strategy&

Winning in China's changing economy

A strategy for managing complexity

pwc

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About the authors

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Executive summary

In spite of the headlines about China's slowing growth and the country's efforts to reform and rebalance its economy — a set of conditions the government has termed the "new normal" — the Chinese economy is undergoing a profound shift away from any kind of investment and export-led GDP growth. In the past decade China had been rapidly evolving from export-led growth, a model it couldn't sustain as the economy reached a more mature stage of development. The focus in recent years has been on upgrading its industries to higher-value-added activities and boosting its service sector and domestic consumption, as well as on building new urban centers in the inland provinces to spread the wealth that economic development has brought to the major cities and coastal provinces. Those measures, too, are proving hard to sustain. Yet throughout the country are pockets of great opportunity for both multinational and domestic companies to expand their markets.

The challenge is that China is no longer one vast emerging market. Demand for products and services, along with growth itself, varies greatly across sectors, populations, and geographic regions. The implications for companies are clear: increased competition, overcapacity, a decentralization of demand from China's eastern Tier One markets, and increased heterogeneity in every market. Add to this scenario the rising cost of manufacturing in China, especially in the coastal provinces. Companies in China, both domestic and foreign, are facing a new era of complexity, in which they have to develop new markets and adapt to changing ones while also reevaluating the supply chain itself.

Still, China's markets can continue to be highly rewarding for companies that manage complexity well. We believe every company needs to develop a complexity management strategy, one that by definition is highly customized to each participant. It begins with the recognition that much of what a company operating in China could take for granted 20 or even 10 years ago must be rethought. Few can rely, for example, on an untapped market to cultivate or on low-cost manufacturing. Every aspect of the business, from research and development to supply chain and distributor relationships, to pricing and point of purchase, must be carefully reexamined. Every choice can make a big difference.

How complexity works

When China’s economy was growing in the double digits, many companies could count on reaping profits and growth just from participating in the world’s biggest emerging market. Now, however, the growth is uneven. In some sectors, such as healthcare and “silver hair” services that cater to the aging population, growth is accelerating. On the other hand, a number of sectors such as heavy industrials and real estate have contracted as demand has slowed or officials hesitate to make decisions out of fear of displeasing the wrong parties and being caught up in China’s anticorruption campaign.

The uneven economic scenario requires most companies to rethink their China strategies. The country’s ever-widening array of markets, products, and service offerings is leading to more complexity for businesses. China’s current economic climate, in which consumer demand and growth and services have not fully offset weakening global trade and volatile commodity prices, will require companies to boost their capabilities.

The uneven economic scenario requires most companies to rethink their China strategies.

The challenges for domestic companies are different from those for international companies operating in China. Nearly all players, however, are experiencing growing complexity, both within their organizations and from outside economic forces. Different markets in China often have very different characteristics from a product perspective. Within a company, there will be organizational challenges as manufacturing, marketing, distribution, and other functions grow more and more complex. The supply chain is affected too, especially as China begins outsourcing more of its own manufacturing and concentrating on becoming a producer of more value-added products. An iPhone, for example, is assembled in China with components that come from all over the world. Pulling the system together in a way that minimizes the cost for the companies but still delivers on market demands is an exercise in complexity management.

Part of the strategy, too, requires analyzing just how many products a company should sell in China and what types of products are optimal for which markets — concentrating on the best-selling products, or those most likely to be top sellers, rather than just cutting down on the number of products. It requires dividing the market into customer segments and developing a clear understanding of each segment — what it wants, how much it is willing to pay, how to deliver what it wants, and how meeting its demands will impact the supply chain, R&D, distribution, staffing, and overhead, not to mention revenues and profits.

