, and are beating domestic and global competitors in China's smaller cities. In essence, these high-performing companies took best practices from operations elsewhere and adapted them—sometimes a little, sometimes a lot—to the realities of China.

This is the gold standard for how multinationals will raise the bar for execution in China over the next decade.

First came emerging market strategies

Fifteen years ago, multinational companies won in China by developing strategies to create privileged or first-mover access within highly focused markets. They secured government permission to enter, partnered with Chinese companies, and sold existing brands—from cars to cosmetics, hearing aids to handbags, skis to scarves—at premium prices to affluent buyers and large companies in China's four or five largest cities. One European automaker, for example, moved quickly during the 1980s to secure preferential treatment for sales in Shanghai: the right location, the right government relationships, the right joint ventures. It then shut out other global OEMs from this market for nearly a decade. Industrial companies lined up in Beijing to sell their existing catalogs, with little adaptation to local circumstances. Simply showing up in China was a strategy that paid dividends.

Making the right strategic choices was critical; execution was another matter. Superb operating performance on the level that multinationals expect of their managers in competitive developed markets has been hard to achieve—even to define. Reliable data on markets and customers are rare, so it is difficult for managers to make decisions with as much clarity and confidence as they would in Europe or the United States. Managers in developed markets have access to a wealth of information, from point-of-sale data to reports on segments, products, and markets from third-party research firms. Not so in China. The managers of multinational companies thus found that they couldn't replicate the marketing and product-development processes they had honed in developed markets, using information obtained there.

Similarly, multinational companies in China have had to work within logistics and distribution structures dating back to the days of the planned economy. What's more, building a reliable base of high-quality suppliers has been a constant challenge. Even recently, some multinational companies have suffered high-profile setbacks because of problems with Chinese suppliers.¹ In response to the seemingly unique situations encountered in China, multinational managers often created made-to-order processes and systems.

Many multinationals, for instance, designed custom HR systems and management-development processes, separate from their global systems, for organizations in China. A number of companies coped with the variability of manufacturing there by adding more people and machines—a solution they would never have adopted at plants in Brazil or Germany. Others dealt with unreliable suppliers by double- and triple-sourcing components and carrying more inventory.

As these examples suggest, the China-specific practices companies have created might be judged subpar elsewhere. But operations in China reflect market entry strategies and a high-growth environment that gave companies a lot of breathing room: competition held at bay, influential partners, pricing power, and affluent buyers hungry for global brands. Such systems, processes, and functions got the job done and were often good enough to accept.

Say goodbye to that era. Today China is open for business, and competition from both multinationals and local companies is increasing. Strategies based on creating and sustaining privileged access look more and more outdated. Joint-venture partners and acquisition targets are available to the highest (or at least most suitable) bidder. Business licenses are readily available. Particularly since joining the World Trade Organization, in December 2001, China has changed many of its rules and procedures governing business. It is beginning to resemble the rest of the world.

In other words, China has turned a corner, from an emerging market, where local context drives most strategic and operating decisions, to a maturing one, with world-class execution a cornerstone for success. As multinationals expand beyond the big cities and Chinese companies become more competitive, executives will need to ensure that their organizations develop, produce, sell, market, and distribute goods to customers as effectively and efficiently as possible.

Who's getting it right?

A few successful multinationals in China already understand this. Their managers ran against the grain by rejecting the idea that China required unique operating approaches and performance standards. Instead, these managers focused on implementing top global processes in China, tuning them locally as needed, and linking them globally at every opportunity.

Alcoa, for instance, introduced its highly successful Alcoa Business System at its Shanghai manufacturing plant in 1998. Modeled on Toyota's integrated lean operations, the system helped boost the company to a global leadership position in its sector during the 1990s. This approach to lean operations, with some adaptations, is working in China. Within six years of beginning to transform the Shanghai plant, Alcoa shortened lead times by 30 to 50 percent, doubled sales volumes (for domestic sales and exports alike), and greatly reduced inventories.

Other companies have also brought global systems and practices to China. GE has introduced, to great effect, its Six Sigma quality control standards at its lighting division's plants there. To lower procurement costs, the company has implemented a version of the sophisticated online bidding system it uses in more mature markets. Citigroup and HSBC have extended their finely honed leadership-training and -development processes and systems to China. Each year, HSBC puts 400 managers from around the world, including China, through a global-rotation program that trains them in world standards and practices.

Cleveland-based Preformed Line Products (PLP), a telecommunications hardware supplier, is another company that has introduced world-class lean techniques in its manufacturing operations in China. Adherence to hierarchy has a very long history there, however, so line workers tend to seek answers from bosses rather than solve problems as teams, though team-based problem solving is a cornerstone of lean manufacturing. PLP therefore adapted its problem-solving meetings to the cultural realities of China—holding shorter, more focused gatherings, for instance—to achieve the results that might come out of lean initiatives in Brazil or the United States.²

The point is that multinationals succeeding in China selectively transfer global standards, practices, and techniques, adapting them where necessary to the local context. Sometimes the adaptations are relatively insignificant. Chinese customers, for example, are still learning about the products and services they are buying, so they frequently change their minds about purchasing decisions at the last minute. Some manufacturers are thus putting their employees in stores to ensure that their products are promoted effectively at the point of sale. Some adaptations are more important: for instance, companies must augment their world-class due-diligence practices when they assess potential acquisition targets in China, for this is a country where records on mortgages and pledges—let alone accurate historical financial records—are not kept systematically. Good due-diligence teams in China have learned to take extra steps to ferret out everything from murky ownership rights to financial performance.

To get companies into fighting shape in China, multinational executives must turn their thinking around 180 degrees. Many executives we speak to there continue to say that the country is unique, so what works in Peoria or Paris won't here. But that kind of response has become provincial. China has changed; they have not.

