

# A new era for manufacturing in China

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Companies that continue to base their manufacturing strategies solely on China's rock-bottom wages and stratospheric domestic growth rates are in for a rude awakening. New challenges will require new competitive priorities.

**China's emergence** as a manufacturing powerhouse has been astonishing. In seventh place, trailing Italy, as recently as 1980, China not only overtook the United States in 2011 to become the world's largest producer of manufactured goods but also used its huge manufacturing engine to boost living standards by doubling the country's GDP per capita over the last decade. That achievement took the industrializing United Kingdom 150 years.

Today, however, China faces new challenges as economic growth slows, wages and other factor costs rise, value chains become more complex, and consumers grow more sophisticated and demanding. Moreover, these pressures are rising against the backdrop of a more fundamental macroeconomic reality: the almost inevitable decline in the relative role of manufacturing in China as it gets richer.<sup>1</sup> Manufacturing growth is slowing more quickly than aggregate economic growth, for example, and evidence suggests that the country is already losing some new factory investments to lower-cost locations, such as Vietnam, sparking concern about China's manufacturing competitiveness.<sup>2</sup>

<sup>1</sup>Empirical evidence suggests that manufacturing's relative contribution to a national economy tends to peak when it reaches 20 to 35 percent of the country's GDP. Today, China's manufacturing sector accounts for roughly 40 percent of its GDP.

<sup>2</sup>In 2011, the growth rate of China's manufacturing GDP had slowed by 34 percent from its precrisis peak. Overall GDP growth slowed by 20 percent over the same period.

Competitiveness, of course, is a broad term that can confuse more than clarify. During the 1980s, for example, there was much hand-wringing in the United States about declining manufacturing competitiveness versus Japan. In the following decade, however, those concerns faded, replaced by a focus on the failings of “Japan Inc.,” the SUV-fueled resurgence of the US automotive sector, and the boom in US high-tech manufacturing. In the United States then, as in China today, there isn’t just one manufacturing sector; there are many, each with different competitive strengths and weaknesses.

In this article, we move beyond the hyped hopes and frantic fears for Chinese manufacturing as a whole, to gain a more balanced picture of this diverse sector. We start with a summary of four key challenges that affect different types of manufacturers in different ways and then move on to a discussion of competitive priorities whose importance again varies for players of different stripes. Despite the variation across manufacturing subsectors, companies—Chinese owned and multinational alike—can’t escape the need to raise their game and move up the value chain by boosting productivity, refining product-development approaches, and taming supply-chain complexity. Those that do should prosper in the years ahead, while those that rely on yesterday’s model of rock-bottom wages and stratospheric domestic growth rates are likely to fade.

## **Four challenges**

For years, China’s low salaries; strong supply base; high investment in port, road, and rail infrastructure; and solid engineering and technical skills provided a strong platform for manufacturing exports. Meanwhile, a vast domestic market helped fuel China’s continuing transition to a consumption-based economy. Today’s outlook is more mixed. Here, we review four core challenges and the types of players particularly affected by each of them. In doing so, we draw on a set of global manufacturing archetypes established recently by the McKinsey Global Institute (see sidebar “The makeup of Chinese manufacturing”).<sup>3</sup>

<sup>3</sup>Sectors were grouped according to the intensity of the following: capital, energy, labor, R&D, trade, and value. For the full McKinsey Global Institute report, see *Manufacturing the future: The next era of global growth and innovation*, November 2012, [mckinsey.com](http://mckinsey.com).

## The makeup of Chinese manufacturing

	<b>Global producers for local markets</b>	<b>Energy- and resource-intensive commodity players</b>
	Around one-third share of both Chinese and global 2010 manufacturing value added	Around a quarter of Chinese and 22 percent of global 2010 manufacturing value added
<b>Sectors</b>	Appliances, automotive and transport equipment, chemicals, electrical machinery, and pharmaceuticals	Metals and mining, pulp and paper, and other extractive industries
<b>China-based players</b>	Bohai Chemical, ChemChina, China Resources Pharmaceutical Group, First Automotive Works (FAW), Midea, Shanghai Automotive Industry Company (SAIC), Shanghai Electric, and Sinochem	Baosteel, Chalco, China Minmetals, China National Petroleum (CNPC), Shandong Chenming Paper, and Sinopec
<b>Multinationals</b>	ABB, BASF, Dow Chemical, GM, Pfizer, Sanofi, and Volkswagen	BP, International Paper, Posco, and Shell
<b>Success factors</b>	Global R&D, ability to generate stream of new products and models	Privileged access to raw materials and energy, high resource and energy productivity, transportation and infrastructure logistics, proximity to demand

China's manufacturers can be classified into five distinct groups, or archetypes, defined by different labor- and resource-cost exposures, innovation intensities, access to trading opportunities, or a mix of these.

