strategy&
Formerly Booz & Company

Applying a Fit for Growth approach in China

&

Implications for Chinese players and multinationals

Contacts

Beijing

Bill Peng
Partner
+86-10-6563-8300
bill.peng
@strategyand.pwc.com

Steven Veldhoen
Partner
+86-10-6563-8300
steven.veldhoen
@strategyand.pwc.com

Shanghai

Sarah Butler
Partner
+86-21-2327-9800
sarah.butler
@strategyand.pwc.com

John Jullens
Partner
+86-21-2327-9800
john.jullens
@strategyand.pwc.com

Adam Xu
Partner
+86-21-2327-9800
adam.xu
@strategyand.pwc.com

Huchu Xu
Partner
+86-21-2327-9800
huchu.xu
@strategyand.pwc.com

About the author

John Jullens is a partner with Strategy& based in Shanghai. He co-leads the firm's engineered products and services practice in Greater China.

* *Fit for Growth* is a registered service mark of PwC Strategy& Inc. in the United States.

Executive summary

After 30 years of unprecedented economic growth, China has arrived at another crucial turning point. Its export-based development model is rapidly running out of steam and needs to be replaced by higher-value activities and more domestic consumption as the country continues the notoriously difficult transition from a low-cost to a high-value economy. The eventual outcome remains uncertain, and this transition will have serious, albeit very different, implications for both local Chinese firms and foreign multinationals. Although both must significantly improve their capabilities in this new environment, the actual steps that local Chinese firms and multinationals need to take will differ significantly.

For local Chinese firms, a *Fit for Growth** approach means developing world-class capabilities along the entire value chain from innovation to operational excellence, including management itself. By contrast, a *Fit for Growth* approach for foreign multinationals means reconfiguring operations, lowering costs, improving productivity, strengthening local management, and designing products that truly appeal to the often unique wants and needs of Chinese consumers, especially those in the fast-growing mid-market.

* *Fit for Growth* is a registered service mark of PwC Strategy& Inc. in the United States.

An economy in transition

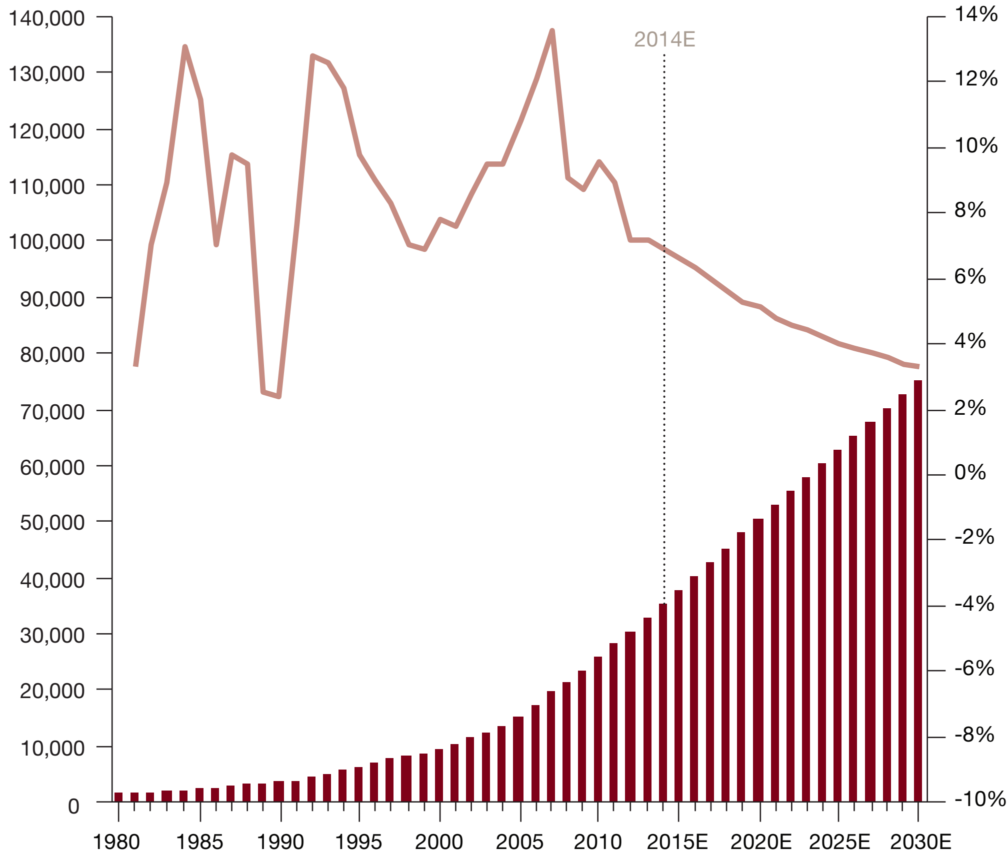
When China started its economic recovery in the late 1970s, under the leadership of thrice-purged Deng Xiaoping, the government implemented a series of pragmatic economic reforms that closely resembled the extraordinarily successful development policies of its East Asian neighbors: Japan, South Korea, and Taiwan. In a nutshell, the government raised rural productivity through innovative land reform policies; put the resulting surplus farm labor to work in low-cost manufacturing jobs; bargained for advanced technology and know-how by selectively granting market access to developed market multinationals; actively intervened to create a pro-development financial system; and used the money gained from exports, foreign direct investment, and domestic savings to make massive investments in new infrastructure, education, and other growth drivers. That model worked extraordinarily well; in fact, never before has an economy risen to help eradicate poverty and become so globally powerful so quickly.

