Operations in Emerging Markets: China

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Abstract

This paper offers a high level overview of the issues involved when a company decides to outsource operations in China. Beyond the basic reduction in labor and material costs, China offers high levels of productivity for firms that use the country as a base for operations. However, along with these advantages are several challenges associated with logistics, manufacturing, and management of a complex supply chain that stretches around the globe. These issues must be considered before any outsourcing decision is made, and several methods are discussed that companies may want to employ in order to reap the benefits that China can offer while mitigating the challenges it presents.

China’s Advantages

In today’s survival of the fittest world, companies cannot continue to operate the way they have been and be successful. Globalization has become a necessity. Whether in a manufacturing industry or a service industry, companies are going global to tap the resources available that can help them be competitive in the global market. Globalization involves integration of trade and financial markets. It also creates a plethora of opportunities for companies who set up their operations in different countries. These countries not only provide low cost operations, but also open new markets. China is one such country that has seen influx of manufacturing companies. Cheap labor is one of the main factors behind companies setting up their operations in China, but it is not the only one. There are host of other advantages that this country offers, which makes it
a desirable destination for many manufacturers. These factors are helping China attract an increasing amount of foreign investment. The following represent some of these factors:

1. **Cost advantage** – China offers cost advantages in both labor and raw materials. The difference in both the categories large enough that companies that once competed from their home countries are re-examining the option of sourcing from China gain these benefits.

   a. **Labor Savings** – Wages in China are drastically less that those in the US. According to a Boston Consulting Group (BCG) outsourcing report, the average hourly pay (including benefits) of production workers in China is $0.80 versus $21.86 in the United States; given the same equipment, American workers need to be 25 times more productive than their Chinese counterparts to remain competitive\(^1\). China has huge pool of workers, which will help keep the wages low in near future and will help attract foreign investment for years.

   b. **Cost Savings** – Chinese plants are more likely to control the cost of components and materials from their suppliers than U.S. plants, with 75% of U.S. plants reporting that costs had increased in the past year vs. 51% of Chinese plants. Some of the reasons attributed to these cost savings are government subsidies of petroleum, metal, basic materials and a high degree of supply chain integration between suppliers and customers. The cost advantage of moving production to China can easily top 20% with no loss of quality\(^2\).

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2. **High Productivity Level** – Along with the low wages advantage, China also enjoys high productivity levels. Harvard’s Dan Rodrik in his article “What's So Special About China's Exports?” makes the following comment:\(^3\):

> “...*what is so special about China’s exports is not that they are voluminous or that its large pool of labor gives it a huge labor cost advantage. What stands out is that China sells products that are associated with a productivity level that is much higher than a country at China’s level of income. This helps account both for why China’s trade is viewed as problematic in advanced countries and for China’s rapid economic growth...*”

Low wages can only take you so far. Moreover, low wages alone cannot make a country competitive in the global market. There are host of other countries who offer low labor costs, but none has achieved the success that China has, so there has to be complimentary factors that contribute to its advantages. In case of China, it is high productivity. People in places such as the Dominican Republic and Romania are willing to work just as cheaply as workers in China, but are not as productive\(^4\).

3. **Higher Value Chain Integration** – According to the recent study by Grant Thornton LLP, Chinese plants (as opposed to U.S. plants) more often report "extensive integration" with suppliers (29% vs. 11%) and customers (33% vs. 16%). The more integrated the company is with suppliers, the more benefits it can reap from the relationship. Also, being well integrated with customers not only strengthens a supply chain against competition, but also fortifies the position of the supplier within that chain\(^5\). One of the reasons for extensive integration can be attributed to the fact that often customers and suppliers have a parent/subsidiary relationship or are truly partners.

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4. **Rapidly Growing Market** – As a large and rapidly growing market, China offers a great opportunity to companies looking for new markets. This in part is due to an increasing amount disposable income. The rise of a middle class, as well as a small affluent class, is creating opportunities for increased sales. The following are some facts about the Chinese market:

   a. In 2003, total consumer spending in China was US$1.1 trillion.
   
   b. China passed the U.S. in machine tool consumption in 2002, and will likely be more than twice as big a market in 2004.
   
   c. 1,000 new automobiles are being put on the road every day in both Beijing and Shanghai.
   
   d. In 2003, China spent roughly US$56 billion on clothing, a figure that is expected to grow rapidly in the coming years.

5. **Manufacturing Flexibility** – Companies need not invest heavily in automation in China because of the low-cost labor pool available. This not only provides cost savings, but also provides flexibility to respond to customers demands quickly. This can help companies to adapt to market changes quickly without huge investment in equipments. Substituting human hands for expensive, specialized machines can actually improve the flexibility of production lines.

