Chinese Supply Chains Reach an 'Inflection Point' – and Multinationals Recast Strategies

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The recent detention and subsequent freeing in Beijing of American businessman Charles Starnes over a worker dispute is symptomatic of Western companies struggling with rising Chinese wages and a strong renminbi. Starnes, co-founder of Florida-based Specialty Medical Supplies, had planned to move the firm's plastics business to Mumbai, India. He had let go of 30 workers at his firm's plant in Huairou district near Beijing with severance packages. Other workers who retained their jobs wanted similar severance payments. They were also upset when they saw Indian engineers visiting the plant and items packed for shipment to India. They held Starnes captive for six days, freeing him after he agreed to a "ransom" of about half-a-million dollars in a compensation deal, according to media reports.

Starnes wanted to move for two reasons. One, he found cheaper workers in Mumbai for some of his firm's labor-intensive operations. Two, the dollar had eroded about 25% against the renminbi over the past four-five years, while it had gained strength against the rupee. Recent research on Chinese supply chains by Wharton professor of operations and information management Marshall Fisherand Wharton lecturer Edwin Keh underscores the challenges Western companies face in China and charts the new strategies they are employing to overcome them.

From 1979 until now, wages in China have risen rapidly and the renminbi has appreciated to the point where China is no longer the cheapest source for many products, causing companies to shift production to other countries "in search of the 'next China,'" according to the two researchers. Between 1997 and 2008, Chinese wages increased by more than five times, while those in the U.S. grew a mere 50% in that period, they add. Meanwhile, the dollar-renminbi exchange rate has made it costlier for Western brands to import from China. The renminbi hit a 19-year high against the dollar at 6.27 last October, and has since strengthened further.

An Ocean Liner Changing Course

The transformation in Chinese supply chains has evolved almost unnoticed over several years, says Keh. Keh was formerly the chief operating officer and senior vice president of Walmart Global Procurement, and has closely studied those trends. “If you look at this on a quarter by quarter basis, you may not see it because it is not a singular event, but certainly it is a trend,” he says. “Imagine it as a huge ocean liner that is changing course.”

Fisher says that despite the huge changes in China in the two decades from 1986 to 2006, the country’s basic economic strategy was unchanged over this period: Its basis of competition was labor-cost arbitrage. Over the past two decades, factories in Southeastern China’s provinces like Guangdong, Jiangxi and Hainan have become the pre-eminent contract manufacturers for top brands including Apple’s iPhones, Dell computers, Nike sports goods and Liz Claiborne apparel.

In the summer of 2010, in one of their numerous visits to China, Fisher and Keh saw the first signs of that economic strategy facing serious pressures. This time around, labor unrest marked the country’s business environment. A strike at Honda and worker suicides at Foxconn’s facilities in Longhua, Shenzhen, made headlines.

The ‘Inflection Point’

However, with the double whammy of rising wages and a strong RMB, those Chinese supply chains have reached an “inflection point,” say Fisher and Keh. They identify a few distinct trends.

One, Chinese companies like iPhone-maker Foxconn and apparel supplier Luen Thai are relocating or expanding operations from high-wage coastal provinces to cheaper locations in interior China or other countries like India and Indonesia.

Two, many Chinese contract manufacturers are building their own brands, investing in R&D and innovation, such as Goodbaby, a maker of baby strollers, and Daphne, a footwear manufacturer.

The more ambitious among them are buying Western brands. Fisher points to Lenovo’s US$2 billion buy of IBM’s personal computer business with the Think Pad brand and Chinese automaker Geely buying Volvo from Ford for US$1.5 billion in 2010.

Three, both Chinese suppliers and Western brands are now actively focusing on China’s domestic market, which is now more attractive with rising incomes and a burgeoning middle class. Alongside, Chinese suppliers are investing in lean management techniques to improve productivity and control costs.

Four, many Western companies that sourced solely from China are finding suppliers elsewhere in a “China + 1 strategy” — or “+2, +3, etc.,” depending on the volumes. In the case of Walmart, for example, it is “China + 17,” and it is also considering sourcing locations that might have been out of question a decade ago, such as Ethiopia, Myanmar, or even the U.S., says Fisher.