Yet while China's development model has been extraordinarily successful thus far, it is now rapidly losing steam, as the economy has reached middle-income status and the country must embark on the long and notoriously difficult transition to high-income status (*see Exhibit 1, next page*). The surplus of cheap labor is running out, the "easy" gains in technology and other capabilities have already been made, and investments are increasingly less efficient, in part because China's opaque banking system hides the true cost of capital. Meanwhile, demand for Chinese exports is unlikely to pick up the slack, as growth will likely remain anemic in the West for some time. Some manufacturing activity is actually leaving the country, as rising labor costs in China and lower factor costs elsewhere prompt some multinationals to move their operations to other emerging markets — elsewhere in Southeast Asia, for example — or even bring them back home. In addition, the negative spillover effects of unprecedented economic growth have become all too apparent, and increasingly unacceptable, in the form of endemic corruption, rising inequality, safety issues, traffic congestion, and severe pollution and environmental degradation.

Exhibit 1
China's development model is rapidly losing steam

Chinese real GDP

1980–2030E, in RMB (billions)



Real GDP growth

Real GDP

Source: The Economist Intelligence Unit

Implications for policymakers

To its credit, China's central government, under the new leadership of President Xi Jinping and Premier Li Keqiang, clearly recognizes that wide-reaching structural reforms are both necessary and urgent. When designing these reform initiatives, policymakers should pursue five broad actions (*see Exhibit 2, next page*):

Slow down. Further investment-led growth will only exacerbate China's problems along financial, environmental, and natural resource dimensions. The key is mitigating the impact of a slowdown — such as overcapacity and unemployment — while adjusting GDP growth expectations.

Clean up. It's urgent that China address the numerous negative side effects of growth by making the banking system more transparent and efficient, strengthening environmental and regulatory policies, and stamping out corruption.

Implement structural reforms. The government must shift from direct intervention to facilitating China's ongoing transition to a more market-based economy over time. Necessary steps include changing local government incentives and budgets, improving governance of state-owned enterprises, selectively increasing competition, and, eventually, commercializing the banking system, liberalizing interest rates, and opening up the capital account.

