

by

Ronald Haddock  
haddock\_ronald@bah.com

Frank Mizuno  
mizuno\_frank@bah.com

Paul Ngai  
ngai\_paul@bah.com

# Achieving Operational Excellence in China

Strategic Need and Practical Solutions

# Achieving Operational Excellence in China

## Strategic Need and Practical Solutions

While few people today really believe that China's economic development is still centered around legions of bicycle riders dutifully heading to assembly lines to churn out low-cost, lower-quality products for consumers in China or the West, many executives from both leading multinational companies (MNCs) and local businesses still act as though the low-cost model is a substitute for operational excellence. It appears that they have not yet taken notice of the crisis in operations that looms ahead.

Since the early 1990s, China's low labor costs and focus on lower-value-added products led to many companies turning their attention to getting capacity into place, lining up distribution, building a local team—and doing it all fast. In this rush to get products out for export as well as for potentially millions of consumers in China's vast domestic market, companies were able to exploit the labor cost gap between China and other markets and cut corners on production efficiency and operational excellence, including quality.

Now, however, the game is changing—and with it, the role of operations. Executives around the world have turned to China to solve the age-old problem of delivering growth and profits. So far it seems to be working: American Chamber of Commerce (AMCHAM) surveys over the past several years show continuing

upward trends in profitability, with 70 to 80 percent of MNCs in China realizing profits and, in many cases, enjoying higher profit margins than anywhere else in the world.

But too often, operations in China have not delivered the full margin potential that low-cost labor should make possible. In some cases, growth is being hamstrung by operations that were not designed to support the phenomenal growth rate that many industries in China are seeing, or the intensity of competition stemming from the continuing stream of investments in China from companies around the world and Chinese companies themselves.

### Addressing China's Changing Needs

To fulfill the needs of growing industries, the role of operations must extend beyond cost savings and address three key challenges: the labor productivity gap, poor asset productivity, and the increased importance of quality.

*Labor Productivity Gap.* Low cost is no longer enough. For years, companies have been shifting capacity to China to achieve proximity to customers and markets, including automotive and high-tech, while harnessing impressive labor-cost differentials. But those cost differentials, while still sizeable, are narrowing. Increasingly, foreign and Chinese executives alike lament that large cities like Shanghai and Shenzhen are no longer low cost. Instead, new low-cost regions and cities in China, such as the western provinces

and the northeast, as well other countries in Asia, including India, Vietnam, and Malaysia, are challenging China's traditional investment destinations and drawing new investments. This is because the traditional low labor costs of the coastal cities do not always offset disadvantages such as logistics costs, quality gaps, and lack of scale. For companies selling into Europe, Eastern Europe continues to be a viable alternative to China for many products. One industry that has demonstrated its understanding of the need to move beyond low costs alone is the electronics manufacturing services (EMS) sector. Many global EMS producers are expanding in the coastal cities of China even though costs are increasing; they are able to do so because they have found ways to participate in a very flexible, responsive global network. Their advantages include manufacturing operations that are regularly redesigned, even laid out again, as often as every six months to adapt to changing market needs. But companies like these are, all too often, the exception.

*Poor Asset Productivity.* More significant than labor productivity is poor asset productivity. In the past, under China's central planning system, the focus for economic growth was always on asset accumulation. Even today, most state-owned enterprises talk about how large their asset bases are as the key measure of their size and, implicitly, of their value. This, along with a "new is always better" mind-set, drove companies to overinvest. More recently, municipalities and local companies have rushed to get their share of investment, particularly FDI and bank loans. Because of the flood of capital driven by easy availability and an often-irrational process for allocation, especially by the banks, many of these investments have not generated acceptable returns. Companies need to be sensitive to the fact that there may actually be a lot of capital and unused resources and capabilities in their own companies, as well as in competitor companies, and that this might be a great opportunity to release hidden value or avoid unneeded investments.

The shift of China from a source market to a destination market, as entire value chains move to

the region, is also increasing the capital intensity of China-based activities. Global competition has arrived in China, with GE and other stalwarts bringing in world-class processes and capabilities that they can apply from their inception in the market. In increasingly capital-intensive industries, where a high-quality product is the minimum entry requirement, many of the more traditional local companies, as well as foreign companies that have not brought in their best capabilities, will be at risk.