Foxconn Picks Cheaper Location

The labor unrest at Foxconn in 2010 was a symptom of the deeper problem for Chinese suppliers of higher costs eroding their competitiveness. Foxconn doubled wages in Longhua, but also got wiser from the episode. Fisher says wages in Longhua had reached “a tipping point in the tumultuous summer of 2010.”

In October 2010, Foxconn opened a US$2 billion plant in China's Southwestern city of Chengdu, linking wages to local prices that were lower than those in Longhua. A portion of the output of this factory flows not east to China's coastal ports, but west via the Russian rail network to Europe, Fisher notes. In an unrelated development, an explosion and fire in May 2011 at the Chengdu plant killed three people and injured 15.

Tapping the Domestic Market

The Goodbaby Group, a maker of baby strollers and related products based in China's Southeastern coastal province of Jiangsu near Shanghai, has built its own brand and is successfully tapping into the country's domestic market, says Fisher. Zhenghuan Song, a teacher, founded Goodbaby in 1989 after inventing the company's flagship "push and rock" stroller. The company's other products include children's tricycles and bicycles, baby walkers, children's clothing and toys. Last year, it posted revenues of six billion yuan (US$1 billion), and a fifth of that came from exports to the U.S., according to Tongyou Liu, the company's chief operating officer.

Fisher finds Goodbaby's R&D record "pretty distinctive in China." The company has five R&D centers and owns 4,465 patents in China and overseas, according to a company note. Many Chinese companies reverse-engineer Western products and are imitators, "but this company is different," he adds. "What makes Goodbaby striking is that it is unusual and a harbinger of the future – where China is trying to go. It competes on innovation."

Goodbaby is also successful in exploiting China's domestic market. The company has a network of about 8,000 distributors, department stores, supermarkets and specialty stores, which it serves through 25 sales offices across the country. The company commands 70% of China's juvenile products market, according to the country's ministry of light industry.

Fisher says it is significant that Goodbaby's innovation efforts are consistent with the Chinese Communist Party goals for 2010-2020. One goal is to "spend 2.2% of GDP on R&D and 3.3 patents per 10,000 people." Another goal is for the coastal regions "to turn from 'world's factory' to hubs of R&D and high-end manufacturing."

Fisher has prepared a list of the emerging Chinese innovators: Haier and Gree Electric in appliances; Huawei and HTC in cell phones; Li-Ning, 361 Degrees and Anta Sports in sports shoes and apparel; Goodbaby in strollers; LukFook Jewellery (called China's Tiffany's) and Hong Kong's Chow Tai Fook in jewelry; and Taobao, Baidu, Alibaba and Yihaodian in Internet services.

Chinese manufacturers that are closer to their customers have more opportunities to control their own destinies as they tap into the country's domestic market, says Keh. One example of that is Daphne, a Chinese maker of women's shoes, which began as a contract manufacturer but has built its own brand over the years. Fisher estimates its 2012 revenues at more than US$1 billion. Keh says that Daphne, like Chinese handset manufacturer HTC, has "serendipitously first created a great manufacturing capability and then a design capability to move further and further up the value chain." Daphne was "in the right places at the right time," and represents "the ultimate story of cutting out the middleman," he adds.

Luen Thai Bets on Flexibility, Productivity

Luen Thai, a large Hong Kong-based supply chain logistics and private label apparel manufacturer, has responded to rising costs by improving productivity at its Chinese locations through lean technologies, expanding into the Philippines and getting into retailing. The US$1.2 billion conglomerate's flagship garment business produces 74 million pieces annually for customers including Liz Claiborne, Nike, Victoria's Secret, Polo Ralph Lauren, Sears, Kohl's and Walmart.

Luen Thai launched apparel manufacturing in 1983 in Saipan, China. Soon thereafter, it expanded to other locations within the country and in the Philippines, Cambodia and Vietnam. In the mid-2000s, it set up two design and development centers in Dongguan in Guangdong province on the southeastern coast for customers including Liz Claiborne, Nike and Victoria's Secret. In recent years, it has cushioned increased costs with higher productivity in Dongguan.

In the past two years in Dongguan, Luen Thai has translated into improved space utilization by 47% and reduced throughput time from 25 days to less than a week, as Fisher learned from Luen Thai's chief operating officer Raymond Tan. Those gains also helped it absorb higher wages more comfortably than for others in its industry. A 10% increase in labor costs resulted in retail prices for its products increasing by only 1%, Tan told the Wharton researchers.