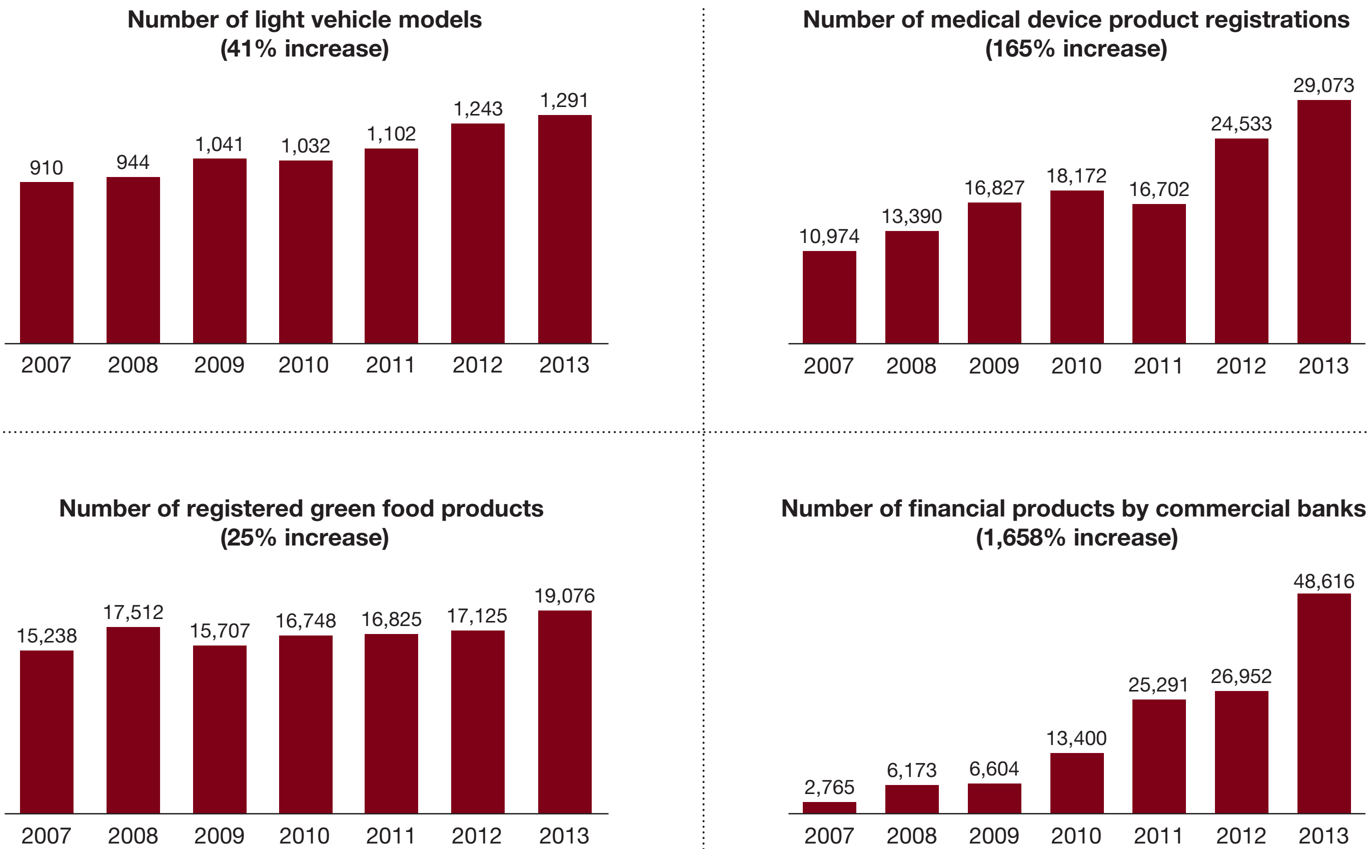
In the past decade, both foreign and domestic companies have pursued growth in China by innovating products or extending into new markets. Often, this has resulted in companies introducing arrays of products and services (*see Exhibit 1, next page*).

Territory expansion has also been an important lever for growth. For example, the Japanese casual wear retailer Uniqlo almost doubled the number of stores it operates in China over the last two years, to 350 in 28 provinces, expanding from Beijing, Shanghai, and other major cities to markets as far-flung as Baotou in Inner Mongolia and Xining in the far northwest.

All of this expansion has produced an era of excessive complexity in China. Complexity takes many forms, and each form leads to a unique set of problems (*see Exhibit 2, page 7*).

A clear understanding of market requirements, value drivers, and trade-offs among price, service level, and variety can help companies make the right choices when managing complexity. Having a complexity management strategy in place enables companies to choose to deliver the right level of complexity for each segment, based on market requirements, service models, and incremental costs to the organization weighed against the value that can be created in that segment.