This shift, from an environment in which low labor costs are the definitive advantage to one in which more sophisticated products are driven by knowledge, R&D, and innovation, has shifted the competitive mix from labor arbitrage to capital and white-collar productivity and value added. This requires the ability to manage multiple aspects of a business more effectively and to optimize trade-offs consistent with the evolving market and competitive context.

*Increased Importance of Quality.* With each passing day, there are more products to choose from in China and more suppliers to provide them. The market has become much more crowded over the past decade and being present in China is no longer enough. Products increasingly have to meet global standards for cost, quality, and service, even among Chinese consumers.

### **What Is Operational Excellence?**

The term *operational excellence* can be defined so broadly that the areas to which it applies vary greatly depending on a company's specific context. A company's business objectives determine the operational areas in which it needs to focus its quest for excellence. If a fast-food chain, for example, has determined that it can stand out from its competition by getting food to the counter quicker, then the key to operational excellence lies somewhere between the kitchen and the service counter and the supply chain of ingredients. If a company is trying to offer an outstanding experience to the customer, then it will want to focus its efforts on improving service. For auto components, the focus is increasingly on managing the costs of complexity, as the need for new products

and the resultant product and component proliferation replace costs derived from scale as the primary focus for operational excellence.

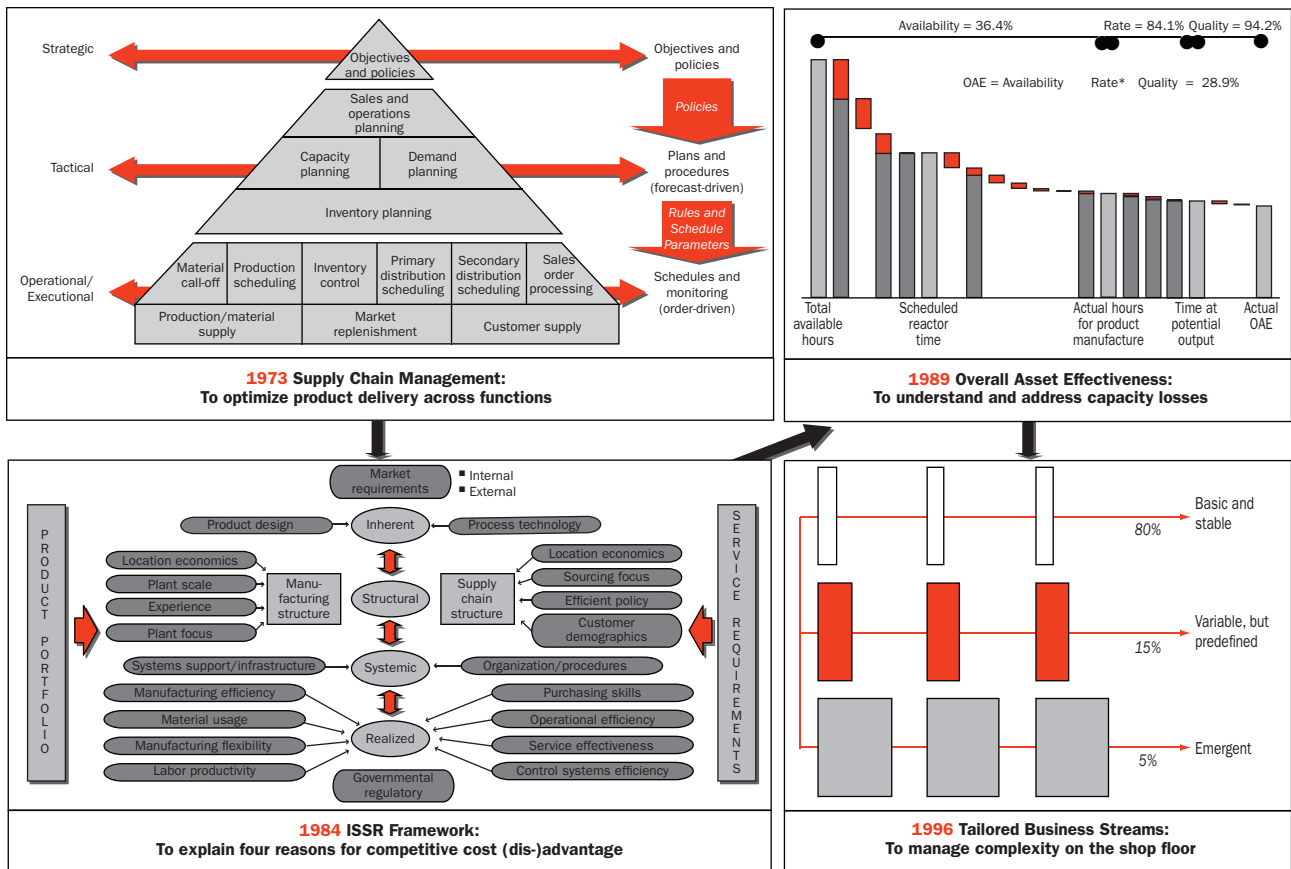
Operational excellence is a very straightforward concept: Put simply, it means doing things well across a company's operations—effectively across the entire supply chain—in a way that gives a company a competitive advantage in the marketplace.