Luen Thai is also expanding overseas. It is building a large manufacturing hub in the Philippines, where it has had a presence since the mid-eighties. It already has four production facilities in that country with more than 10,000 employees. Keh says the group also benefits from preferential tax treatment in the Philippines and strong, personal relationships it has cultivated in that country over the years.

However, within China, Luen Thai has decided to stay put in Dongguan and not expand in interior locations like Foxconn did. Fisher says it is not easy to relocate management teams from Southern China, and explains why. Automation and innovation require strong management teams, and it is hard to duplicate them outside of Southern China. Further, it is difficult to justify long-term investments in new locations until it fully utilizes its existing assets.

The Lure of Chinese Consumer

For Chinese factories that have become less competitive in the exports, they have a readymade answer in the domestic Chinese market, the Wharton researchers note. Western brand owners that fail to figure out how to sell into this market place risk "missing out on the fastest growing consumer market place in the world," they say. Fisher points to a market practice called "U-turn export" that further underscores the significance of the domestic Chinese market. Here, a factory with an export license will first ship its products to Hong Kong, claim the export incentives and then re-import the products into China.

Western companies have had mixed results in the domestic Chinese market. In luxury goods, foreign companies have an edge, says Fisher. Nike does "very well" in China, competing against the local sportswear company Li-Ning, founded by China's Olympic athlete of the same name, who won six medals in the 1984 Los Angeles Games.

Other Western companies like Walmart Stores have not tasted instant success in China's domestic market. "Walmart China, for example, is far from being the country's largest grocery retailer or general merchandize retailer," says Fisher. "Yet that market offers a huge growth opportunity for Walmart as a corporation."

The Chinese market is far more fragmented than that in the U.S., and it is not set up for a "winner take all" scenario where the top three companies have an 80% to 90% market share, says Fisher. In cell phones, computers or other product categories, the top 10 companies may account for just about half the market, he points out. With the ongoing changes in supply chains, both Chinese and Western companies could emerge winners, according to Fisher. "China is such a big place that everybody can win."

'Made in USA'

The foremost mantra for Western companies to succeed in the domestic Chinese market is to keep costs low, according to Fisher. One way is for companies to continue sourcing from their existing suppliers but improve productivity as much as they can, before they consider sourcing from other locations, he says. He borrows a phrase in the apparel industry – “chasing the cheapest needle” – as western companies identify other low-cost countries.

That symbolic needle is a moving target, indeed. Fisher recalls how shoe manufacturing has moved from place to place over the last few decades. In the 1960s, Boston’s suburbs had many shoe factories, but cost pressures forced that activity to move progressively to southern parts of the U.S., then to Brazil, Taiwan and coastal China before heading to Vietnam and Indonesia, he says. “Who knows where it will go next?” he asks. “Chasing the needle is *the* norm for high-labor products.”

However, shoe makers find it profitable to continue to make their premium products in the U.S. New Balance, a Boston, Mass.-based maker of athletic shoes that posted 2012 revenues of $2.4 billion, boasts that it makes in the U.S. a quarter of all the shoes it sells in that market. It outsources the rest from locations including some in China, Vietnam and Indonesia.

Nike Converse of Andover, Mass., outsourced only select activities of its manufacturing chain, such as parts of the design process and testing. “They would make small batches of complicated products, and if they worked, they would roll it out overseas in [big] volumes,” says Keh. However, it retains in the U.S. the development of its relatively more expensive and high-tech products because it can bring them to market faster than if they were outsourced. The key reasons are better intellectual-property protection in the U.S. for its higher-end products and greater control over time-to-market, he explains. With higher-priced shoes, manufacturers would have the margins to absorb the higher labor cost in the U.S., says Fisher.

Macro-level Shifts

Taking a broader view, Keh traces the changes companies are facing in China to some macroeconomic shifts. The traditional notion of manufacturing cheaply in developing markets to serve developed markets is eroding, as the former group now owns the biggest markets. “The entire reason for going overseas and to faraway places for manufacturing is disappearing very rapidly,” Keh says.

Keh points to a chart from *The Economist* magazine, which shows that China and India had the highest GDP shares for most of the past 2,000 years, except in the last 100 years. It is natural for India and China to regain their prominence in the global economy, he says. “They have the resources, the population and the markets. They are going back to a historic norm.”