Rethinking profitable growth: the productivity imperative for foreign multinationals in China
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About this study

This study is part of a program of research Ernst & Young is undertaking on productivity in China. Our fundamental point of view is simple: companies in China will need to transform their approaches to productivity improvement to remain successful in a rapidly changing and more challenging business environment.

This report examines how foreign multinationals are adjusting to this new environment. The survey on which this report is based was conducted by the Economist Intelligence Unit using its Opinion Leaders Panel. C-suite executives and senior managers from over 200 foreign multinational corporations responded to our survey between March and May 2012. All respondents were based in China.

This report, written by Ernst & Young, draws on findings in Ernst & Young’s white paper *China’s productivity imperative*, a study on the decline in national productivity growth and its impact on companies.¹ Readers interested in the macroeconomic background to our productivity research are encouraged to read our white paper.

In addition, we conducted in-depth interviews with thought leaders from a number of leading foreign multinationals in China. These included:

- Dan March, CFO of McDonald’s China
- Herman So, Executive Vice President of Finance at LF Asia
- Michael Foy, Finance Director of Cisco China
- John Lawler, CFO of Ford Asia Pacific Africa

We gratefully acknowledge all those who took part in our survey and to those who have participated in our quarterly CFO Roundtable events, where productivity has been a consistent theme. We give special thanks to the executives who shared their ideas and experience in our in-depth interviews with them.
Executive summary

Rethinking profitable growth: the productivity imperative for foreign multinationals in China
Past performance is no guarantee of future success

Foreign multinationals have had a good run in the past decade in China, benefitting from world-beating productivity gains, an expanding labor force, rising inflows of investment, and accommodating government policies that have kept the price of inputs low. Demand has been supported by domestic investment in industrial capacity and infrastructure and – until the global financial crisis – steady growth in the world's major markets.

Although conditions have grown tougher in the last few years, our survey found that most foreign multinationals in China remain profitable. Almost half of our respondents reported earnings before interest, taxes, depreciation and amortization (EBITDA) of over 10 percent, compared with only 3 percent that reported negative profitability.

There is a growing awareness, though, that past performance is no guarantee of future success. 59 percent of respondents in manufacturing, for instance - long the mainstay of foreign multinationals in China - reported a decline in EBITDA margins compared with two years ago.

What's different now?

The old engines of growth in China are starting to run out of steam. Growth in exports has slowed significantly in the past two years as a result of gloomy conditions in key markets in Europe and North America.

This has coincided with a fall in China's productivity growth. Earlier rounds of market liberalization and privatization have largely run their course, and the mass reallocation of labor from low productivity agriculture to higher productivity manufacturing could be coming to an end.

Very rapid expansion of capital investment – such as the kind we've seen in the wake of the massive fiscal stimulus unleashed in 2008-10 – has led to a decline in capital efficiency, and will eventually inhibit growth if productivity does not accelerate. Raising productivity is now therefore critical for China's economic future.

Productivity on the government agenda

Companies can expect increasing pressure to raise productivity in coming years. The Chinese government’s industrial policy will give incentives to raise productivity, and increasingly penalize unproductive and wasteful companies.

The government is expected to implement further reforms to input factor (labor, capital, natural resources) markets in line with the current five-year plan’s binding targets to lift average incomes and increase resource efficiency. This, in turn, is likely to make cost inflation a permanent feature in a slowing economy, something that most companies in China have yet to experience.

Feeling the pulse of foreign multinationals

Foreign multinationals in China know that the game is changing. Executives and managers across industry sectors overwhelmingly acknowledge the increasing significance of productivity. 84 percent say that productivity will be either “extremely” or “very” important to business performance in the next one to three years.

Companies are already feeling the pressure of rising costs. Half of our respondents identified labor costs as the leading factor impacting profit. Other important factors included exchange rate movements, commodity costs, and competition from domestic companies.
Nor are companies able to pass these rising costs on to their customers. 85 percent of our respondents expect that they can pass on a third or less of rising costs to their customers.

As margins come under pressure and demand is redistributed, the old paradigm of doing business in China is going to change, perhaps radically.

**Where will productivity improvements come from?**

Most of our respondents considered that more needed to be done to align their operating models with the new business environment. Almost two thirds of our respondents agreed that their companies needed to improve their competitiveness in the local market and to overhaul their organizational structure in China to tap new opportunities.

Many foreign multinationals have already achieved a great deal from back office initiatives, and are now shifting the focus of their performance improvement programs to the front office, particularly placing more emphasis on sales and marketing effectiveness.

In terms of technology, there is more scope for companies to capitalize on investments already made in core business systems, such as enterprise resource planning. Very often companies fail to capture the full value of IT because implementation does not match the unique operating practices and local requirements of the Chinese market. Leading companies are also leveraging new technology enablers such as mobile internet, e-commerce, cloud computing, and data analytics to drive productivity.

Any effective productivity program must of course also take into account the many barriers that exist in every organization. The most prominent in the minds of our respondents were issues relating to human resources and organizational governance.