Exhibit 1
Examples of product growth in China*



*Examples of growth in number of available products or models by industry

Source: IHS Global Insight Automotive; State Food and Drug Administration of China; China Ministry of Agriculture; SJTU; Strategy& analysis

Exhibit 2
Examples of complexity experienced by companies in multiple industries

Company type	Drivers	Type of complexity	Impact
Engineered polymers	– Application differentiation – Service level	– SKU proliferation – Numerous and complicated warehouse network	– Lower manufacturing efficiency – Higher cost-to-serve
Construction equipment	– Local market requirement – Industry cycles	– Product optionality – Complicated and inconsistent service levels	– Low productivity of working capital – Low profitability and lost sales
Consumer durables	– Sourcing cost optimization in low-cost countries	– High number of suppliers in low-cost countries – Long development time leading to unnecessary prototyping	– Limited cost visibility – Low profitability – Price erosion due to nimbler competitors
Building materials	– Differentiated channel strategies	– Multiple brands – Multiple price points for similar products	– Underperforming product portfolio

Source: Strategy& analysis

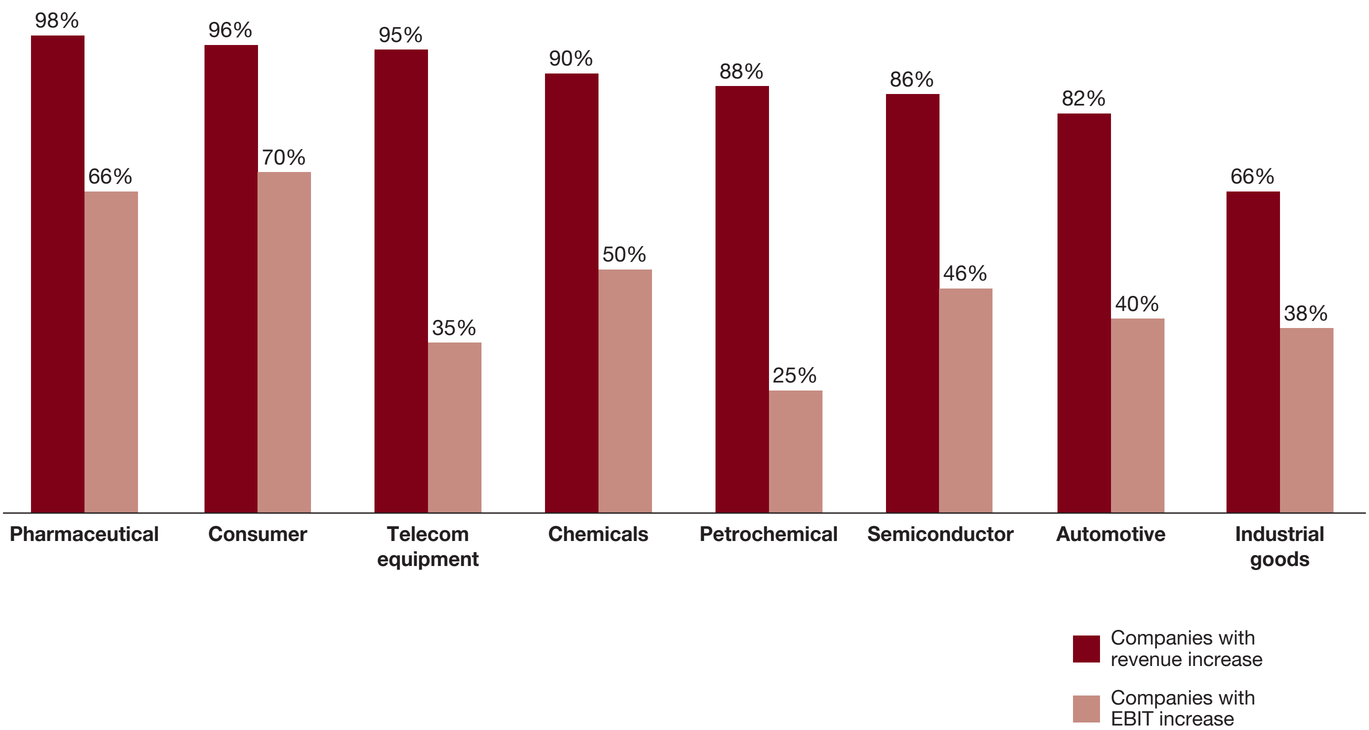
Domestic companies

For many domestic companies, growth, share, and speed-to-market are the key issues on the minds of executives. Many were easily achieving these goals until a couple of years ago, often with annual revenue growth of 10 to 20 percent or more. Profitability, however, has been harder to come by. In our research of Chinese listed companies, almost 90 percent of them registered revenue growth between 2010 and 2013 (*see Exhibit 3, next page, and Exhibit 4, page 10*). (These are the latest figures available for many companies, as some stopped releasing annual reports during the slowdown.) Yet during that period they did not see corresponding increases in their margins; only half reported earnings before interest and tax (EBIT) increases, and less than 30 percent reported improvement in EBIT margins. What most domestic companies have found is that as they develop new products and add new markets, their costs go up and greater complexity begins to encumber them.