6. **Favorable Tax Structure** – China offers a favorable tax structure to foreign investors. Foreign manufacturers enjoy a tax rate of 15%, as opposed to 33% for domestic enterprises, and the government rebates up to 15% of value-added taxes (VAT) on exports. Though the government has plans to unify the business tax structure and phase

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6 Freedenberg, Paul. “Impressions from China,” americanmachinist.com

7 "Sourcing from China, Part 2: Why China?," resources.alibaba.com
out some of these incentives, localities are likely to continue to offer incentives to lure investors.

7. **Opportunities for Retail Market Operations**⁸ – The retail sector represents a huge opportunity for growth. China’s retailing industry is on the verge of a major acceleration in modernization, foreign investment, consolidation, and privatization. These changes are results of the rules governing distribution in China were radically altered in December 2004 in accordance with China’s WTO obligations. Some of the new rules are:

   a. Foreign retailers may own 100% of their Chinese subsidiaries.
   
   b. Foreign retailers may operate in any geographic location within China.
   
   c. Foreigners may source global brand merchandise locally.
   
   d. Foreign companies may integrate all aspects of distribution

**Challenges**

There are clear advantages for a company to outsource operations to China; however, there is often the lack of a clear strategy for gaining the most from this process. There are many issues and challenges that must be considered for a company to fully realize the benefits of beginning operations in China. Those challenges can be classified into three main groups: Logistics, Manufacturing, and Managerial.

**Logistics**

The logistics sector within China continues to grow at an astounding rate. A report by Transport Intelligence Ltd, predicts compound annual growth rates of 33% up to 2007, and this growth is further supported by increasing use of third-party logistics companies⁹. For shippers, this growth

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⁸ Deloitte Research – “China’s Consumer Market: Opportunities and Risks”
results in better access and higher-quality services. However, there are still a number of challenges facing companies’ logistics activities within China.

Poor infrastructure presents an obstacle for transportation activities. The coastal economic zones possess well developed road and rail systems, but moving inland the rail systems in particular are patchwork and archaic. There is little integration of transport networks, IT, warehousing and distribution facilities. China, however, does possess a sophisticated inland waterway system that represents a large part of the capabilities for reaching the interior of the country.

There is also a significant amount of entrenched regulation that inhibits the growth of national service networks. The Chinese logistics market is one of the most regulated in the world, and those looking to enter the market are forced to acquire various permits from several government agencies. Regulations exert tight control at the provincial and even city levels. The state of the regulatory environment, especially at local levels, is a major reason why the small domestic transportation firms rarely travel outside of their own region.

Poor training in the logistics field continues to pose a problem for companies seeking to operate in China. There is little practical training in IT skills and warehouse management. However, many young, Western-trained managers are returning to China, and are proving to be capable business managers. Demand, however, is currently outpacing supply, and poaching has become a common occurrence regarding logistics talent.

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10 Ibid. p. s64
11 Ibid. p. s67
Perhaps the greatest logistics challenge concerns the difficulties and hidden costs involved in a 7,000 mile long supply chain. Logistics costs in the United States are below 3% of revenue; however companies in China pay between 6%-12% depending on the product and factory location. There is a significant amount of complexity added when managing a cross-border, multi-mode network compared to a domestic trucking network. Transporting goods from China to the United States can involve 17 to 24 parties. Port backups either in China or the U.S. can significantly shrink margins, due to the extended lead times affecting speed to market. Companies end up holding extra inventory to account for an inflexible supply chain with four to five weeks of inventory in transit at any given time. Expedited service expenses can also increase as a result of this inflexibility. The extended supply chain is also slow to react to changes in product mix. A U.S. producer can respond in a day, while in Mexico it may take 3 to 4 days. A supplier in China needs five to six weeks to react to a schedule change.

**Manufacturing**

The logistics challenges facing companies deciding to begin operations in China have a significant impact the manufacturing strategy implemented. These factors to large extent dictate the types of products chosen for sourcing or manufacturing in China. Additionally, when the decision is made to manufacture in China a new set of challenges is brought to the forefront that must be handled appropriately.

The lack of flexibility regarding the manufacturing schedule managed from half a world away limits the effectiveness of producing certain types of products in China. Most companies will limit outsourcing to products or components that rarely require changes and have predictable

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markets\textsuperscript{14}. Such a system has evolved regarding electronic components. Many low-cost parts including resistors, capacitors, switches, and relays are readily available in China\textsuperscript{15}. These products tend to be bought in large volumes and are labor intensive to produce, maximizing the benefit of China’s advantages in labor costs, while minimizing the negative aspects of lack of flexibility and long lead times.