**How high-performing companies are boosting productivity**

We looked closely at our survey results to identify what high performing foreign multinationals were doing to raise productivity. For these purposes, we classified ‘high performing’ companies simply as those reporting the highest levels of profitability. From a list of 50 productivity improvement methods, the top five undertaken by these high performing respondent companies were:

1. business unit strategy reviews
2. improved people development and management
3. cost reduction programs
4. enterprise resource planning (ERP), and
5. greater autonomy for country management

Significantly, all five of these methods require a strategic, cross-business approach to improving productivity. Moreover, we were struck by the fact that these high performers were much more likely to have adopted these initiatives compared with the others in our sample group. The implications are clear.
A call to action

The days of foreign multinationals in China focusing solely on growth are disappearing fast. Instead, executives now have a mandate for “profitable growth”, placing huge pressure on local leadership teams. To achieve this goal, five lessons emerge from our survey:

► Leading companies are adopting strategic, cross-functional approaches to raise productivity. Whereas in the past the focus was on growing the “top line”, strategic planning is being rebalanced to give more weight to productivity goals such as targeting customers more effectively and reducing inputs per unit of revenue.

► As China becomes more important to foreign multinationals, leading companies are working to ensure that increased decision-making power is given to their China leadership teams, balanced by a rigorous approach to risk, controls, and governance. Significant transformation needs to be made to business and operating models for foreign multinationals to capture fast growing domestic consumption.

► Proactive and successfully executed cost management programs are essential. This means aggressively managing costs across the organization, but also making bold investments to upgrade operations. Managers in China are often choosing to initiate these programs themselves, to get ahead of cost cutting directives from headquarters.

► When designing and implementing IT systems, leading companies need to balance the importance of globally consistent processes with local needs, then work to improve the level of compliance. ERP, business analytics, and customer relationship management tools are powerful enablers to improve operational efficiency, target customers, and better predict outcomes and risks.

► As wages continue to increase, companies are transforming process flows that impact labor productivity and doing more to incentivize and motivate their staff. In a tougher business environment, building both effective management capability, and training and development programs will be even more important to ensure the organization is focused on productivity.

In our view, for many foreign multinationals in China, adopting these and other initiatives to proactively and urgently improve productivity will be key to their future success.
Foreign multinationals have had a good run in the past decade in China, buoyed by world-beating productivity gains, an expanding labor force, and rising inflows of investment. Demand has been supported by domestic investment in industrial capacity and infrastructure and – until the global financial crisis – steady growth in the world’s major markets.

Despite tougher conditions in the last few years, most foreign multinationals in China remain profitable. 97 percent of foreign multinationals that responded to our survey reported positive profitability (Figure 1). Almost half of our respondents reported EBITDA of over 10 percent, compared with only 3 percent that reported negative profitability.

Breaking the data down further, services industries in aggregate, seem to be most profitable (see Figure 2), suggesting that the shift toward a more services-driven growth model has already begun to happen. 14 percent of respondents in services sectors reported EBITDA of over 20 percent, compared with only 7 percent in industrial sectors.

**Figure 1**

For the last full financial year, what was your company’s approximate earnings before interest, taxes, depreciation and amortization (EBITDA) margin in China?

<table>
<thead>
<tr>
<th>Company’s number of years in China</th>
<th>Overall</th>
<th>Less than 5 years</th>
<th>5 - 10 years</th>
<th>More than 10 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBITDA margin</td>
<td>3%</td>
<td>49%</td>
<td>39%</td>
<td>9%</td>
</tr>
</tbody>
</table>

**Source:** Ernst & Young; Economist Intelligence Unit.

Despite foreign multinationals’ strong record on profitability, the future looks less certain. There is a growing awareness that the times are changing, and potentially changing very fast.

Time in China was a key determinant of profitability. 52 percent of companies with over 10 years experience in China reported EBITDA of over 10 percent compared with 37 percent of companies that had been in the country for less than 5 years. The survey data seems to bear out the old saying that “China is a long game”.

**Figure 2**

For the last full financial year, what was your company’s approximate earnings before interest, taxes, depreciation and amortization (EBITDA) margin in China?

<table>
<thead>
<tr>
<th>Industrial</th>
<th>Overall</th>
<th>Less than 10 percent</th>
<th>10 to 20 percent</th>
<th>Over 20 percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage</td>
<td>3%</td>
<td>53%</td>
<td>38%</td>
<td>7%</td>
</tr>
</tbody>
</table>

**Source:** Ernst & Young; Economist Intelligence Unit.
As margins come under pressure and demand is redistributed, the old paradigm of doing business in China is going to change, perhaps radically.

Manufacturing, long the mainstay of foreign multinationals in China, has been hit the hardest. 59 percent of our respondents in this sector reported decreasing EBITDA margins compared with two years ago (Figure 3). Other sectors that have not done so well include information technology, professional services, and chemicals, suggesting a relative decline in overall corporate demand and in industrial activity.

Some sectors, on the other hand, look to have benefited from increasing Chinese consumerism. Retailing is a strong performer, with 53 percent of companies reporting increased margins, followed closely by consumer goods with 50 percent.

**Figure 3**

How does your company’s current EBITDA margin in China compare to two years ago?