It is getting even more difficult for these companies to be profitable now, with growth slowing in many sectors. A lot of companies, anticipating continued demand for their products, overextended. Geely, for example, launched multiple automobile brands in early 2009 in pursuit of growth in various market segments, only to find sales disappointing. In 2014, the company announced plans to cut costs by consolidating its brands and dealerships in response to a slowdown in auto sales across the country.

Exhibit 3

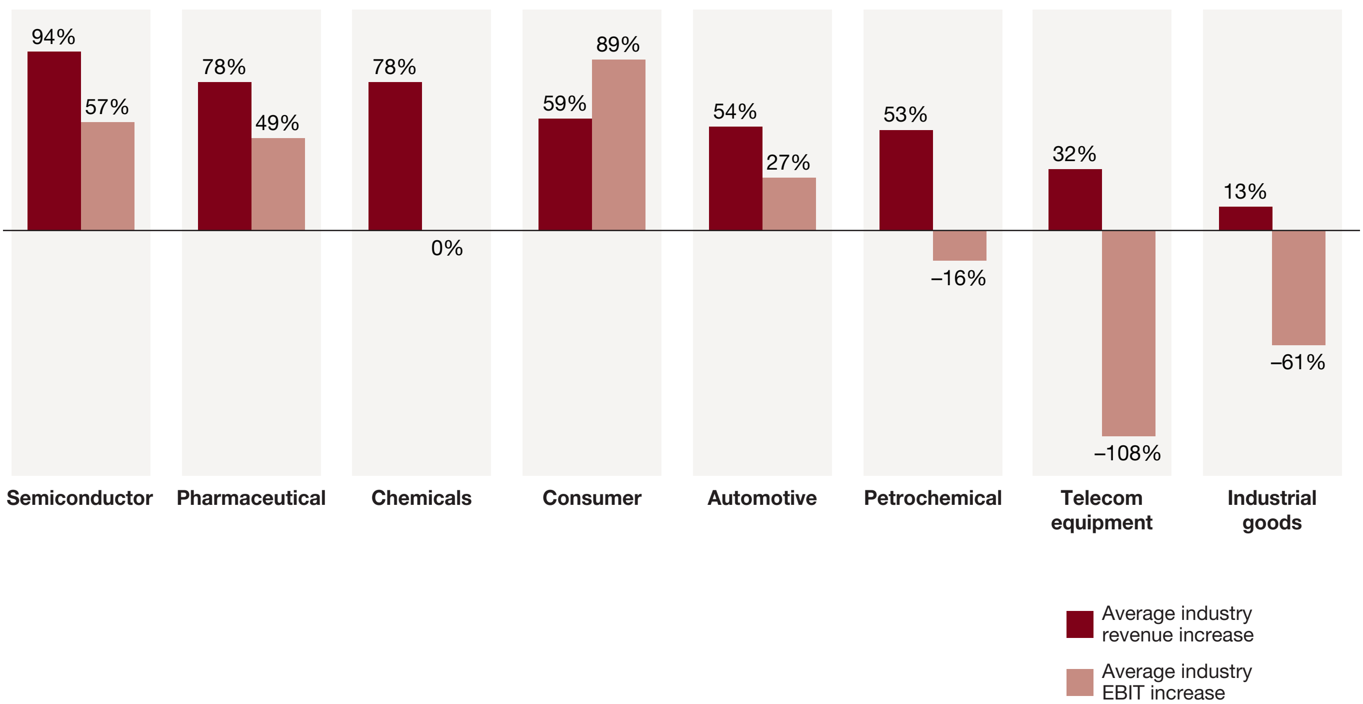
Percentage of top Chinese listed companies posting revenue or EBIT increases, 2010–13



Note: Selection of 328 companies listed on Shanghai Stock Exchange including top revenue companies by industry: automotive (OEMs, auto parts); chemicals (specialty, basic/diversified); consumer (consumer electronics, retailing, dairy, foods and beverage, apparel); industrial goods (machinery, electrical equipment, manufactured goods); petrochemical; pharmaceutical; semiconductor; telecom equipment.

