

# “Closing the Gap” Against Low Cost Competition in China

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Though many western executives protest that Chinese firms have unfair competitive advantages due to government subsidies, selling below costs (dumping), etc., the simple fact is that many Chinese producers indeed can make good quality product --comparable to that made in the West--at substantially less cost and making some profit. This ability is not just in low tech, commodity goods. Chinese producers continue to creep higher up the value-add chain as they improve both their technologies and processes.

Many of these same western executives have looked at establishing their own production facilities in China to capture similar low costs, but their financial proformas don't seem to close the cost gap sufficiently with their Chinese competitors. We have been involved in many comparisons between Chinese producers and their western counterparts and have noted some common cost factor trends that shed light on this issue, as well as point out ways to help western firms to optimize their costs in China.

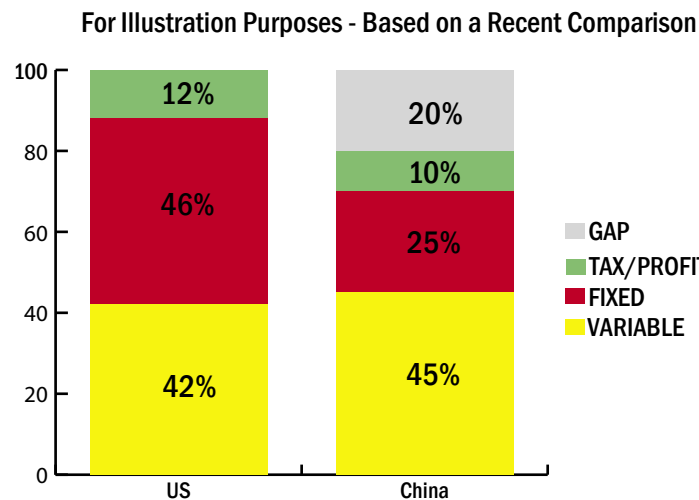
Firstly, it should be recognized, that it is often difficult to make accurate comparisons to China producers, both because they may categorize cost lines differently but also because getting accurate cost numbers is problematic. As a result of deliberate obfuscation to avoid paying tax, hiding funds for personal gain

or shifting costs and profits between operating units, official financial and tax statements often do not tell the real cost story (even if you can get them). So before you begin to assess costs, make sure you get your hands on quality data and that you analyze it carefully.

Generally, China's producers have significant advantage in fixed or general overhead costs, despite potentially having higher variable or manufacturing costs compared to international players. The

combined result often is an overall, meaningful cost advantage for the Chinese.

In viewing a basic manufacturing cost model between China and the US in a chemical product (~70,000 ton capacity plant), one can see a significant difference in variable versus fixed cost competitiveness.



If raw materials are “world commodities” then the Chinese generally have little advantage (or may even have some disadvantage) in variable cost. A China producer may replace some raw materials with local "equivalents" or substitutes but this can degrade the product's quality or performance. Further, their western competition may have advantage in purchasing scale due to large facilities in multiple locations outside of China.

Typically, China has higher utility costs, sometimes two times those of the West. Local logistics costs can also be significantly higher, even 3-4 times those in the West. Of course, lower factory labor rates in China (1/10<sup>th</sup> the West in even the more developed regions in China – even less in outlying areas) are a major plus for the Chinese. In the case above, the chemical production process is reasonably automated and capital intensive so these low labor rates do not have as much impact. Where the process is very manual and labor intensive, the Western variable costs are significantly higher. Many industries with this manufacturing profile have long ago migrated to China and are now often untouchable by western firms. The cost gap is likely impossible to close.