Defining what to be excellent in and implementing excellence, however, are a bit more complicated. The range of tools and frameworks used to build operational excellence is broad, but an overview of these frameworks and their evolution in more developed markets can perhaps provide a glimpse of the likely operations challenges that companies

in China face today and will probably face in the foreseeable future (see Exhibit 1).

These operations frameworks, developed by Booz Allen Hamilton over the last 30-plus years, provide a macro view of the issues that companies have faced in developed and, increasingly, developing markets. In the 1970s, for examples, companies were focused on improving the performance of their supply chains. In the 1980s, downsizing and cost restructuring caused companies to look very scientifically at the nature of costs and their fundamental drivers. By the late 1980s, developed markets entered the era of asset management as they scrutinized the drivers of return on capital employed (ROCE). By the mid-1990s, as products and services proliferated, the focus switched to segmenting not only customers but the entire

**Exhibit 1**  
Operations-Centric Frameworks



Source: Booz Allen Hamilton

business streams that served them to more precisely match service and product propositions to the sensitive cost targets required to win customers. The new millennium has ushered in an era that Booz Allen calls “Smart Customization,” which takes this one step further.

Unfortunately, however, operational challenges are too complex to just plug in to a template.

Operations strategies will be very different from company to company, depending on the company’s circumstances, market context, and business performance objectives.

### **First Step: Defining Your Strategy**

A company’s first priority will be to define the operations capabilities it is trying to build and determine how these capabilities will create competitive advantage. We have built on the research of Harvard Business School’s Robert H. Hayes and David Upton, working their classic theory of operations-based strategy, which outlines “positioning,” “capacity,” and “internal learning” as the three primary strategy options. In adapting that theory for the China market, our experience points to three strategies that have proven successful in this market: positioning, execution, and internal learning.

*Positioning: Appeal to Different or Emerging Customer Needs.* Companies can choose to stand out from the pack by identifying a different combination of competitive dimensions than other players in the space and configuring their operations systems accordingly. For this strategy to work, of course, the factors that the company is focusing on must be valued by at least some of its customers; those factors should be something that its competitors haven’t been able to emphasize or have chosen not to; and the company must be able to be flexible in the fast-changing China market. Because companies opting for this strategy have chosen a different competitive priority than their peers, they will arguably be difficult to copy.

Starbucks offers an excellent example of how a positioning strategy can pay off. Even for middle-

class mainland Chinese, Starbucks coffee is a luxury. However, it turned out that the booming Chinese middle class is quite willing to pay a premium for the customer experience. Starbucks is adopting its highly acclaimed in-store training and people-development model in China to ensure that its brand positioning remains consistent with what customers have come to expect of Starbucks worldwide. Others have attempted to copy Starbucks’s business and operational model, yet none have been as successful in getting all of the operational details right to support a differentiated strategy to Starbucks.

*Execution: Being Better at the Same Game.* This strategy is the goal of every company that has tried to do the same thing as other players—but bigger, better, and faster. It simply involves executing a strategy more effectively than competitors and building enduring, advantaged capacity and capabilities, based on a process, system, or organizational structure. To succeed, companies will need to climb the learning curve quickly, aggressively building experience and developing their own unique organizational capabilities. Competitors will find success based on this strategy hard to replicate because this kind of capacity can be developed only with conscious effort, experience, and time.