<table>
<thead>
<tr>
<th>Sector</th>
<th>The margin has decreased</th>
<th>The margin has stayed roughly the same</th>
<th>The margin has increased</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>59%</td>
<td>24%</td>
<td>18%</td>
</tr>
<tr>
<td>Information technology</td>
<td>50%</td>
<td>27%</td>
<td>23%</td>
</tr>
<tr>
<td>Professional services</td>
<td>45%</td>
<td>36%</td>
<td>18%</td>
</tr>
<tr>
<td>Chemicals</td>
<td>40%</td>
<td>28%</td>
<td>32%</td>
</tr>
<tr>
<td>Retailing</td>
<td>33%</td>
<td>13%</td>
<td>53%</td>
</tr>
<tr>
<td>Consumer goods</td>
<td>30%</td>
<td>20%</td>
<td>50%</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>27%</td>
<td>33%</td>
<td>40%</td>
</tr>
<tr>
<td>Healthcare, pharmaceuticals</td>
<td>20%</td>
<td>45%</td>
<td>35%</td>
</tr>
<tr>
<td>and biotechnology</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Overall</td>
<td>35%</td>
<td>29%</td>
<td>36%</td>
</tr>
</tbody>
</table>

Source: Ernst & Young; Economist Intelligence Unit.
What’s different now?

The old engines of growth in China are starting to run out of steam. A gloomy global macroeconomic outlook, particularly for Europe and the United States, has already had considerable impact on the Chinese economy. China’s export growth to key markets in Asia, Europe, and North America has slowed significantly since 2010 (Figure 4). Although the situation now is nowhere near as bad as 2008-09, when exports collapsed, the current slowdown is likely to have longer-lasting effects for companies’ revenues.

At the same time, China’s productivity growth has also fallen (see Figure 5). Earlier rounds of market liberalization and privatization have largely run their course, and the mass reallocation of labor from low productivity agriculture to higher productivity manufacturing is coming to an end.

Growth in the size of the labor force has also fallen since 2005, and demographers forecast that the size of China’s workforce will begin a long-term decline from 2015. Worryingly, capital has played a progressively larger role in the Chinese economy. The efficiency with which that capital is used has diminished as capital investment has expanded in recent years. This has had the effect of “crowding out” productivity growth.

The experience of other East Asian economies demonstrates that capital-driven growth is not sustainable. Very rapid growth in capital stock without productivity growth leads to a decline in capital efficiency, and eventually inhibits growth. Raising productivity is now therefore critical for China’s economic future.
China’s leaders recognize the importance of productivity to China’s economic future. A key objective of the 12th five year plan (2011-2015) is shifting the growth pattern toward consumption-led, efficiency-focused growth. Companies can expect that industrial policy will give incentives to raise productivity, and increasingly penalize unproductive and wasteful companies.

The government is expected to implement further reforms to input factor (labor, capital, natural resources) markets in line with the current five-year plan’s binding targets to lift average incomes and increase resource efficiency (Figure 6). This, in turn, is likely to make cost inflation a permanent feature in a slowing economy, something that most companies in China have yet to experience.

**Figure 6**

### 12th five-year plan targets

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP growth</td>
<td>10.3%</td>
<td>7.0%</td>
</tr>
<tr>
<td>Urban disposable income (CNY)</td>
<td>19,109</td>
<td>26,810</td>
</tr>
<tr>
<td>Energy consumption per GDP (TCE/CNY millions)</td>
<td>80.9</td>
<td>68.0</td>
</tr>
<tr>
<td>R&amp;D as percentage of GDP</td>
<td>1.75%</td>
<td>2.20%</td>
</tr>
<tr>
<td>Service sector value-added output as percentage of GDP</td>
<td>43.0%</td>
<td>47.0%</td>
</tr>
<tr>
<td>Minimum wage standard (CNY)</td>
<td>870</td>
<td>1,603</td>
</tr>
<tr>
<td>CO₂ emissions (billion tonnes)</td>
<td>8.33</td>
<td>6.91</td>
</tr>
<tr>
<td>Strategic emerging industries as percentage of GDP</td>
<td>3.0%</td>
<td>8.0%</td>
</tr>
</tbody>
</table>

#### Growth
- Lower growth, but more efficient and sustainable
- Shift away from capital-intensive industrial production growth

#### Labor
- Raise urban disposable income
- Gradual increase in social welfare benefits and minimum wage
- Pressure to boost labor productivity

#### Resources
- Increase carbon and energy efficiency
- Reduce water and land use per unit of GDP
- Pressure to boost resource efficiency

#### Innovation
- Movement up the value chain for the entire economy
- Supported by an increase in R&D spending
- Incentives for innovation

*Source: National Bureau of Statistics; Ministry of Human Resources and Social Security; Xinhua; Reuters; Ernst & Young analysis.*
When it comes to raising its productivity, however, China still has a long way to go. Our construction of the world technological frontier (Figure 7) shows China’s productivity relative to 36 comparable economies. While China’s labor productivity has improved a lot over the past decade, it is still far from the productivity performance of developed economies, and even certain developing economies.

For foreign multinationals, this presents both risks and opportunities. Declining productivity growth has worrying implications for the sustainability of profits, of course. What is clear, though, given China’s distance from the technological frontier, that foreign multinationals still have an important role to play in driving up productivity in China through the import of advanced technologies and managerial methods.

Figure 7

Source: World Bank, Ernst & Young analysis.
Feeling the pulse of foreign multinationals

The importance of productivity

Foreign multinationals are acutely aware that in this changing business environment, raising productivity is a strategic imperative in order to maintain profitable growth.

The strength of the responses we received from foreign multinationals show this quite starkly. Executives and managers across industry sectors overwhelmingly acknowledge the increasing significance of productivity (Figure 8).

Nine out of ten respondents said that the importance of improving productivity has increased in the past two years. Further, 84 percent say productivity will be either “extremely” or “very” important to business performance in the next 1-3 years.