Stimulate domestic consumption. Chinese consumers are actually spending at a healthy rate, but much more must be done to free up latent disposable income. For instance, specific measures include improving social services such as pensions and health and unemployment insurance, implementing *hukou* (household registration) and land rights reform, and further developing the services sector, which will create new jobs and raise the country's disposable income levels.

Upgrade the industrial base. China must become more competitive in higher-value-added industries through top-down policy initiatives

Exhibit 2
Five actions for Chinese policymakers

1. Slow down

Further investment-led growth will only exacerbate China's problems along financial, environmental, and natural resource dimensions.

2. Clean up

Although highly successful, China's current growth model also produced numerous negative side effects, including endemic corruption, rising inequality, safety issues, severe pollution, and environmental degradation.

3. Implement structural reforms

The role of the government must change from direct intervention to facilitating the ongoing transition to a more market-based economy.

4. Stimulate domestic consumption

Though domestic consumption has actually grown at a healthy rate, much more must be done to free up latent disposable income.

5. Upgrade the industrial base

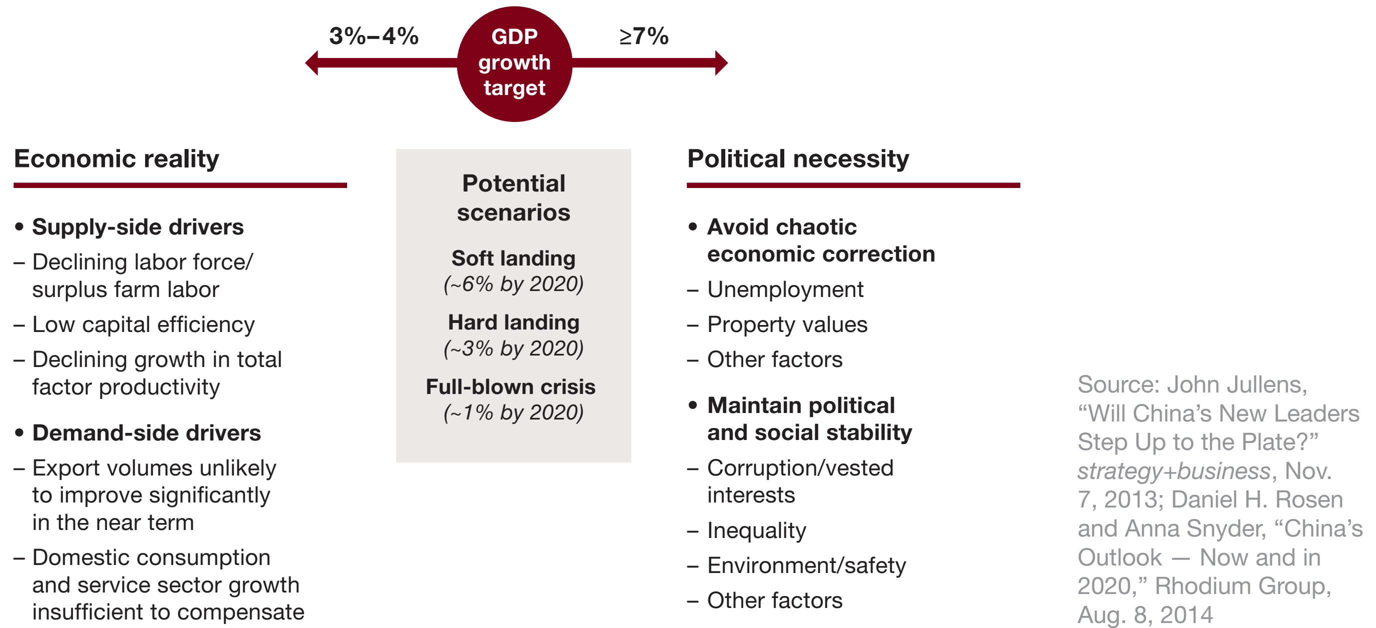
China must become more competitive in higher-value-added industries through top-down policies and firm-specific bottom-up initiatives.