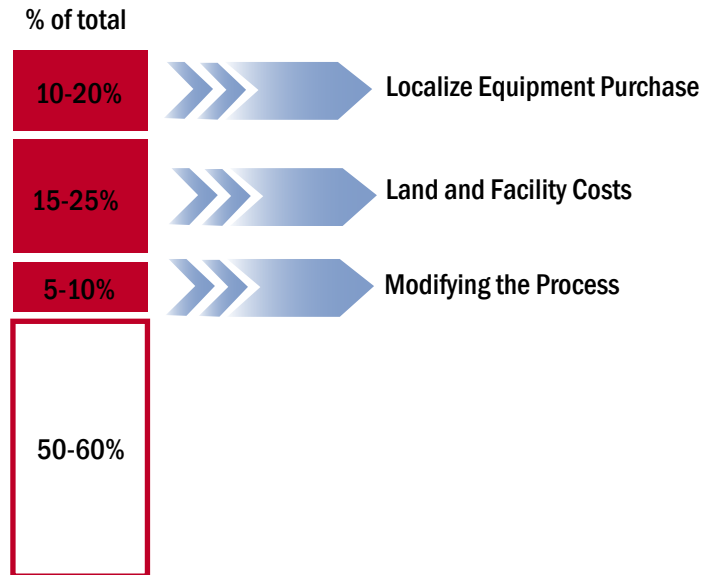
However, it is in the area of fixed costs where we often find the real gap. On almost every item, a Chinese producer will have advantage due to lower people costs, lower depreciation due to substantially less plant and facility investment, subsidies on land use rights, etc., not to mention their willingness to take less profit. Western firms often complain of an un-level playing field due to government subsidies, tax breaks and various financial shenanigans. While in many cases these complaints are not without merit, they do not tell the whole story.

Once you have a good handle on the true cost gap, what can you do to try and close it? Western firms have struggled to replicate these "China costs" via their own local facility. We believe more can be done here to lessen the cost advantages of the local Chinese players.

When considering whether to establish one's own facility in China, the goal is to match these lower costs as much as possible without compromising process, quality, environmental, safety or ethics. Finding an acceptable balance here is very important and may challenge a company to re-evaluate longstanding operational principles. We have found that western customers of these companies, as a result of severe cost down pressure, may start to compromise on product specification and performance. Companies need to be able to accurately read this tendency in their customer base.

Unfortunately, many western firms evaluate a China facility investment using a developed country paradigm, missing fertile opportunities for cost reduction. We have witnessed western firms who have sent their engineering team (often with no international experience) to China for an investigation, returning with a site factor of only 0.9 to their US plant (i.e. a plant in China would be 90% of the cost of a comparable facility in the West). However, the reality is that a China facility investment can be as little as 50-60% that of a comparable facility in a "developed" country, and produce good quality product. Of course, the type of facility influences how low the ratio can go. In "cleaner" industries such as pharmaceuticals and light manufacturing, one can

**Potential Cost Savings Areas**



typically fare better than in chemical production.

To understand this prospective cost improvement, we have segmented areas of potential cost reduction in the initial facility setup as follows:

Western firms often over-estimate equipment costs when setting up a China facility, primarily due to their reliance on imported equipment. China has made significant advances in production/process equipment manufacture in the last 5 years to the point where equipment specified to similar international standards can be acquired (or built) in China, often at 50% of imported equipment costs. Many of the local equipment suppliers are WFOEs (wholly foreign owned enterprises) or joint ventures of international equipment companies. Equipment such as pressure

vessels, piping, furnaces, HVAC, etc. are all available locally. High end control systems typically are still imported but even many of these are being localized now. Some companies have contracted a local producer to “build to spec” their process equipment, and with good results.

Land and facility costs are also areas where significant cost reduction can be made. As an example, in a quality industrial estate such as the China-Singapore Suzhou Industrial Park outside of Shanghai, 50 year land use rights (with 6~9 accesses to utilities and one leveling) are going for ~US\$15 per square meter. These land prices are cheaper in surrounding industrial parks and continue to fall as competition between these industrial parks intensifies. Obtaining competitive land use rights is often a key negotiating variable in setting up in a locale. Good deals can be made with local government hungry for foreign investment (and jobs). A local partner should also be able to be supportive here in negotiating a good deal.

Our analysis indicates that building or buying a facility can be significantly cheaper than in the West. For instance, in the same Suzhou industrial park a 10,000 sq. meter building (1 storey, beam and wall concrete construction) costs in the area of US\$100 per square meter to construct, significantly less than in the West.

A word of caution here. One must be careful about grandiose claims made from local officials or suppliers. Often these promises are empty in the end. You still get what you pay for so take care to deal with reputable players and manage the process carefully.

Cost reductions can be gained in ongoing operating costs as well, notably in the manufacturing process itself. Of course, a foreign firm will want to retain the integrity of its manufacturing processes and will often replicate them in total in China. However, given the low labor costs of China, wisely using "manual intervention" in the process can be very effective.