Figure 8
Has the importance of improving productivity increased in the past two years?

- Yes: 91%
- No: 9%

How important is increasing productivity to your company’s performance in the next 1-3 years?

- Extremely important: 26%
- Very important: 58%
- A little important: 16%
- Extremely important: 0.5%
- Not at all important: 0%

Source: Ernst & Young; Economist Intelligence Unit.

A focus on productive growth

At the same time, companies are also very focused on growing revenue in what is still a rapid-growth market. When asked what areas could have the most impact on company profitability in the next 24 months, 47 percent of respondents identified the introduction of new and better products/services (Figure 9).

Increased productivity also featured prominently (35 percent), followed by restructuring of current operations (33 percent), and the hiring of new talent/management of existing talent (29 percent).

Figure 9
In your opinion, what are the areas that could have the most impact on your company’s productivity in the next 24 months?

- Introduction of new and better products/services: 47%
- Increased productivity: 35%
- Restructuring of current operations: 33%
- Hiring of new talent/management of existing talent: 29%
- Increased focus on research and development: 24%
- More sophisticated pricing management: 23%
- Better use of outsourcing/subcontracting: 21%
- Geographic expansion into new/more profitable markets: 18%
- Exit from certain less attractive markets: 16%
- Undertaking mergers and acquisitions: 8%

Respondents were asked to choose up to three.

“Productive growth” looks to be the name of the new game for foreign multinationals – capturing growth segments in the China market with targeted products and services whilst reducing inputs for every dollar of revenue generated.
Companies are already feeling the pressure

The current environment is characterized by rising cost pressure, intensifying competition, and continuing volatility in global markets. When asked what factors most impacted their companies’ profitability (Figure 10), half of respondents identified labor costs as the leading factor. Other important factors included exchange rate movements (32 percent), commodity costs, and competition from domestic companies (both 27 percent).

**Figure 10**

What drivers are having the most impact on your company’s overall cost structure and profitability?

<table>
<thead>
<tr>
<th>Cost Factor</th>
<th>Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor costs</td>
<td>50%</td>
</tr>
<tr>
<td>Exchange rate movements</td>
<td>32%</td>
</tr>
<tr>
<td>Commodity costs</td>
<td>27%</td>
</tr>
<tr>
<td>Competition from domestic companies</td>
<td>27%</td>
</tr>
<tr>
<td>Cost of capital</td>
<td>22%</td>
</tr>
<tr>
<td>Competition from foreign companies</td>
<td>22%</td>
</tr>
<tr>
<td>Energy costs</td>
<td>22%</td>
</tr>
<tr>
<td>Regulatory costs</td>
<td>21%</td>
</tr>
<tr>
<td>Reduced demand</td>
<td>19%</td>
</tr>
<tr>
<td>Other, please specify</td>
<td>2%</td>
</tr>
</tbody>
</table>

Respondents were asked to choose up to three.

*Source: Ernst & Young; Economist Intelligence Unit.*

Foreign multinationals’ concerns about labor and commodity costs reflect what has been happening in the market. Both labor and commodity costs have increased substantially in the past five years (Figure 11). Labor costs have increased the fastest, with average wages doubling since the beginning of 2007. In the same period, the average price of commodities consumed by China increased by 51 percent, soft commodities rose 60 percent, metals rose 19 percent, and energy prices rose 77 percent.6

**Figure 11**

Weighted cost indices, China domestic (Jan 2007=100%)

<table>
<thead>
<tr>
<th>Cost Factor</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor</td>
<td>100%</td>
<td>77%</td>
<td>19%</td>
<td>60%</td>
<td></td>
</tr>
<tr>
<td>Soft commodities</td>
<td>100%</td>
<td>77%</td>
<td>19%</td>
<td>60%</td>
<td></td>
</tr>
<tr>
<td>Metals</td>
<td>100%</td>
<td>77%</td>
<td>19%</td>
<td>60%</td>
<td></td>
</tr>
<tr>
<td>Energy</td>
<td>100%</td>
<td>77%</td>
<td>19%</td>
<td>60%</td>
<td></td>
</tr>
</tbody>
</table>

We expect these cost increases to continue. The roll out of mandatory employer social welfare contributions, accompanied by government targets to increase the minimum wage, rising expectations from employees, and the increasing cost of living, will undoubtedly put continuous upward pressure on labor costs.

The price of commodities, generally lower in China than globally, will also continue to rise relative to international prices as the Chinese government removes administrative controls. Commodities prices are likely to remain volatile, and will be subject to spikes and sharp corrections depending on global conditions.

Volatility in global markets itself also imposes a significant cost upon companies, which must hedge against uncertain movements in prices. These costs especially impact firms that source components and raw materials internationally.

**Nowhere to pass on costs**

Our respondents were united in telling us that there was little scope for customers to absorb these expected cost increases (Figure 12). 85 percent of our respondents expect they can pass on a third or less of rising costs to the final customer, with half of these companies expecting to pass on none at all.

**Figure 12**

What percentage of rising costs do you expect your company to be able to pass on to your customers?