Source: John Jullens, "Will China's New Leaders Step Up to the Plate?" *strategy+business,* Nov. 7, 2013

that focus on, for example, indigenous innovation and education, and firm-specific bottom-up initiatives such as developing world-class organizational capabilities in product development, branding, postmerger integration, and "management" in general, among others.

It is inevitable that China's growth will slow down as a result of these policies, from an average of 10.5 percent from 1978 through 2008 to something around 5 percent by 2020. But Beijing simply has no choice. Leaders must bear the pain now, or face much greater pain later. Managing this slowdown will require the Chinese government to navigate between the economic reality of both supply- and demand-side drivers, and the political necessity of avoiding a full-blown financial crisis (*see Exhibit 3, next page*).

Exhibit 3
Beijing must navigate a slowdown in the country's GDP growth



Source: John Jullens, "Will China's New Leaders Step Up to the Plate?" *strategy+business*, Nov. 7, 2013; Daniel H. Rosen and Anna Snyder, "China's Outlook — Now and in 2020," Rhodium Group, Aug. 8, 2014

Implications for Chinese firms

Many Chinese companies embody an important contradiction. They're early movers in often nascent domestic sectors, yet simultaneously latecomers to globally mature industries dominated by world-class competitors that have been honing their capabilities for decades. Today, these firms still compete primarily in labor-intensive, low-skill manufacturing activities, such as garments, shoes, toys, and similar products. However, they can't rely indefinitely on simply buying advanced equipment, copying best practices, and providing basic technical training to employees. Instead, they must develop their own set of differentiated capabilities — including innovation, operational excellence, and marketing and sales — and migrate into activities that add increasingly higher value.

Chinese companies will need to develop another capability: the art and science of management itself.

Going forward, these firms face a difficult catch-up period during which they'll need more advanced capabilities at all points along the value chain. They'll have to decide which of these new capabilities need to be best in class, world-class, or just good enough. And they'll need to lay out a clear plan for how they will acquire these new capabilities. Will they develop them in-house, outsource them to third-party providers, or acquire them through M&A? In practice, companies will require a combination of all three. These elements, in turn, require developing another type of capability: the art and science of management itself (strategy, M&A, organizational design, performance measurement, and other aspects of the discipline).

Western commentators often express skepticism that Chinese companies can develop the necessary capabilities to catch up with world-class multinationals. They argue that China's education system, with its emphasis on rote learning, inhibits creative thinking and innovation. They also claim that the country can't build strong brands because China suffers from a "romantic deficit" — in the words of one pundit (David Brooks, "The Romantic Advantage," *New York Times,* May 30, 2013). From this perspective, Chinese executives see business deals in transactional instead of relationship terms.