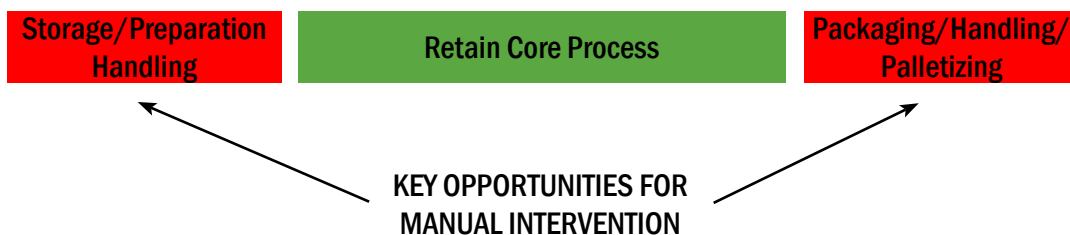
Taking out simple automation tasks at either end of the line can reduce costs without impacting the integrity of the core process.

Companies need to aggressively and creatively search for ways to modify the process to take advantage of low labor costs in China. The talent pool of skilled and semi-skilled workers is vast in China. With good process and management, they can be very productive.

Lastly, localizing management should be a major objective. Expatriate burdens are significant, costing upwards of two times the compensation levels in the West (including housing, schooling, tax equalization, etc.). And these costs will be many times those of a comparable local staff. Transferring skills and knowledge must be done as quickly as possible at various levels of functional management, only retaining expat positions in critical and/or sensitive areas (such as finance and general management).

Many companies are also considering contracting out manufacturing, especially in lower end or mass market product lines. In this way, they can often capture some of the unobtainable cost reductions (such as subsidies, lower cost of capital, local Guanxi, etc.). With minimal investment, the western firm can bring some technological enhancement to the Chinese producer’s manufacturing process to upgrade product quality and performance, and even improve the efficiency of the process. This approach can blend the best competencies from both worlds. Of course there are compromises in this approach in control of the operation and in intellectual property risks so the costs-benefits need to be assessed closely.

The aggressiveness by which a company addresses closing this cost gap should be directly relational to its urgency on their business. For some companies, if they cannot close the cost gap it threatens the very existence of their business. When data suggest this condition, we have seen some management remain in a state of denial and do nothing about



it. Why? Because the consequences are so significant, e.g. shutting down a plant in the West or even exiting a business segment. This denial is often masked by unrealistic future assumptions on pricing levels, existing customer loyalty and the ability of Chinese producers to move up the quality curve.

In these cases, we like to propose the "Apollo 13 approach" from the popular movie (the need to build a square filter for a round hole with only the materials on board the spacecraft). Our challenge to management is "find a way" to get to a 0.5-0.6 site factor (or whatever the necessary target is). It is senior management's job to determine whether the "conditions" of hitting this target are acceptable to the company. To reach the cost targets, management may be faced with going against core values of the company. Our position is to face these issues head on and not sweep them under the table and hope that destiny will change market conditions. The net result may be the need to make a tough decision among some very hard choices:

- ① **Adjust your internal conditions, values, methods, etc. to meet the cost targets. i.e. compromise**
- ② **Change your approach to the market through creative structures (e.g. contract joint ventures, cooperating with the enemy, etc.)**
- ③ **Get out of the business**

The tragedy happens when external conditions make the choice for you due to management procrastination.

There is no doubt that substantial gains can be made in manufacturing cost in China. While a western firm generally cannot replicate in total the cost savings of a local Chinese producer, it can significantly reduce the gap versus its facilities in the West. On manufacturing costs, through its strength in technology and process management as well as purchasing scale, a foreign firm can often take advantage over its local Chinese competitor in more capital intensive production. On fixed costs, a measurable dent in the cost advantage of its local competition can be achieved through rigorous and creative analysis and tough negotiation. These cost reductions can be leveraged both to defend against local China competition as well as to take the offensive against other foreign based competitors with a higher cost base.

*This article was written by Technomic Asia, a Shanghai based market strategy firm. Technomic Asia has assisted over 140 multinational firms with their China growth strategies across a wide range of industries. This article is one in a series on myths about China business. For further information, please contact Technomic Asia Directors, Kent D. Kedl or Steve Ganster. You can also visit our web-site at [www.technomicasia.com](http://www.technomicasia.com).*

Kent Kedl - [kkedl@technomicasia.com](mailto:kkedl@technomicasia.com)  
Steve Ganster - [sganster@technomicasia.com](mailto:sganster@technomicasia.com)

US Office: 612-239-4029

Shanghai Office: +86-21-6473-2599