- None or very little: 43%
- Less than 33 percent: 42%
- Between 33 to 66 percent: 12%
- More than 66 percent: 3%
- All: 1%

*Source: Ernst & Young; Economist Intelligence Unit.*

Significantly, remarkably little variation existed between industries in terms of the extent to which companies expected to be able to pass on rising costs, suggesting that this is a pervasive issue.
To understand this phenomenon, we used national statistics to compare input prices and output prices (factory gate prices) for the industrial sector. Our findings confirmed what our survey respondents told us.7

In manufacturing, for example, input prices have consistently risen faster than output prices. The gap between the two has increased from an average of 4.5 percent in 2009 to 10.0 percent in 2011 (Figure 13). This reflects both the rising cost of commodities and the problem of overcapacity, whereby production capacity has grown faster than consumption. As revenue growth now declines, companies are cutting prices, resulting in further pressure on profit margins.

**Figure 13**

Input/output price ratio growth, manufacturing

In the tougher environment that is emerging, most companies are faced with a difficult choice, either protect profit margins and concede market share to competitors or protect market share at the expense of margins.
China is the fastest growing market for McDonald's outside the United States. In 2009, after nineteenth years in the country, the world's largest quick service restaurant opened its 1000th restaurant in China. Based on the accelerated growth since, it will only take another four years for the company to open its next 1,000 restaurants.

The cost of food, utilities, and occupancy all have an impact on margins in the restaurant industry, but it is the cost of labor which has emerged as the leading consideration. McDonald's restaurant staff have seen their real wages rise steadily throughout the past decade, culminating in double-digit increases the past couple of years.

As Dan March, CFO of McDonald's China says, “whilst the hourly wage is still not that high compared with other areas of the world, it’s the year-on-year compounding growth in wages which becomes a big challenge.”

Aside from costs, McDonald's also monitors the external environment to gauge customers’ expectations around level of service and menu price points. Like any other retailer, food service companies like McDonald's adjust their prices as a result of rising costs but only up to a point which the consumer can affordably accept.

For McDonald’s, the balance between rising costs and maintaining standards of customer service lies in productivity improvements. Mr March explains, “a key driver of success for us has been our ability to run our restaurants more efficiently, by continuing to seek ways to speed up service while not compromising the consumer experience”.

Case study: McDonald’s
Balancing rising costs and service standards
Concern about operating model alignment

We found broad-based concerns among foreign multinationals about their operating models (Figure 14). Almost two thirds of respondents agreed that their company’s operating model impaired their competitiveness. The majority of respondents also said that their operating model did not allow them to keep pace with rapid growth, and that their companies needed to overhaul their organizational structure in China to tap new opportunities.

In the current environment, productivity is about more than reducing costs. It should be understood in its widest sense: improving processes and organization within a business, targeting customers and delivering products and services more effectively, and deploying resources to the most profitable opportunities.

All of this requires a competitive operating model tailored to the unique features of the domestic environment in China.

**Figure 14**

Please indicate your level of agreement with the following statements.

- Our company’s current operating model impairs our competitiveness.
  - Strongly agree: 36%
  - Agree: 28%
  - Neither agree or disagree: 21%
  - Disagree: 14%
  - Strongly disagree: 5%

- Our company’s operating model does not allow us to keep pace with rapid growth.
  - Strongly agree: 23%
  - Agree: 37%
  - Neither agree or disagree: 21%
  - Disagree: 16%
  - Strongly disagree: 4%

- We need to overhaul our organizational structure in China to tap new opportunities.
  - Strongly agree: 19%
  - Agree: 43%
  - Neither agree or disagree: 29%
  - Disagree: 8%
  - Strongly disagree: 2%

Source: Ernst & Young; Economist Intelligence Unit.
More productivity gains will come from the front office

When respondents were invited to cite the two functional areas that offered the most scope for productivity improvements in their organizations (Figure 15), the two top choices were operations (45 percent) and marketing and sales (37 percent). These two areas are also typically the biggest in terms of cost, where productivity initiatives usually have the biggest impact.

The importance of marketing and sales is telling, showing that companies are increasingly focused on improving sales effectiveness in China to become more productive. We expect that had we asked this same question a few years ago, the result would have been much lower.

Respondents were asked to choose up to two.

*Source: Ernst & Young; Economist Intelligence Unit.*

Functions that figured less prominently included research and development (23 percent), finance (21 percent), and IT (16 percent). Many foreign multinationals have already achieved gains from back office initiatives, and it seems that they are now moving the focus of their performance improvement programs to the front office.
Established in Guangzhou in 1906, Li & Fung is recognized as a world leader in consumer goods design, development, sourcing and distribution. The company has built a reputation for process efficiency in the high-volume, low margin trading business. In this more mature market, raising productivity is not a one-off event. Li & Fung has had to raise its productivity ceiling year after year.

The company has made full use of the shared service center model, centralizing finance, human resources, and IT functions to reduce back office costs per unit of output. For instance, LF Asia has many financial support services concentrated in Nanjing, where labor costs are relatively cheaper and the workforce is more stable than first tier cities like Beijing or Shanghai. LF Asia has also outsourced certain functions, such as logistics.

“For the next few years, technology is what we will focus on,” says Herman So, Executive Vice President of Finance at LF Asia, “because outsourcing and shared services has been a model which we’ve been using for many years.”

In terms of raising productivity, the center of gravity will move from back office to sales and marketing. The company has, for example, introduced tablet computers to the company’s sales force to increase their effectiveness and efficiency when away from the office. Mr So expects to do more business over the internet, both for its obvious cost advantages, and to access the vast online population in China.