Source: Company filings; Strategy&

Exhibit 4
Average revenue and EBIT growth of top Chinese listed companies by industry, 2010–13



Note: Selection of 328 companies listed on Shanghai Stock Exchange including top revenue companies by industry: automotive (OEMs, auto parts); chemicals (specialty, basic/diversified); consumer (consumer electronics, retailing, dairy, foods and beverage, apparel); industrial goods (machinery, electrical equipment, manufactured goods); petrochemical; pharmaceutical; semiconductor; telecom equipment.

Source: Company filings; Strategy&

Case study

A Chinese client of Strategy&, PwC's strategy consulting business, was experiencing significant growth in its emerging markets. But its recent growth trajectory was falling below its targets. It turned out that the company was experiencing a number of key problems related to complexity. These included a lack of strategic focus due to competing priorities, an inability to adequately serve different market segments, unsystematic pricing mechanisms, channel conflicts, and subpar supply chain performance.

We identified a set of potential growth themes, including a focus on lagging sales in market segments that were experiencing strong growth, protecting premium applications, and penetrating the inland market. We segmented customers based on how attractive they were to the client's overall strategies, cost-to-serve, and capabilities required to serve each customer. We concluded that focusing on a select group of established and high-potential customers was vital to achieve the strategic goals of the company.

Once the executive team had agreed on these market choices and the products and service levels required to serve these segments, we built a differentiated value chain for each segment. Working across functions and business units, the company reengineered its application development, manufacturing channels, pricing, customer services, technical support, and supply chain for specific market segments. Dedicated research and technical teams were deployed to develop the products and applications for each segment, while direct sales teams were assigned only to some customer segments. The company also worked with distributors to serve smaller customers on a transaction-by-transaction basis, thus removing complexity from the organization and lowering the cost-to-serve. Tailored pricing models were applied with more favorable terms for strategic high-growth customers that viewed pricing as the primary purchasing criterion. Service levels were tweaked to provide more favorable supply terms for some strategic customers with high service-level requirements while reducing service levels to others. The result of this transformative exercise was a business that operates a set of differentiated value chains tailored end to end for each market segment it participates in. The design and implementation were engineered from the ground up, not the outcome of piecemeal work-arounds of existing systems.

Finally, the company implemented a set of operating model enhancements to optimize processes, structure, culture, systems, and information flow. The company added metrics and motivators to measure and deliver its complexity management capabilities. It now forecasts that these capabilities should help grow the business at an above-market rate and improve gross profits in excess of US$150 million in the next five years.

Multinational companies in China

Although most multinational companies (MNCs) operating in China are accustomed to managing complexities in other markets, changes in China's economy and business environment require them to adapt in ways that they haven't always anticipated.

A perception that the regulatory environment tends to favor domestic players has made it trickier for MNCs to invest in China or position China as core to their strategy and operations. Although there are no official policies stating such a preference, the government has, for example, come out with position papers that establish more stringent requirements for MNCs selling software and other technology products. This makes it challenging and more complex for MNCs to operate in China and may require companies to localize parts of their value chain or set up partnerships with local players.

MNCs need to reexamine their strategies as the consumer market fragments into multiple segments.

MNCs that have done well building Chinese business models and local operations will also need to reexamine their strategies as demand fragments into multiple segments. Consumer product purveyors have been catering to China's growing middle class as well as the rising demand for high-end products, but there is also a geographic shift occurring as the consumer population grows in the lower-tier cities, including those that are being developed inland. Businesses will find that their supply chains have to become more complex to cater to the fragmentation in demand, as well as the vast geographic range. Adding to the complexity is the increasing viability of other low-cost countries for manufacturing or supply bases; is it more profitable, for example, to outsource certain products or parts of products, or do shipping costs and delays offset the lower costs of manufacturing elsewhere?

Case study

Executives of a global industrial company realized in 2012 that they were ill-equipped to compete in China's maturing economy. The company had been in China for many years, selling high-tech products, but had started experiencing negative growth. One of the problems was that its lower-end line, which had been popular for its budget prices, had been severely hit as a string of strong domestic competitors had moved in with even lower prices. At the same time, a number of local mid-tier companies that were not the company's customers had sprung up as emerging domestic players and were beginning to achieve scale and globalize, often supplied by the company's competitors. Unfortunately, the company was not in a position to serve these emerging domestic players because they required a service model that the company did not offer. In most cases lead time was a determining factor for these new players, while pre- and post-sales support was less important.