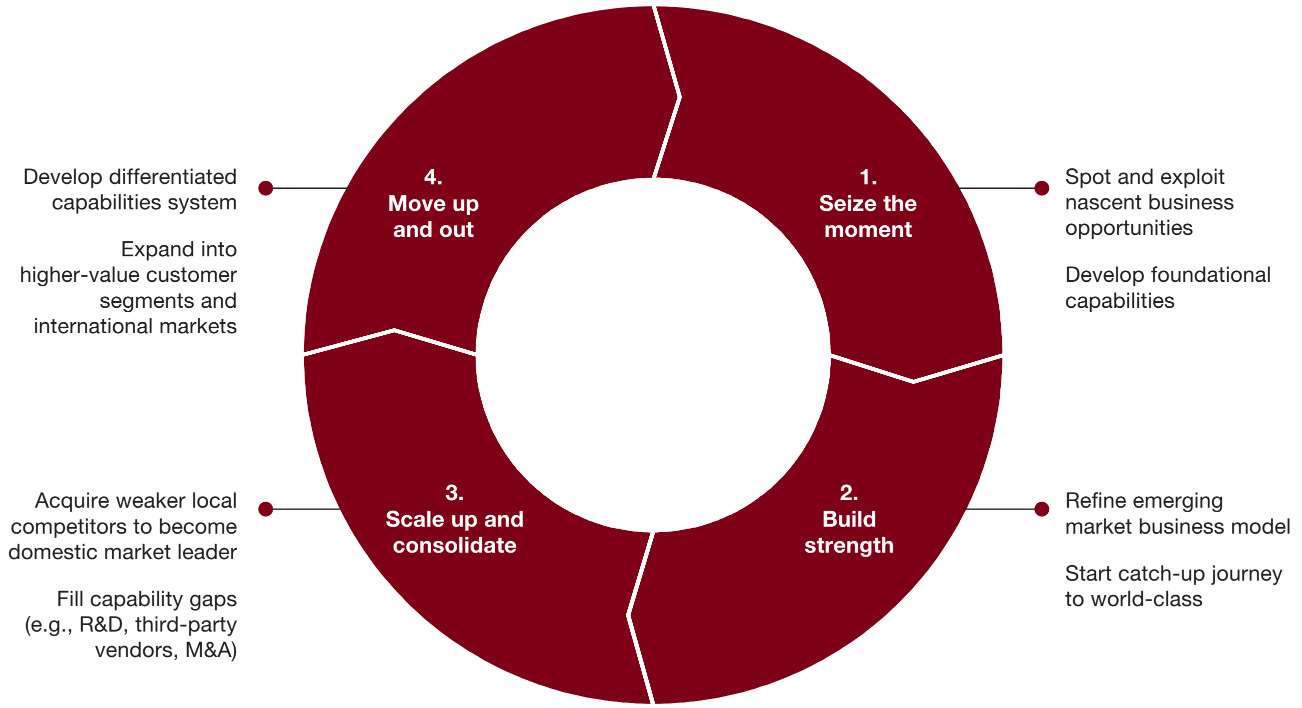
In reality, there is a long tradition of entrepreneurialism and innovation in China, supported by recent evidence that innovation is, in fact, on the upswing. In Strategy&'s 2014 China Innovation Survey, two-thirds of the multinational executives surveyed said some of their Chinese competitors are already just as innovative as or more innovative than their own companies. (See John Jullens and Steven Veldhoen, "China's Innovation Engine," in "Global Innovation 1000: Proven Paths to Innovation Success," by Barry Jaruzelski, Volker Staack, and Brad Goehle, *strategy+business,* Winter 2014.

To close the capabilities gap with multinational companies (MNCs), Chinese firms should follow a four-stage evolution (*see Exhibit 4, next page*). The goal is to advance from initially relying primarily on country-specific advantages (such as ultra-low labor costs) to leveraging their own firm-specific advantages, including superior product design and innovation, over time.

Stage 1: Seize the moment. Doing business in emerging markets can be exceptionally challenging due to market imperfections, including underdeveloped supply chains and distribution channels, laws, regulations, basic data, and other institutional voids. Local entrepreneurs, with their superior market understanding and extensive network of personal, business, and government connections, are naturally in a much better position to negotiate these institutional voids and exploit opportunities than a foreign multinational. The overriding objective during this stage is to create or acquire the basic lights-on and foundational capabilities to simply get started in the industry — or reposition the firm to take advantage of new opportunities. Getting this right often means adapting the industry's global business model to local market conditions and may require some experimentation.

Stage 2: Build strength. As competitors enter the market and institutional voids start disappearing, being well-connected becomes less important than developing a strategy and a set of strong capabilities. In sharp contrast to later stages, the focus at this stage should be not on differentiation and creating unique capabilities, but on imitation and developing foundational capabilities. The typical emerging market firm is not a true startup but a latecomer to an established industry. Given this market position, the firm first needs to learn the business — through internal development, contract manufacturing, licensing, selective partnerships, and/or outright acquisitions — while taking advantage of such emerging market and latecomer advantages as low costs and leapfrogging to new technology standards. In our work, we have found that this stage is the one most often overlooked by firms. Firms that underinvest during this stage tend to run into challenges later as industry growth slows, labor costs rise, and competition intensifies.