In addition, LF Asia has started experimenting with selling account services to its existing customers - services such as importation support, billing, and invoicing. By leveraging its existing organizational infrastructure, the company drives economies of scale through greater volume.
A failure to capitalize on information technology

Given the potential, a surprisingly low number of foreign multinationals have adopted IT initiatives to drive productivity (Figure 16).

More needs to be done to capitalize on IT investments already made in core business systems such as enterprise resource planning (ERP). Our experience has been that companies often make one-off investments in IT without making other changes in their business to capitalize on those investments. For instance, some companies have spent millions of dollars on global implementation of ERP tools that simply doesn’t match the unique operating practices and local requirements of the Chinese market, or are not fully utilized.

The time appears right for companies to take advantage of new technology enablers to improve productivity in a much more strategic way. Mobile internet and e-commerce are already changing the retail industry. With local government support and serious industry investment, cloud computing in China is also moving to the adoption stage. Data analytics offers the promise of harnessing data to reduce costs, improve performance, and manage risk.

Figure 16

Has your company adopted any of the following methods to increase productivity?

<table>
<thead>
<tr>
<th>Method</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Workforce mobility tools</td>
<td>40%</td>
</tr>
<tr>
<td>CRM systems</td>
<td>39%</td>
</tr>
<tr>
<td>Cloud computing services</td>
<td>37%</td>
</tr>
<tr>
<td>Data center capacity</td>
<td>33%</td>
</tr>
<tr>
<td>Supply chain management systems</td>
<td>30%</td>
</tr>
<tr>
<td>Enterprise resource planning</td>
<td>30%</td>
</tr>
<tr>
<td>Staff collaboration tools</td>
<td>23%</td>
</tr>
<tr>
<td>Data analytics</td>
<td>15%</td>
</tr>
</tbody>
</table>

Source: Ernst & Young; Economist Intelligence Unit.
Cisco Systems is the world's largest maker of networking equipment. The industry is highly globalized, with significant research and development, software coding, and manufacturing in China. Despite pressure in recent years from both low cost manufacturers and innovative start-ups, the company has sustained its position as the leading provider of enterprise network solutions.

Michael Foy, Finance Director of Cisco China says “Cisco is in the business of selling productivity tools, but we’re also a primary user of the same technology - often before it goes to market.” As a global organization, Cisco has created ‘communities of practice’ across geographical and functional units to share resources more effectively. The company employs common productivity metrics globally, and tries to limit administrative complexity - for example by simplifying its legal entity structure.

TelePresence is a collaboration platform developed by Cisco to help geographically dispersed organizations overcome physical barriers and cut down on travelling costs. When it was rolled out internally, Cisco reported savings in excess of USD100 million, including a saving of two hours per week per employee. Mr Foy also sees great potential in cloud computing to raise utilization rates while slashing IT costs by 20 percent or more.

These technologies have applications for all organizations which share sophisticated information and have been implemented successfully by a number of Chinese universities and hospitals.
Barriers to improving productivity

Every organization faces barriers to improving productivity, but not every manager takes the time to systematically assess what may inhibit the success of productivity programs in their organization.

Our survey results point to the importance of human resources and governance issues when it comes to achieving long-term improvements in organizational productivity.

When asked what barriers they faced to improving productivity, almost a third of our respondents highlighted a shortage of labor or management talent (Figure 17). Other noted obstacles were an inappropriate business model (29 percent), unclear accountability (25 percent), lack of communication between management and the workforce (25 percent), and overly centralized control by home country headquarters (23 percent).

Figure 17

What barriers are most likely to hamper your organization’s efforts to improve productivity?

<table>
<thead>
<tr>
<th>Barriers</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shortage of labor or management talent</td>
<td>30%</td>
</tr>
<tr>
<td>Inappropriate business model</td>
<td>29%</td>
</tr>
<tr>
<td>Unclear accountability</td>
<td>25%</td>
</tr>
<tr>
<td>Lack of communication between management and workforce</td>
<td>25%</td>
</tr>
<tr>
<td>Overly centralized control by home country headquarters</td>
<td>23%</td>
</tr>
<tr>
<td>Excessive government regulation</td>
<td>20%</td>
</tr>
<tr>
<td>Lack of access to up-to-date productivity information</td>
<td>15%</td>
</tr>
<tr>
<td>Incompatible information systems</td>
<td>14%</td>
</tr>
<tr>
<td>Other</td>
<td>3%</td>
</tr>
</tbody>
</table>

Respondents were asked to choose up to three.

Source: Ernst & Young; Economist Intelligence Unit.
We analyzed what high performing companies were doing to raise productivity. We define this group as companies that, according to respondents, achieved EBITDA margin of over 10 percent in the past financial year. We asked our respondents to choose from a menu of 50 potential productivity improvement tools and approaches which ones their organizations had taken.

Out of that 50, the survey found that the five top productivity initiatives were (1) business unit strategy reviews, (2) improved people development and management, (3) cost reduction programs, (4) enterprise resource planning, and (5) greater autonomy for country management (Figure 18).

Interestingly, high performers were significantly more likely to pursue these initiatives than the others. On average, high performing companies were 14.2 percent more likely to pursue the top five productivity initiatives than the others in our survey. The conclusions from this are, we believe, self evident for those companies looking to generate industry-leading profitability.

**Figure 18**

Has your company adopted any of the following methods to increase productivity?