Wal-Mart is one example of a company that has followed this strategy globally. Wal-Mart has world-class capabilities in its source-to-shelf management of products, providing suppliers with point-of-sale data in real time so they can manage their own production-to-ship cycle to optimize service levels and inventory costs. As 95 percent of merchandise in Wal-Mart China is already sourced locally and as Wal-Mart expands its network of stores in China, we can expect to see it deploy these world-class capabilities in China. Yet the cost/service trade-offs in China today are not the same as in more developed markets. As the pioneer in getting the balance right, we can anticipate that Wal-Mart will apply its vaunted capabilities in China to provide the differentiation that has been its hallmark.

Haier, which specializes in technology research, manufacturing, trading, and financial services, also

exemplifies this strategy. The company has always been known for insisting on high quality: In the past, the CEO was known to destroy products that did not meet with the company's exacting standards in order to make the point that quality would not be compromised at Haier. Due in part to this approach, in 2005, Haier was ranked first of China's Top 10 Global Brands by the *Financial Times*.

*Internal Learning: Developing an Organization's Ability to Learn.* Companies that take this approach to building capabilities in China recognize the need to develop locally and internally and accept that excellent operations capabilities can rarely be developed quickly or bought off-the-shelf. They implement motivational practices to cultivate internal innovation and don't confine their improvement activities to matching or copying other companies' best practices, seeking instead to develop their own. Competitors may be able to replicate these companies' equipment and operating policies, but they will find it difficult to emulate the best way to use them.

Procter & Gamble is one company that has internally developed a number of capabilities that will contribute to its success in the China market. Its sourcing practices, for example, are focused on helping its suppliers develop quality and reliability levels that support P&G products' premium positioning on store shelves. The company has already begun introducing these practices in China, working closely with packaging suppliers, for example, to ensure that P&G's products not only perform well, but are also packaged consistently with its brands' market positioning.

GE, meanwhile, is implementing its famous Six Sigma programs in China to ensure that the company not only achieves consistently high levels of quality, but embeds processes that take hold in the local organization to establish a foundation for future growth. GE's great strength has always been its ability to build processes and the leaders that drive them, which allows the company to create—or at least ride—successive waves of opportunity.

### **Either/Or: Accepting the Necessity of Trade-Offs**

Once the operations-based capabilities that will best support a company's business strategy have been determined, trade-offs need to be made across a number of complementary, and sometimes competing, priorities at the operations level (see Exhibit 2, page 6). Our work with one client, a leading U.S. technology and engineering-services company, demonstrates the choices that an MNC entering the China market must make as it attempts to grow quickly and profitably without sacrificing quality.