However, even if implementing such a limited outsourcing strategy, companies still face a potential strategic challenge from competitors. Those players in the industry not outsourcing to China may undertake actions to amplify the disadvantages involved with managing Chinese operations. For example, there is the threat of competitors increasing the fashion quotient of a product category, thus increasing demand variability, which the China-bound manufacturer will be hard pressed to accommodate\textsuperscript{16}. Such actions can eat into the gross margin of products as manufacturers struggle to get the right product on hand. This can offset the benefits of low Chinese manufacturing costs, ruining a China sourcing strategy.

There are also various other issues that must be taken into consideration before the decision is made to outsource manufacturing to China. Quality inconsistency can be a serious issue\textsuperscript{17}. Inconsistent raw materials, poor process control or quality systems, and low machinery capabilities can all contribute to poor quality of products coming off of the line. Additionally, design and application engineering remains weak in China as most Chinese engineers have no exposure to the U.S. market or any knowledge of customer needs. Also, raw materials costs can be high depending upon current market conditions. For example, the high demand for steel in

\textsuperscript{14} Ibid. p. 39
the Chinese automotive market has driven up the price of local iron and steel prices. Furthermore, there is a technology transfer requirement that companies must agree to in order to build factories in China\textsuperscript{18}. Once the foreign company agrees to such a transfer, the technology moves freely to local competitors who may now be able to compete with the foreign company.

**Managerial**

Beyond logistics and manufacturing challenges facing companies outsourcing operations in China, there are significant managerial issues associated with various government agencies and policies and with relationships concerning Chinese suppliers or partners. Of critical concern is the lack of protection regarding intellectual property\textsuperscript{19}. It is widely known that China lacks robust policies for protecting companies’ intellectual property, but it is also difficult to quantify the loss associated with this practice. It is not necessary for a company to operate in China for its intellectual property rights to be violated, however, with the technology transfer requirements of the central government; it becomes an increasingly important issue.

In addition the requirements of the central government, companies must deal with competing interests among the provincial and municipal levels of government and on each level navigate through the requirements of various commissions, agencies and departments\textsuperscript{20}. These interests have overlapping control, and companies must understand the mechanisms of decision-making that require agreement at multiple levels for their business to operate effectively. Also, there are personal loyalties spread throughout these organizations that add to the complexity of managing a successful venture in China. It is not possible for foreigners to understand all of the

\textsuperscript{18} Brown, p. 37.

\textsuperscript{19} Brown, p. 38

\textsuperscript{20} Kuhn, Robert. “Mastering the art of doing business in China: not enough CEOs know how to play the game to their advantage,” The Chief Executive. December 2005.
machinations occurring within Chinese organization, but those that are politically naïve may never understand why a deal was delayed or aborted, or how negotiations can be facilitated and problems resolved.

Additionally, corruption is an issue tied to the complex political and regulatory environment. The problem has continued to along with China’s rise in world markets\textsuperscript{21}. Along with the need to know the right people is an implied need to “influence” those people. What may exacerbate this problem is the lack of a developed system of case law, which leads to everything handled by negotiation\textsuperscript{22}.

All of these issues lead to the conclusion that a great deal of managerial oversight is needed by any company looking to outsource operations in China. China cannot be managed from corporate headquarters, and strategic business decisions cannot be delegated in China as easily as they could in the West\textsuperscript{23}. Significant time and energy is required to manage projects on the other side of the world and to understand the needs of a complex supply chain.

These challenges must be taken into consideration before any company makes the decision to outsource operations in China. Many companies have proceeded believing that only labor costs drive product costs. This is an incorrect assumption, and companies must not only consider full acquisition costs, but also intangible costs such as endangering intellectual property, navigating the political system effectively, and oversight of the operations.

\textsuperscript{21} Trunick. p. 46
**Recommendations:**

The decision to do business in an emerging market has to be a strategic rather than reactive decision. The decision should encompass long-term plans. Establishing a presence in markets like China strictly to ship product back to North America would not maximize the potential benefits in the long run. Shipping products back to North America can be more easily done through a global sourcing strategy than by making a long-term commitment to a market you know nothing about. It is very important for companies to develop a well conceived strategy and act on it with precise control.