The company launched a program to ensure coherence among China's heterogeneous market requirements, the company's strategic China goals, and its complexity management initiatives. First, however, its executives had to make some challenging decisions about which segments of the Chinese markets were most important to them. Once they had a deeper knowledge of the new players in the market and the requirements of the various market segments (e.g., price points, product choice, service levels), the executives were better equipped to make strategic market participation choices that supported the company's China goals. They then reengineered their operations to cater to the requirements of each market segment, varying their approach to product development for different segments of customers, optimizing the inventory buffer points in the supply network, introducing new pricing schemes, and reorganizing the distributor network. Through this concerted effort, the company gained valuable insight into the complexity required to serve China's evolving market requirements. Ultimately, with an improved operational structure, the company was able to deliver the required market complexity at the lowest possible cost.

Misguided approaches to complexity management

Complexity manifests itself in multiple ways, and companies in the past have undertaken a variety of initiatives to manage it and improve profitability. Too often, however, complexity management initiatives are ad hoc or improvised. In many cases a company will add new layers to an existing system without assessing whether the old system is still viable. Using this kind of guesswork can in itself create additional unnecessary complexity.

It is fairly typical for a company to try to simplify and standardize product and service offerings to reduce product and service complexity — but sometimes the company will find that it has trimmed away too much.

Besides product and brand portfolio management, operational optimization — typically supply chain–related changes (sourcing, logistics, distribution, etc.) — can also help manage complexity and drive profitable growth.

Too often, complexity management initiatives are ad hoc or improvised.

A consumer products company found that it could realize substantial savings and reduce complexity by standardizing its purchase of commodities such as leather for footwear. But though operational improvements alone can often lead to bottom-line improvements, companies often miss out on the opportunity to build market-winning operational capabilities that deliver the required market complexity at the lowest cost. In the case of the consumer products company, the managers shifted from a cost-cutting exercise to one that focused on building new capabilities around shorter time-to-market. The company revamped its design processes and collaborated more closely with its various suppliers, optimizing the organization and staffing levels; as a result, it cut its time-to-market by 50 percent. These investments were funded by the initial savings generated by the sourcing organization. The company now has a set of capabilities that makes it possible to deliver the variety of products that its various global markets need at a lower cost, while keeping up with rapidly changing fashion trends.

As a company expands its lines of business and adds more people and more facilities — in short, it builds a more complex organization — it will usually introduce metrics and processes to manage new priorities, some of which might compete with others. These additional layers of metrics and processes often create even more complexity and result in the organization losing its ability to respond swiftly to problems or changes. Even worse, the multiple demands and processes can create organizational fatigue and inertia.

Executives often think they understand what their customers' requirements are. However, without a deep knowledge of the product variety, service levels, and prices that customers expect — and even more critical, an understanding of the premium that customers are willing to pay for an increase in product availability or variety or the discount they expect for a reduction — the company will overserve or underserve segments of the market. Proper investigation of the complexity the market requires and the potential value that can be extracted by serving different segments of the market can lead to an increase in complexity for a segment of the business and a reduction in complexity in other areas. The net result is a business that appropriately fits the market rather than one that is needlessly or organically complex.

A solution based on three guiding principles

Naturally, there is no single methodology for managing complexity while growing profitability. Rather than trying to reduce the number of intricacies within an organization, however, leaders should aim to build an optimized business that delivers the right level of complexity to the right market segment while supporting the firm's strategic goals. In our experience, companies can solve this puzzle successfully by following three guiding principles: understand the market; determine the areas that are most aligned to your overall strategy; and pursue a holistic, end-to-end value chain approach.

1. Understand the market

Companies need to understand the market requirements for complexity in terms of product features, product availability, and price. More important, companies also should strive to understand the premium the market is willing to pay on any of these variables.

There is little homogeneity of customer requirements in different markets, even within a single country. In China, B2B customers across a range of industries tend to require much faster deliveries but they expect simpler product offerings from the supplier than in more developed Western markets. However, customer expectations can vary greatly between southern China and northern China.