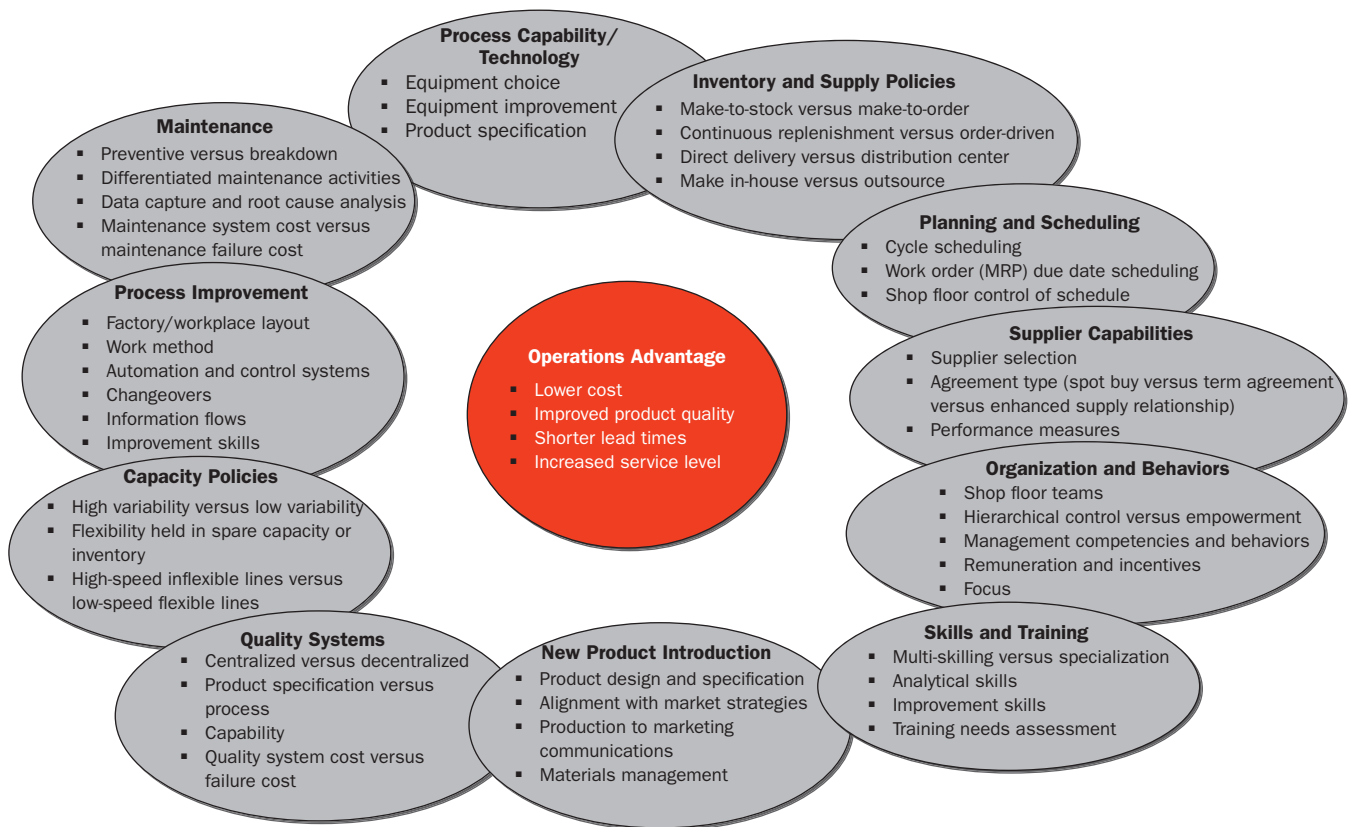
The company's China operation incorporated global best practices from the very beginning—from the implementation of standardized global processes to the rollout of best-in-class IT platforms and systems. Dozens of executives from the United States and Europe relocated to China both for the short term, to build up the operation, and for the long term.

However, despite a sound strategy and excellent initial support from corporate, the operation in China had not been excellent. Because the company underestimated the time frame for developing the required capabilities, migration of work to China happened before the operation was ready to handle it. As a result, quality and service levels suffered and customers were not happy. It became increasingly clear to the management team that operational excellence, such as improving overall asset productivity and enhancing the overall customer experience, should be on the very top of the management agenda.

The client invited Booz Allen to assist them in the pursuit of operational excellence—of implementing more efficient, faster, and more customer-centric operations. In order to achieve higher scalability and visibility, many companies tend to align key processes and organization structures with global best practices. However, identifying the optimal focus and level of standardization is not easy. For example, if the approach lacks flexibility, there is a high risk of failure; global best practices must be adapted from the relatively stagnant and stable economies of the United

**Exhibit 2**

## Making Trade-Offs Between Operations Priorities



Source: Booz Allen Hamilton

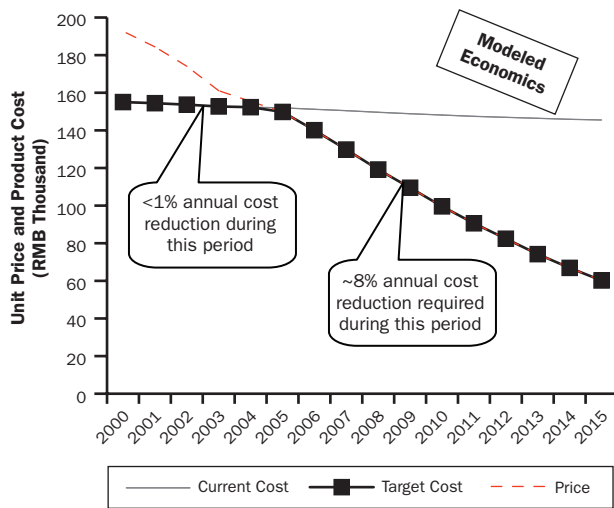
States or Western Europe for the high-growth and rapidly changing complexities of China or India.

Another key success factor in achieving operational excellence is the capability and the culture to drive continuous improvement. In today's increasingly global marketplace, a one-time optimization of processes and organization was not sufficient for the company to establish a sustainable competitive position. As a result, senior executives and key managers undertook executive coaching and workshops to learn how to dynamically manage capacity and growth while continuously optimizing the trade-offs on key attributes such as cost, quality, and service levels to customers. In addition, the company introduced performance metrics to institutionalize these fundamental changes in the culture of the operation.