- **Business unit strategy reviews**: 32%
- **Improved people development and management**: 39%
- **Cost reduction programs**: 29%
- **Enterprise resource planning tools**: 24%
- **Greater autonomy for regional or country management from global/regional headquarters**: 18%

<table>
<thead>
<tr>
<th>Initiative</th>
<th>High performers</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business unit strategy reviews</td>
<td>49%</td>
<td>32%</td>
</tr>
<tr>
<td>Improved people development and management</td>
<td>48%</td>
<td>39%</td>
</tr>
<tr>
<td>Cost reduction programs</td>
<td>45%</td>
<td>29%</td>
</tr>
<tr>
<td>Enterprise resource planning tools</td>
<td>38%</td>
<td>24%</td>
</tr>
<tr>
<td>Greater autonomy for regional or country management from global/regional headquarters</td>
<td>33%</td>
<td>18%</td>
</tr>
</tbody>
</table>

*Source: Ernst & Young; Economist Intelligence Unit.*
Case study: Ford

Raising productivity on many fronts

The Ford Motor Company has clearly signaled its intentions with recent announcements of nine new plants in Asia Pacific and Africa. Six of the plants will be in China, where current production volume is estimated to double by 2015. John Lawler, CFO of Ford Asia Pacific Africa stresses the importance of managing cost structures relative to growth plans: “You have to look at every cost element, pay attention to every line on the income statement.”

Ford’s plants in China aim for global best practice. The company continues to invest in training and development to accelerate labor productivity in its relatively young workforce. Within each business unit and region, Ford assesses performance against its peers around the world.

Globally consolidated functions work across geographies in a matrix structure. Mr Lawler says, “You need to balance the global capacity to share assets, ideas, and technologies, with an in-depth knowledge of local business and employee practices.”

Within the Chinese market, Ford is growing market share to fully leverage economies of scale. The company intends to become a full-line automotive manufacturer in China, with a full portfolio of products to satisfy all customers. Its ‘15 by 15’ plan aims to have 15 automotive models in China by 2015.
This year’s survey paints a complex picture of the Chinese business environment, one that calls for a fundamentally different approach from foreign multinationals. The days of foreign multinationals focusing solely on growth are disappearing fast.

By combining our analysis of what high performing companies in our survey were doing with our experience consulting with and advising executives and senior managers in China, five key lessons emerge for foreign multinationals on how to achieve the goal of “profitable growth”.

1. Productivity as a strategic imperative

In what is still a rapid-growth market, companies are focusing on both aggressively growing revenue and improving profitability. Whereas in the past the focus was primarily “top line”, strategic planning is being rebalanced to give more weight to productivity goals. Leading companies are adopting cross-functional approaches to raise productivity, with managers taking a broad view of possible areas for productivity improvement.

In our work with clients we are observing two broad approaches. Firstly, strategies are becoming more focused. A strategy lacking clarity or focus is a major source of complexity and wasted effort. In China, with all the emerging market complexities, this is certainly the case. For example, strategies that target customers more effectively help grow volume and revenue, and raises productivity. Resources are then freed for other revenue generating activities. As scale and market share increase, companies acquire long-term competitive advantages in key business capabilities such as distribution and purchasing power.

Second, companies are prioritizing operational improvement initiatives that drive productivity improvements, and allocating resources accordingly. We cover these in the following paragraphs.
2. Operating model alignment

As China becomes more important to foreign multinationals, the balance between global control and local autonomy is changing. For the past ten years or so some multinational companies have been localizing their China operations to be more responsive to local market conditions, to tap into the emerging mass market in China (success in which requires very different business models), and to drive growth.

The results of our survey indicate high performing companies are now recognizing that these localization efforts also improve productivity. Companies that give more decision-making power to their in-country managers allow faster decision making than those maintaining decision control globally. Local autonomy, however, needs to be balanced with a strong risk, controls, and governance framework, so that decisions taken locally happen within agreed parameters.

Our survey also found that high performing companies are pursuing opportunities for active mergers and acquisition activities in China to increase local market presence. For example, a multinational may consider acquiring a local manufacturer to compete in the low-end market.

Most sectors are also exploring the opportunity for further collaboration and partnership. This allows assets to be shared and risks to be mitigated. Partnering with suppliers on productivity improvement goals, for instance, is a sustainable approach that can enhance key relationships and benefit the bottom line.

3. Proactive cost management

While cost reduction approaches are commonly used in mature markets, until recently they have been less of a priority for foreign multinationals in China. In 2008, with their global organizations under pressure, it was common to see companies mandate cost reduction measures such as travel and headcount freezes on a global basis. For China-based executive teams focused on growth this was seen as a blunt instrument. So what’s changed now? As our survey results indicate, in-country management are now prioritizing locally initiated cost management programs. This enables them not only to deliver on bottom line commitments in a slowing market but also to stay ahead of global initiatives and in so doing retain more control.

As the outsourcing industry has started to mature in China, many firms have optimized their back office through shared service centers for specific non-revenue producing activities. Processes are streamlined and non-core functions outsourced, while making sure that core information and expertise is retained.