Rethinking your China operations

Transforming Chinese operations from good enough to world class isn't easy. It can be vexing even to decide where to begin. Should marketing improvements come before manufacturing ones? What roles should senior executives from the home office and in China assume? And of course, no single solution is common to all companies in all industries, nor would a single answer handle all the complexities and uncertainties of the Chinese market.

Yet our work in China with the multinational and domestic companies getting things done very well there shows that executives can use a single approach to sort through the choices and trade-offs. A sequence of steps can help managers move through a complex agenda, from redefining a global corporation's goals in China to defining its impact on global strategies.

Elevate your aspirations

For most companies, the first step in improving a Chinese operation will be to reexamine their goals and, possibly, hit the reset button. China's economy is changing at an unprecedented pace. Business goals set a decade ago are likely to be out of date. And before raising the bar on execution, some companies may need to rethink the strategies they are executing against.

That's what Danfoss, a \$3 billion global manufacturer headquartered in Denmark, discovered in 2005. At the time, its business in China was thriving—growing by around 35 percent a year, primarily by making and selling components and devices designed in Europe to Chinese manufacturers. But when the company conducted a review of its products and markets, it realized that despite growth rates a Silicon Valley entrepreneur might envy, it was losing market share in China.

Danfoss aimed its products primarily at the market's high end. A Danfoss motor-speed control used in commercial refrigerators, for instance, appealed to Chinese makers of costly appliances, but manufacturers selling midpriced or inexpensive commercial refrigerators needed controls that were less pricey, saved energy, and better withstood dust—a need in China but not Europe. The company's managers realized that these less-than-premium markets were staggeringly large, so even if Danfoss sustained its double-digit growth, higher-volume competitors would soon eclipse it. The upshot: Danfoss refocused its metrics from revenue to market share growth.

To meet these new goals, Danfoss overhauled its operations in China. It expanded its distribution network

from the big cities to nearly 40 urban markets across the country, opened R&D centers there, dramatically expanded its Chinese employee base (from 700 in 2004 to almost 4,000 projected by 2008), and shifted to China much of the responsibility for developing new products for Chinese markets.³

Once companies change or ratify their business goals and operating plans, managers should raise the bar on execution—across every function, from marketing to sourcing, manufacturing to product development, talent management to M&A. In our experience, many multinational executives in China settle for the performance they have rather than the performance they could get. Top- and bottom-line numbers may look great, but they could look a lot better if companies started to reduce waste and inefficiency. Multinationals can realistically cut their operating costs in China by around 15 percent annually and expect their revenues to rise by 30 percent as well. In fact, we know of several multinationals in China that should regard these as their minimum targets.

Setting new goals in China is a top-down process involving the CEO and, typically, the board as well. Danfoss reset its goals there at the behest of its chief executive, Jørgen Clausen, who had traveled the Silk Road while on vacation in 2004 and saw first hand the potential for his company in the smaller cities and towns.

Companies also need top-down support to raise the bar on execution; high aspirations demand effective blocking and tackling. Getting this job done may require top executives to remove barriers and create space for experimentation. In a survey we conducted recently with CEOs at 40 multinationals, most said that they supported the efforts of their organizations to develop a China strategy. But the CEOs whose companies are winning there reported that they have been personally involved in resolving issues (such as legal problems, budgeting challenges, and HR concerns) that impeded the creation or growth of the China business.

Face trade-offs realistically


The crux of the transformation must be importing world-class global processes and adapting them to Chinese realities when necessary or overhauling current China processes by raising performance to the level of a company's best global processes. This means upgrading its manufacturing quality and productivity, as well as the effectiveness of sales and marketing, to achieve global standards and realize this huge market's full potential. Knowing what practices to take from the global tool chest and how to adapt them to China requires both a good understanding of world-class management techniques and a practical sense of how the country operates.

Frequently, managers must make trade-offs. Some innovations developed in China, for example, should be designed to meet local needs and take advantage of low-cost supply or capital-expenditure opportunities. But sometimes global consistency can be equally important—for instance, if an innovation designed and made in China goes global.

Companies should base such strategic choices on local realities, not popular myths. To take advantage of differences in capital and labor costs, for example, Honda built its factory in China with substantially less automation than it had in plants in Japan or the United States. But in the steel industry, shop floor labor is a much less important factor. That helps to explain why Capital Steel has built a vertically integrated automated plant at an astonishing pace and scale.

Globalize from China

Finally, winning companies will leverage their local success by globalizing their China operations. They will rethink China's role in worldwide strategy, organization, and operations and integrate that role globally wherever possible. As competition in China's markets intensifies, managers at domestic companies are rapidly learning how to adopt best practices from around the world. Chinese companies recognize that they must step onto the global stage before the multinationals lock them out. The best of both domestic and foreign companies in China are working to apply global standards.

In such a competitive hothouse, adapted practices will evolve quickly, and as China merges into the world economy best practice there will become best practice globally. More products developed in China will become global products; more industrial processes developed in China will become global processes. The ability to develop a Chinese talent pool will therefore be critical across all functions. Learning how to execute in China—the world's most competitive market—will teach companies how to compete more aggressively elsewhere. 

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Notes

¹ At the time of this writing, a number of products, made wholly or partly in China, containing dangerous materials have been recalled in the United States and Latin America in several segments: pet foods, toothpaste, and toys, among others.

² Sasan Aminpour and Jonathan R. Woetzel, "Applying lean manufacturing in China," *The McKinsey Quarterly*, 2006 special edition: Serving the New Chinese Consumer, pp. 106–115.

³ William E. Hoover Jr., "Making China your second home market: An interview with the CEO of Danfoss," *The McKinsey Quarterly*, 2006 Number 1, pp. 84–93.

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