### Global technologies/ global innovators

9 percent of both Chinese and global 2010 manufacturing value added

Consumer electronics, office machinery, semiconductors, and telecommunications equipment, as well as medical, optical, and other precision equipment

Hisense, Huawei, Lenovo, Mindray, Semiconductor Manufacturing International (SMIC), Shinva Medical, Spreadtrum, and ZTE

Alcatel-Lucent, Cisco, EPSON, Ericsson, Intel, Nokia Siemens Networks (NSN), Philips, and Samsung

Strong global R&D and production networks, high value density of products, economically transportable from production sites to customers around the globe

### Regional processing

Around one-fifth of Chinese and 28 percent of global 2010 manufacturing value added

Fabricated metals, food and beverages, printing, and tobacco

China Tobacco, COFCO, Mengniu Dairy, and Wahaha

Anheuser-Busch InBev, Coca-Cola, Nestlé, P&G, and Yihai Kerry (Wilmar)

Close observation of customers and competitors to develop deep insights

### Labor-intensive tradables

10 percent of Chinese and 7 percent of global 2010 manufacturing value added

Apparel, textiles, and other handcrafts

ANTA Sports, Li Ning, and Metersbonwe

adidas, Kappa, and Nike

Low-cost production critical

### Rising factor costs

Rising wages and the appreciation of the renminbi have dampened China's exports in recent years and focused global attention on its future viability as a low-cost manufacturing center. Most multinationals that produce labor-intensive goods, like textiles and apparel, are actively seeking to diversify beyond China to reduce costs and mitigate political and supply-chain risks. China-based processors of goods such as beverages, fabricated metals, food, and tobacco are also concerned about rising costs, including those for packaging. Yet their regional focus makes this less a global competitive issue and more a question of which players in the value chain will create the most value.

### Rising consumer sophistication

McKinsey research suggests that by 2020, the income of more than half of China's urban households, calculated on a purchasing-power-parity basis, will catapult them into the upper middle class—a category that barely existed in China in 2000 (for more, see “Mapping China's middle class,” on [mckinsey.com](http://mckinsey.com)). The members of this group already demand innovative products that require engineering and manufacturing capabilities many local producers do not yet adequately possess. An executive of a Chinese television-panel maker, for example, recently confessed that his company cannot fully meet the requirements of high-end customers and that the quality of his company's flat-screen panels is exceeded by that of products from fast-moving South Korean competitors. China's automakers face a similar challenge: consumers perceive their brands as lower in quality, even compared with foreign brands assembled in nearby Chinese factories.

These issues confront players in a range of other sectors—from appliances and chemicals to electrical and office machinery, pharmaceuticals, telecommunications gear, and transportation equipment. What they have in common is that they compete on the strength of their R&D, technology, and ability to bring customers a steady stream of new products and services. Rising consumer expectations will require even food and beverage players to raise their game on freshness and regulatory compliance, areas where China's standards still lag behind Western ones.

### Rising value-chain complexity

Another big challenge is coping with the rising value-chain complexity that accompanies consumer growth. Greater affluence and rapid urbanization require product makers to manage, make, and deliver an array of increasingly diverse and customized products to increasingly remote locations. Between now and 2015, for example, almost two-thirds of the growth in demand for fast-moving consumer goods will come from smaller (Tier-three and Tier-four) cities, which outnumber their Tier-one counterparts, such as Beijing or Shanghai, by a factor of 20.

Product proliferation and booming e-commerce also contribute to value-chain complexity. Business-to-consumer online sales in China are expected to grow by 45 percent a year from 2010 to 2015. For product makers, this means smaller and smaller lot sizes and deliveries to households farther and farther “out there.” During Chinese festival periods, the supply chains of many companies already creak under the strain of online orders. Demanding consumers contribute to supply-chain headaches, as well. Since many retailers in China accept cash-on-delivery payments, it’s not uncommon for shoppers to pit online retailers against one another by ordering, say, three identical products from three retailers—and refusing delivery to all but the first to arrive.

Such issues are relevant for technology companies and others responding to the Chinese consumer’s increasingly sophisticated tastes. But rising value-chain complexity is also a worry for manufacturers of more labor-intensive goods, given the sheer variety of products they make, and for regional processors, whose logistics networks are affected by urbanization and booming infrastructure development.

### Heightened volatility

The uncertain global economic environment since 2008 has complicated life for manufacturers everywhere. Those in China have arguably been the most severely affected, given the country’s status as the workshop of the world.

In China’s steel industry, for example, annual demand growth slowed to 3 percent in 2012, after a decade of double-digit increases.

The result has been lower capacity utilization, cutthroat competition, and a 56 percent decline in average profit margins for the industry from 2010 to 2012. Similarly, in China's massive auto industry, annual growth rates over the past five years have varied from 7 percent to 52 percent.<sup>4</sup> Appliance and electrical-machinery producers have also experienced strong demand fluctuations, exacerbated by gyrating overseas demand.