At the same time, the capability to strategically control and reduce costs is still developing in China. As companies’ capabilities grow, approaches to cost management will evolve. More sophisticated techniques will include identification of companies’ cost drivers and use of analytics techniques to target cost areas. Initiatives will move beyond employee expense management and the back office to include process efficiency improvements in sales, marketing, and manufacturing. Cost reduction may be the short-term goal, but increasing the efficiency and flexibility of core business processes should be the longer-term objective.
4. Driving business value from information technology

IT can be a powerful enabler of productivity. For foreign multinationals, China is now often included in the early releases of new IT systems being deployed globally, but companies can – and should – do more to capitalize on these investments. When designing and implementing systems, leading companies balance the need for globally consistent processes with local needs, then work to improve the level of compliance, ensuring workarounds are minimized and all users are using the system as intended.

ERP is a good example – our survey showed that the use of ERP tools for productivity purposes was one of the methods that differentiated high performing companies from the rest.

Many foreign multinationals in China have been the beneficiaries of global ERP systems often rolled out as part of a global or regional program. The initial period following a system implementation can be challenging as adjustments to work patterns are made and new technology is learned. These survey results indicate that high performing companies that have overcome these challenges are now seeing significant productivity benefits from their use. For those companies still struggling with bedding down the technology from a current or recent implementation, the lesson is clear: implement the system as quickly as practical and focus on the productivity (and other business) benefits the system was originally intended to deliver.

Large amounts of data are now being generated by the IT systems currently in place. Leading companies are leveraging this data through the use of business analytics tools to improve their operational efficiency, more closely target customers, and better predict outcomes and risks.

5. Enhancing people development

As labor costs continue to soar, leading companies are doing more to boost the productivity of their employees. This can mean introducing innovative ways to incentivize staff and transforming process flows so as to reduce physical and technical barriers between employees. For the foreseeable future, it’s likely that demand for skilled workers and managers will outstrip supply, so foreign multinationals must get more sophisticated in terms of their workforce planning and development.

In a tougher business environment, building effective management capability will be even more important. Leading companies are balancing general management skills with sales ability. Effective managers will need to be able to manage every aspect of the P&L, from forecasting emerging problems in the business to understanding what levers to pull to deliver results in a slowing economy.

Training and development will of course continue to be important. The focus of training programs will include a greater emphasis on productivity topics such as reengineering business processes, reducing costs, and improving sales effectiveness. Training should ideally happen as productivity initiatives occur so that staff benefit from on-the-job training.
Questions for management

► Do the key messages in this paper ring true for you and your business?
► If so, how acute are the current pressures to raise productivity?
► How well are you doing against industry and internal peers?
► Do you know how the major drivers of margin are trending in your industry?
► Have you put in place a program that will boost productivity and ensure the continued success of your business?
► Does your company have the governance structures in place to enable productivity improvement?
► Are your China operations sufficiently responsive to local market conditions?
► Have you made moves to proactively manage costs?
► Have you started to think about the longer term operational improvements that can be made to increase efficiency of core business processes?
► Has your company fully capitalized on investments in IT?
► Does your company have an effective people development plan in place to meet the new challenges of the business environment in China?
### Survey respondent demographics

<table>
<thead>
<tr>
<th>Global revenues</th>
<th>Headquarters by country</th>
<th>Industry</th>
<th>Job title</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$500 million or less</td>
<td></td>
<td>5%</td>
</tr>
<tr>
<td>17%</td>
<td>Europe</td>
<td>Chemicals</td>
<td>Board member</td>
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<tr>
<td></td>
<td>$500 million to $1 billion</td>
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<td>CEO</td>
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<tr>
<td>10%</td>
<td>North America</td>
<td>Manufacturing</td>
<td>Managing Director</td>
</tr>
<tr>
<td></td>
<td>$1 billion to $5 billion</td>
<td></td>
<td>CFO/Treasurer</td>
</tr>
<tr>
<td>24%</td>
<td>Asia Pacific</td>
<td>Information technology</td>
<td>Other C-level executive</td>
</tr>
<tr>
<td></td>
<td>Other</td>
<td>Consumer goods</td>
<td>Senior Vice President</td>
</tr>
<tr>
<td>11%</td>
<td></td>
<td>Healthcare, pharmaceuticals and biotechnology</td>
<td>Vice President</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Professional services</td>
<td>Director</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Retailing</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Telecommunications</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Construction and real estate</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Energy and natural resources</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Financial services</td>
<td></td>
</tr>
<tr>
<td>37%</td>
<td>Other</td>
<td>Other</td>
<td>Head of business unit</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Head of department</td>
</tr>
<tr>
<td>37%</td>
<td>Other</td>
<td></td>
<td></td>
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<td></td>
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</tr>
</tbody>
</table>

Rethinking profitable growth: the productivity imperative for foreign multinationals in China
Notes

1 *China’s productivity imperative* (Ernst & Young, September 2012).

2 *China’s productivity imperative*, p 6-7.

3 Growth in the number of migrant workers looking for work in the cities has slowed since 2005. Although there are 320 million laborers still in agriculture, perhaps as few as 20 million have the potential to migrate to the cities. See Cai Fang, “Demographic transition, demographic dividend, and Lewis turning point in China”, *China Economic Journal* (2010) 3(2), 107-19.


5 The technological frontier is ‘best practice’, representing the greatest output per worker possible at any given level of capital per worker. See *China’s productivity imperative*, p 8.

6 *China’s productivity imperative*, p 13-16.

7 *China’s productivity imperative*, p 17.
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<td><a href="mailto:sunny.chow@cn.ey.com">sunny.chow@cn.ey.com</a></td>
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</tbody>
</table>
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