Exhibit 4
Chinese firms should follow a four-stage evolution



Source: Strategy&

Stage 3: Scale up and consolidate. Once foundational capabilities are in place, the firm must build scale through organic growth and acquisitions. The goal here is to differentiate first on the cost side, because most emerging market firms are still far too weak to compete on demand-side capabilities such as design and innovation. Instead, the best firms focus on relentless cost improvement in every activity of the business and become truly innovative in such areas as low-cost product design, local sourcing, and "manufacturability" — or designing products so they can be easily mass-produced at ultra-low costs. At the same time, it is crucial for the domestic market to be large enough and sufficiently difficult to enter (because of natural or regulatory barriers) to enable local firms to make the transition to global standards while they are still relatively protected from world-class multinationals.

Stage 4: Move up and out. In the final stage, the firm's focus must shift yet again to enable breakout growth by moving up into higher-value segments domestically and into international markets. To succeed at this level, the firm must develop new, higher-order capabilities and learn how to combine them to differentiate itself from competitors. It must also develop a precise understanding of how far to develop each capability (i.e., best in class, competitive parity, good enough) and how to fill existing capability gaps (through internal development, outsourcing, or strategic partnerships). Knowing when to embark on each development path is not straightforward, and should itself become an organizational capability. In other words, the best firms will develop a systematic process for selecting the optimal development path under new or changing circumstances, instead of relying on what has worked well in the past.

Developing these capabilities and closing the innovation gap with multinationals is a daunting challenge, but today's leading emerging giants have all followed a well-defined capability development path that others can follow. There's no guarantee of success, but companies that follow this four-stage path put the odds decidedly in their favor.

Implications for multinationals

Foreign multinationals face a very different set of challenges as China transitions from a low-cost to a high-value economy. These companies are already world-class. Their primary focus thus far has been on how best to adapt their world-class products, capabilities, and experiences to the local business, regulatory, and cultural environment in China. This was a very challenging task, of course. But future success will require other capabilities.

The good news is that there's still plenty of growth potential left in China. The economy will continue to grow at enviable rates for some time to come as an enormous number of middle-class consumers enter the market. The bad news is that the business environment will get a lot tougher as market growth rates decline, demand shifts inland and downmarket, and competition increases, not just from other MNCs but also from increasingly competitive local Chinese firms.

There's still plenty of growth potential left in China. The economy will continue to grow at enviable rates.

To apply a *Fit for Growth** methodology in this environment, multinationals must embark on a series of operational improvements to lower costs and improve productivity for goods and services. This requires fundamentally reexamining the entire supply chain, from inbound sourcing to outbound logistics, and considering anew where and how they operate. To do so, companies will have to answer three related questions:

- First, what changes are required to improve operational performance in the traditional coastal areas as well as in newly emerging inland markets?
- Second, how can we optimize our footprint by relocating all or part of our manufacturing and supply base to lower-cost inland regions, or outside China altogether?
- Third, which organizational capabilities must be added or developed to transform our newly reconfigured footprints and operations?

* *Fit for Growth* is a registered service mark of PwC Strategy& Inc. in the United States.

It's crucial to thoroughly assess all potential productivity and cost-reduction opportunities in existing facilities before relocating a manufacturing operation to a lower-cost location in or outside China. Typical performance improvement opportunities include substituting capital for labor, process automation, and adopting lean manufacturing practices.

Similarly, many companies can still realize significant cost savings by designing parts that can be manufactured more easily and cost-efficiently in China itself, and by helping Chinese suppliers improve their ability to produce such parts locally. Firms can further reduce costs by identifying where cheaper local materials can be substituted for more expensive foreign ones, or where off-the-shelf components can replace custom-designed parts. Some multinationals have already set up local innovation organizations focused on designing low-cost products that use local sourcing.