Success in a China trade strategy requires companies to take a "true end-to-end management approach". The strategy should be based not only on pricing negotiations, but also on logistics costs, supplier reliability, flexibility of supply, product quality, and other factors influencing the total cost of doing business. Companies should focus on the following criteria for success in emerging markets:

- lowest total delivered cost
- delivery reliability
- supply chain flexibility
- regulatory compliance and risk minimization

Companies venturing into China need to evaluate the following factors before arriving at a decision:

**Leadership:** American companies have been slow to adapt to globalization, and most company boards have comparatively little international experience on the operational level. Compared to Europeans, who have much more experience dealing with different languages and cultures, American businesses are at a disadvantage.
Chinese operations strategies require the clear and explicit commitment of leaders, CEOs, presidents and boards of directors. Leaders must define their organization's priorities, act, and be seen to act on them. This means that a China strategy must include the leader's vision, and necessitates direct involvement. It means taking the time to travel to China to make direct judgments. This is expensive and time consuming, but considerably less so than the consequences of failing to meet the China challenge head on. In addition to executives, members representing corporate planning, finance, manufacturing and marketing have to be convinced of the China strategy's relevance to them, and their role in its implementation.

**Finding the right partner**\(^{25}\): Avoid the errors of foreign firms, in a rush to make a profit, that were forced into unattractive joint ventures with government enterprises or bureaus. Many of the challenges like dealing with the bureaucracy, understanding the local culture, overcoming threat of intellectual property rights, and managing labor can be effectively overcome by choosing the right partner. Finding the right partner is an important strategic move for the firm\(^{26}\).

**Start Slow**: It is not advisable to immediately take your key technologies to China. It is better to keep critical design and manufacturing activities, which give you a competitive edge, in house. Also, companies may employ a low-skilled labor force that may not be prepared to operate and manage expensive, highly automated equipment.

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\(^{26}\) Kerr, p.74-78
**Think Locally**: It is important to recognize that China does not operate as a single unified economy. Rather, it consists of many regional economies where domestic trade barriers are sometimes even higher than international trade barriers. Regional trade in certain commodities is often banned by local governments to protect local industries. While WTO entry is slowly removing these regional trade barriers, it will be some time before trade can be conducted across China as a single unified economy.

**Culture**: The Chinese culture is highly hierarchical. It is rooted in values where trust is developed through long-term friendships and demonstrable actions. Commit to a team that will work to develop trust with local management and authorities over an extended time period.

**Developing local management**\(^{27}\): It is easy to find labor in China, but the pool of experienced managers is shallow. Work through networks of your customers and suppliers and develop relationships with local universities to find good managers. Local management will help firms understand the local culture and the nuances of negotiating contracts with local suppliers and efficiently implementing plans. Chinese culture prefers more direct and “high-touch” relationships, meaning that a local presence and frequent face-to-face meetings are important. The companies that do the best are those which are able to adapt to the environment by using seasoned and well-trained executives who know Chinese, or western trained Chinese managers.

**Protecting Intellectual property**\(^{28}\): Intellectual property related to technology, equipment and processes are at risk, therefore it is prudent to go slow and avoid outsourcing critical technology to China. One way to protect intellectual property rights would be to allow the local partner to

\(^{27}\) Murad, p. 61-62.
sell the product in their local market under their own brand names, and paying the parent company a license fee.

**Logistical Planning:** Examine the sources of supply and channels of distribution well before deciding on location or breadth of product offering. China's most developed infrastructure is in the coastal regions. Logistics can be a nightmare beyond that. This is another reason to think locally.

**Employee Turnover:** The demand for experienced management and labor is an issue for all companies in China. Considering the dearth of skilled management, it is very important to plan for attrition. One way to counter this problem would be to provide a better work environment with competitive pay

**Managing Information:** When doing business in China, never assume anything either with respect to seemingly objective facts, or very subjective human behavior. The American business environment does not prepare firms for doing business in China. A company’s built-in expectations about return-on-investment, reliability of contracts, rule of law, mutual trust, formal and informal rules of business conduct often have little relevance in China. Companies have to prepare for a totally different operating environment. The same caveat applies to people. Never assume anything about human behavior. There is no alternative to getting to know your counterparts, and getting to know them well.

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29 Murad, p. 61-62
**Project Management**\(^{30}\): Many firms are unprepared for the amount of project management— including late-night phone calls, last minute travel, and supply chain monitoring needed to bring an outsourcing relationship up to speed. It may take months or even years of heavy travel to ensure that both parties understand one another. Even then, companies need strong, consistent internal processes to avoid problems.

**Conclusion:**

The growth of the Chinese economy has caught the world's attention, and more companies will see success in the Chinese market as key to global success. Success in the Chinese market is challenging and requires a long commitment. The companies and individuals that stick-it-out, learn, and succeed, will become the business leaders of tomorrow.

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\(^{30}\) Venetis, p. 42-44
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