We worked with a global industrial goods company to analyze the market and surveyed the distributors and end-users in each of the company's sales regions. The company was accustomed to servicing many different tiers in other parts of the world, and was using five distribution options in China. In surveying customer requirements for lead time and application and product configurations, the company found that customers in China were more interested in speed of delivery than in customization. The company had been offering five distribution options, but through the use of statistical simulations and simulated shopping exercises, it found that it could increase its market share in China by cutting down to just two options. By cutting down in this particular area, the company was able to improve its product availability while maintaining its price structure and reducing risks.

2. Determine participation choices and alignment to strategy

Complexity management is a strategic issue and should not be undertaken on an ad hoc basis or in functional silos. After the company defines and develops an understanding of the right level of complexity for the market, senior executives will need to make a set of decisions, primarily around which segments of the market are most important to them. For each segment, an appropriate service model should be defined. The combination of service models and market segment participation choices will essentially determine the required complexity. In order to achieve the right balance, a set of financial and strategic criteria should be used to evaluate the options.

A global chemicals company was focused only on global accounts when it entered the China market. But the company's management soon recognized the strategic importance of developing a local Chinese customer base to secure future growth. After analyzing the required service level of the different segments, the company reviewed what it would take to serve local Chinese customers. Participation decisions were reviewed against a set of strategic objectives and tested against a set of financial metrics. After deciding to target the local market, the company developed specific product applications with dedicated technical teams and reviewed its product portfolio, service level, and pricing in China against the requirements of the market and the existing competitor offerings. This was effectively the result of aligning complexity decisions to different market segments, made with clarity on market requirements, associated costs, and an alignment with the firm's emerging markets growth strategy. The company was profitable in China because it deployed complexity in the right segments and was serving a fast-growing market space.

3. Pursue a holistic, end-to-end value chain approach

Once a clear understanding of market requirements and participation choices in each key market is obtained, along with alignment to the firm's strategy, a thorough review and transformation of the company's end-to-end value chain and operating model is required. This is a company-wide effort that encompasses every function accountable for delivering the company's market value proposition, from the teams that conceptualize or deliver products to those that are responsible for measuring financial performance. This end-to-end approach should be focused on building value chains that are designed for specific purposes, rather than set up as work-arounds for existing solutions.

The end-to-end approach should be focused on building value chains that are designed for specific purposes.

As the entire company's value chain is reengineered, value-adding complexity may be brought in while unnecessary complexity is removed. Companies can employ different tactics to engineer their value chains, from optimizing product portfolios, production assets, and strategic inventory points to deploying late differentiation in order to deliver complexity while reducing working capital. The most important factor, however, is to use an end-to-end approach when engineering these solutions (*see Exhibit 5*).

These changes must also be institutionalized and made sustainable through an operating model that enables the organization to make the right decisions at the right levels. New processes, decision rights, and even organizations may need to be put in place to systematically manage the new value chains.

Exhibit 5

End-to-end value chain and examples of complexity management layers

Industrial goods

Product development	Internal and external suppliers	Operations	Logistics	Sales and distribution	Customer distribution
– Product configuration aligned to market segment	– Multisourcing of core component – Strategic inventory to buffer demand variation	– Finish to order – Agile production – Lean manufacturing	– Segmented delivery models	– Differentiated service levels – Pricing to shape demand and maximize profit – Channel partner alignment on demand sensing and differentiated delivery models	

Chemicals

Research	Application development	Manufacturing	Logistics	Sales and distribution	Customer service
– Market-based research and development	– Industry-oriented new application development – Prioritized efforts for key accounts	– Differentiated forecasting strategy – Synchronized multi-tier manufacturing	– Postponement and inventory pooling – Efficient seasonal inventory management	– Customer segmentation – Differentiated pricing – Differentiated channel strategy	– Fast response to customer requirements – Differentiated service levels

Source: Strategy&

Conclusion

Complexity is inevitable as companies develop new products and enter new markets in order to pursue growth. Winning companies make strategic choices on where complexity should be added to the organization and how to manage it while removing complexity that doesn't add value.

Companies that excel at managing complexity build their capabilities with a view that is backed by market realities and develop end-to-end solutions that are aligned with their overall strategy. Winning in China's new normal means building a business that is capable of delivering the required market complexity and able to add, remove, and manage value-creating complexity in a flexible manner. This requires a deep understanding of China's market requirements, a coordinated effort guided by an aligned China strategy, and a holistic value chain management approach, along with an operating model tailored to create value and win in the market. Companies that can deliver this will ultimately have a strong competitive advantage.

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