Many companies can realize significant cost savings by helping Chinese suppliers improve their ability to produce parts locally.

Most companies also have plenty of room to improve their manufacturing or assembly operations and optimize their machinery and processes to reflect the new labor cost realities, while simultaneously increasing quality levels and speed-to-market. Likewise, additional opportunities to improve supplier performance may lie in cooperative initiatives with suppliers aimed at helping them achieve best-in-class lean production. Other areas that companies typically find useful to explore include planning and supply chain procedures as well as working jointly with their partners to reduce stock levels at all points of the supply chain, from raw material providers to customers' inventories. While all of these activities are common practice in developed markets, in China they are often either still absent or just not set up in ways that effectively adapt global operating standards and capabilities to local conditions.

Once multinationals have reviewed their manufacturing and end-to-end supply chain practices, they can next turn to developing their ideal operations footprint. This will require a structured product-by-product assessment that takes into account everything from cost drivers to customer location. Simply relocating to an inland site in order to pursue lower costs is unlikely to bring positive returns over the long term. In fact, putting aside the government's major role in making the necessary infrastructure investments, any such move will likely require fundamental measures that extend well beyond a relatively simple location change. As part of their analysis, companies must look at how relocating can allow them to rethink and transform all aspects of their supply chain and production, if they do not want to find themselves facing the same challenges of rising labor and other costs soon afterward.

All these operational steps are vital to tap the growing segment of mid-market consumers who now have enough disposable income to afford manufactured goods and services. The difficulty multinationals have had so far in penetrating this group is partly due to a false assumption: that they can simply "dumb down" existing products to be competitive against local players. In reality, this does not work. To meet these customers' unique needs, MNCs must significantly adapt existing products, or design new ones from the ground up. These products may require different business models and specialized capabilities.

MNCs' struggle to penetrate the mid-market is creating an opportunity for some Chinese companies to establish themselves as mid-market innovators. These domestic companies may not yet have world-class technology and brands, but they are following the four-step process described earlier, and are developing world-class capabilities to design, manufacture, and sell mid-market products at the right price in China. What's more, many of these domestic companies are on the verge of taking these capabilities overseas, which could shake up the global competitive landscape. Indeed, we expect these domestic mid-market innovators to pose an increasing threat to global manufacturers everywhere.

Some MNCs already in China might decide to wait out this period of transition before adjusting their strategy; others contemplating an initial move into the market may decide to delay and stay close to home. But the vast majority of MNCs should not delay. They need to win in China's mid-market — or risk giving their rivals a crucial competitive advantage. A winning mid-market strategy will be different for each firm, but the following seven principles apply to most multinationals in most industries (*see Exhibit 5, next page*).

1. *Develop distinctive mid-market products.* There is a difference between low-cost versions of existing products originally designed for customers in developed markets, and low-priced products that were specifically developed for the often unique requirements of Chinese customers. The former may not be adequate. When designing products for the Chinese mid-market, MNCs must identify and eliminate noncritical functionality, add locally required product features, substitute simplified off-the-shelf components and cheaper materials, and redesign products for ease of manufacturing and serviceability.

2. *Design a mid-market business model.* In addition, MNCs should revamp their existing business models to support mid-market products. Focus on acquisition price and near-term operating costs rather than productivity and lifetime cost of ownership, interchangeable replacement parts instead of proprietary

Exhibit 5
Seven principles for MNCs that operate in China

1. **Develop distinctive mid-market products** that are specifically designed for Chinese mid-market customers, as opposed to merely introducing low-cost versions of existing world-class products.

2. **Design a mid-market business model** to support unique mid-market requirements, including product, price, branding, marketing, distribution, and operations.