Like other MNCs, this company learned that having a presence in China and being low cost is no longer sufficient to succeed. Though China still provides low-cost labor, companies need to take a more strategic view on their operations in China. By operating defensively, companies can achieve competitive parity at a minimum. By thinking strategically, companies can gain operational efficiency in China—a competitive advantage in the global market

### How Much Do Companies Operating in China Need to Cut Costs?

As companies vie to remain competitive, cost reduction will be a major priority for players in the Chinese market—but how far they will need to go in cost-cutting varies by company and by industry. A recent Booz Allen analysis of the automotive industry, for example,

**Exhibit 3****Cost Improvements in the Automotive Industry**

Source: Booz Allen Hamilton

indicated the need for annual decreases in unit costs of at least 8 percent per year for vehicle manufacturers operating in China, as prices continue to drop and the inevitable industry shakeout begins to take shape (see Exhibit 3).

Macro studies of the China market indicate a labor productivity gap that is higher than many of the more developed markets on the basis of units of output per unit of labor, which separates out the hourly cost of labor.

Yet how far a company has to reduce costs will continue to be highly situational, where understanding the sweet spot for targeted productivity will remain critical. The right answer will continue to be driven by capital-labor trade-offs, degree of competition, and the marginal rate of substitution for products produced in China versus production in other geographies, such as Eastern Europe.

Companies that have answered these questions invariably face the challenges of making the shift toward operational excellence. How have some companies managed to achieve operational excellence? We have seen MNCs and Chinese companies at different stages of operational excellence, with varying levels of operational challenges:

- *Apprentices*: These companies have limited, basic operations in place, with a need to change mind-sets, build skills, and fundamentally upgrade operational capabilities across the board, including operations strategy alignment, structure for operations, processes, and performance measures
- *Journeymen*: With some operational management capabilities in place, these companies need to upgrade and adapt best practices from abroad or build within, while conducting training and upgrading mind-sets
- *Role models*: Advanced, with global best practices from day one.

Among the companies that have successfully built Chinese operations that would qualify as operationally excellent, we find that the winners are particularly effective in striking the right balance across a number of operational dimensions:

- *Alignment of operations to business strategy*: Aligning behind a strategy that is realistic for China and that can be implemented in the local environment;
- *Focus*: Identifying the right operational levers that will deliver the results and are consistent with a company's evolutionary stage and the China context;
- *Building a culture of operational excellence*: Finding the right mix of people, with enough energetic people ready to improve the company's operational status;
- *Mix between global/standardized processes versus local best practices*: Getting the right balance of best practices based on the company's global expertise with local best practices based on cost-efficiency ensures profitability from inception, while incrementally introducing sometimes-costly investments and improvements when the business can afford them;
- *Realistic time frame to build up capabilities*: Recognizing and planning for a realistic timeline to get new operational capabilities in place by carefully selecting the right leaders, then building operationally excellent teams around them;

- *Performance measures adapted to local market context:* Business and individual performance measure that make sense in China, as opposed to one-size-fits-all measures developed for mature markets.

These companies are reaping the benefits of operational excellence. They recognize that simply showing up and taking advantage of low costs is no longer enough to succeed in China—and until more companies catch on, they will continue to enjoy a significant advantage over their competition.

---

## What Booz Allen Brings

Booz Allen Hamilton has been at the forefront of management consulting for businesses and governments for more than 90 years. Integrating the full range of consulting capabilities, Booz Allen is the one firm that helps clients solve their toughest problems, working by their side to help them achieve their missions. Booz Allen is committed to delivering results that endure.

With 17,000 employees on six continents, the firm generates annual sales that exceed \$3.5 billion. Booz Allen has been recognized as a consultant and an

employer of choice. In 2005 and in 2006, *Fortune* magazine named Booz Allen one of “The 100 Best Companies to Work For,” and for the past seven years, *Working Mother* has ranked the firm among its “100 Best Companies for Working Mothers.”

To learn more about the firm, visit the Booz Allen Web site at [www.boozallen.com](http://www.boozallen.com). To learn more about the best ideas in business, visit [www.strategy-business.com](http://www.strategy-business.com), the Web site for *strategy+business*, a quarterly journal sponsored by Booz Allen.