3. **Migrate across the value chain,** transferring core activities to China to narrow cost gaps with domestic mid-market competitors through local product development, sourcing, and manufacturing.

4. **Seek out selective partnerships** with local suppliers to fill gaps in mid-market product portfolio, develop optimal distribution footprint, and navigate China's unusually complex regulatory environment.

5. **Craft a multibrand strategy** to successfully operate across premium and entry-level market price points as well as multiple product categories.

6. **Establish a strong local organization,** ensuring that management is capable and sufficiently empowered to enable fast decision making and sensitivity to local market requirements. Clarify decision rights and put in place a strong governance structure.

7. **Adopt a global mind-set,** ensuring that headquarters has at least a basic understanding of China's unique business and regulatory context.

Source: John Jullens, "China's Mid-Market: Where 'Good Enough' Just Isn't," *strategy+business,* July 9, 2013

replacement parts, and after-sales service through independent distributors instead of company-owned stores. Also, offer creative financing options to cash-strapped mid-market customers.

3. *Migrate across the value chain.* Transfer value chain activities to China to narrow the cost gap with domestic mid-market competitors using local manufacturing, sourcing, and supply chain management. Also, since Western engineers often cannot deliver the ultra-low-cost engineering required in China, MNCs need to develop local engineering and other innovation capabilities.

4. *Seek out selective partnerships.* Due to China's complexity and size, most multinationals will need to acquire or partner with one or more local players to fill gaps in their product portfolios; gain complementary mid-market product development and manufacturing capabilities; develop the optimal channel footprint; negotiate with regulators at the local, regional, and national levels; and, in some sectors, merely gain access to the market.

5. *Craft a multibrand strategy.* Some multinationals resist adopting a multibrand strategy on the grounds that mid-market customers will, over time, become premium customers. Aside from the fact that this may not always be true, it is difficult to stretch a brand across too many price points without diluting the value proposition and brand equity over time, especially when there are different business models involved.

6. *Establish a strong local organization.* In addition to localizing the firm's operations, it's also necessary to localize management. Multinationals need to clarify decision rights and put a strong governance structure in place. Many multinationals should also consider treating their China business as a stand-alone entity with its own P&L to ensure that it gets the necessary resources.

7. *Adopt a global mind-set.* A firm's success in China is tied directly to the mind-set of its top managers at headquarters back home. At a minimum, headquarters needs a basic understanding of China's opaque, and often misunderstood, business and regulatory context.

Conclusion: A dynamic future

Few companies that do business in China are fully prepared for the current (and coming) economic and regulatory changes as the economy slows and transitions from low-cost to high-value. The old ways of doing business are no longer as fruitful, and to compete in the future, companies need to grow stronger and improve critical capabilities. For local Chinese companies, the *Fit for Growth* agenda needs to focus on the growth aspect: acquiring the capabilities to scale up the organization and move upmarket and overseas. For foreign multinationals, the *Fit for Growth* agenda should focus on becoming fit: adjusting to slower growth, shifts in demand patterns, and stronger competition. These agenda items will be challenging, but given the country's vast, growing, and increasingly affluent middle class, the potential rewards remain enormous.

Strategy& is a global team of practical strategists committed to helping you seize essential advantage.

We do that by working alongside you to solve your toughest problems and helping you capture your greatest opportunities.

These are complex and high-stakes undertakings — often game-changing transformations. We bring 100 years of strategy consulting experience and the unrivaled industry and functional capabilities of the PwC network to the task. Whether you're charting your corporate strategy, transforming a function or business unit, or building critical capabilities, we'll help you create the value you're looking for with speed, confidence, and impact.

We are a member of the PwC network of firms in 157 countries with more than 195,000 people committed to delivering quality in assurance, tax, and advisory services. Tell us what matters to you and find out more by visiting us at strategyand.pwc.com.

www.strategyand.pwc.com

© 2015 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details. Disclaimer: This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.