---

## Contact Information:

### BEIJING

**Frank Mizuno**  
[mizuno\\_frank@bah.com](mailto:mizuno_frank@bah.com)

### SHANGHAI

**Ronald Haddock**  
[haddock\\_ronald@bah.com](mailto:haddock_ronald@bah.com)

**Paul Ngai**  
[ngai\\_paul@bah.com](mailto:ngai_paul@bah.com)

## Worldwide Offices

<b>Abu Dhabi</b> Charles El-Hage 971-2-6-270882	<b>Brisbane</b> Tim Jackson 61-7-3230-6400	<b>Frankfurt</b> Rainer Bernnat 49-69-97167-0	<b>Madrid</b> Mercedes Mostajo 34-91-411-8450	<b>Philadelphia</b> Molly Finn 267-330-7900	<b>Stockholm</b> Jan-Olof Dahlén 46-8-506-190-00
<b>Amsterdam</b> Marco Kesteloo 31-20-504-1900	<b>Buenos Aires</b> Ivan De Souza 54-1-14-131-0400	<b>Helsinki</b> Timo Leino 358-9-61-54-600	<b>McLean, VA</b> Eric Spiegel 703-902-5000	<b>Rio de Janeiro</b> Paolo Pigorini 55-21-2237-8400	<b>Sydney</b> Tim Jackson 61-2-9321-1900
<b>Atlanta</b> Lee Falkenstrom 404-659-3600	<b>Caracas</b> José Gregorio Baquero 58-212-285-3522	<b>Hong Kong</b> Edward Tse 852-3579-8222	<b>Melbourne</b> Tim Jackson 61-3-9221-1900	<b>Rome</b> Fernando Napolitano 39-06-69-20-73-1	<b>Tampa</b> Joe Garner 813-281-4900
<b>Bangkok</b> Tim Jackson 66-2-653-2255	<b>Chicago</b> Vinay Couto 312-346-1900	<b>Honolulu</b> Chuck Jones 808-545-6800	<b>Mexico City</b> Jaime Maldonado 52-55-9178-4200	<b>San Diego</b> Dave Karp 619-725-6500	<b>Tokyo</b> Steve Wheeler 81-3-3436-8631
<b>Beijing</b> Edward Tse 8610-8520-0036	<b>Cleveland</b> Mark Moran 216-696-1900	<b>Houston</b> Matt McKenna 713-650-4100	<b>Milan</b> Enrico Strada 390-2-72-50-91	<b>San Francisco</b> Paul Kocourek 415-391-1900	<b>Vienna</b> Helmut Meier 43-1-518-22-900
<b>Beirut</b> Charles El-Hage 961-1-336433	<b>Colorado Springs</b> Glen Bruels 719-597-8005	<b>Jakarta</b> Tim Jackson 6221-577-0077	<b>Munich</b> Jörg Krings 49-89-54525-0	<b>Santiago</b> Leticia Costa 562-445-5100	<b>Warsaw</b> Adrian Foster 48-22-460-1600
<b>Berlin</b> Rene Perillieux 49-30-88705-0	<b>Copenhagen</b> Torsten Moe 45-33-18-70-00	<b>Lexington Park</b> Cynthia Broyles 301-862-3110	<b>New York</b> David Knott 212-697-1900	<b>São Paulo</b> Leticia Costa 55-11-5501-6200	<b>Washington, DC</b> Eric Spiegel 703-902-5000
<b>Bogotá</b> Jaime Maldonado 57-1-628-5050	<b>Dallas</b> Mitch Rosenbleeth 214-746-6500	<b>London</b> Shumeet Banerji 44-20-7393-3333	<b>Oslo</b> Karl Høie 47-23-11-39-00	<b>Seoul</b> Jong Chang 82-2-6050-2500	<b>Wellington</b> Tim Jackson 64-4-915-7777
<b>Boston</b> John Harris 617-428-4400	<b>Düsseldorf</b> Thomas Kuenstner 49-211-38900	<b>Los Angeles</b> Tom Hansson 310-297-2100	<b>Paris</b> Bertrand Kleinmann 33-1-44-34-3131	<b>Shanghai</b> Edward Tse 8621-6340-6633	<b>Zurich</b> Jens Schädler 41-1-20-64-05-0