Volatility at such levels makes planning difficult for China's manufacturers. This is problematic for companies that routinely make large, long-lived capital expenditures whose returns are crucial determinants of performance.

## **Three imperatives for China's manufacturers**

As labor costs rise and slowing growth dampens the ability of China's steadily rising industrial output to deliver regular productivity gains, manufacturers there will need to strive for global levels of operational excellence. Energy efficiency is a particular opportunity for many companies (see "Seizing China's energy-efficiency opportunity: A case study," on [mckinsey.com](http://mckinsey.com)), but far from the only one. Companies hoping to differentiate themselves beyond low-cost labor also can focus their efforts upstream (to harness innovation and product-development efforts) or downstream (to tame supply-chain complexity) or both, depending on the characteristics of competition in their sectors.

### **1. Achieve manufacturing excellence**

Lean and Six Sigma are not new to China. Plant managers in domestic and multinational companies alike have worked hard to bring manufacturing-excellence tools and approaches to the country's shop floors. But for all these efforts, significant potential remains, mainly because plant managers in China often focus on "hard" technical tools at the expense of "softer" ones involving mind-sets and behavior. A recent lean-manufacturing transformation at one state-owned enterprise, for example, fell far short of its efficiency targets when managers and supervisors failed

<sup>4</sup>Since China's auto industry is also the world's largest, such volatility can result in eye-popping swings in production. In 1995, for example, production was 300,000 vehicles below what the long-term annual growth rate (1995–2012) would have predicted. By contrast, the production totals for 2010 were 2.7 million vehicles over it.

to complement the otherwise excellent technical changes with the necessary softer skills—including leadership—that would have made the changes stick.

One factor that complicates these problems has been the breakneck development of China's manufacturing sector, which means that many workers are relatively new to the job. We have seen too many frontline managers, lacking the experience to identify the problems inevitably associated with new plants and new ventures, merely react to problems rather than look for their root causes. Companies facing this problem will never get the full benefit of the productivity improvements they expect from lean. In one auto-assembly and body-shop operation, for example, team leaders spent as little as 5 percent of their time on coaching and problem solving (best practice is about 30 percent). Improvement efforts stalled until the company introduced standardized daily work agendas for team leaders and supervisors, to emphasize that shift meetings were occasions for problem solving and coaching—not firefighting.

Cultural differences also continue to thwart operational improvements in Chinese companies. In one auto plant, the multinational joint-venture partner installed visual-performance boards to make the status of work projects transparent, assuming that the tools would be accepted as they are elsewhere in the global auto industry. In fact, the frontline workers resisted them, interpreting the initiative as a criticism of individual colleagues and forcing the joint venture's leaders to devise ways to achieve the same effect without alienating the staff. Moreover, the Chinese company's senior plant managers, while supporting the changes, were initially uncomfortable about role-modeling the more transparent and inclusive way of working. A new continuous-improvement department eventually helped workers and managers alike to view greater transparency and continuous improvement as a new way of working rather than a "flavor of the month" exercise. The automaker's experience is not uncommon; indeed, the fact that the domestic leaders became involved was encouraging—all too often, the front line must sort out such changes itself.

Finally, companies in China must aspire to extend efficiency improvements throughout the value chain. An automotive joint venture recently began this journey by working with 60 of its

suppliers to address the 30 most pressing quality problems. The company fixed them in only six months and has since prevented their recurrence, in large part by equipping its people with assessment tools and skills and by engaging suppliers to address problems at the source. A new performance-management system helps ensure that both the automaker and its suppliers keep up their ends of the bargain. (For more on the relationship between purchasers and suppliers, see sidebar “Seeking purchasing excellence in China.”)

## 2. Look upstream

For industries reliant on innovation, the triple whammy of rising costs, complexity, and competitive pressure means that the old ways of developing products in China now risk becoming liabilities. Staying competitive will require domestic companies and multinationals alike to change, starting with the mind-sets and attitudes that have pervaded product-development activities in China.

**Product-development roadblocks.** Domestic Chinese companies must get beyond the “faster, cheaper” fixation that has characterized their approach to R&D in recent decades. For every world-beating Chinese innovator, we still see dozens of smaller players struggling to develop the R&D pipelines that would help them grow from scrappy upstarts into incumbents that can realize their global ambitions. The growth of one China-based medical-device player, for example, has halved in recent years as smaller domestic competitors copy its designs and undercut its prices, much as the company itself copied from multinationals in earlier years. Yet even as it works now to boost its R&D capabilities and to generate market insights—extremely difficult tasks given the absence of necessary skills and institutional processes—the copying mind-set remains strong.

To some extent, multinationals face a mind-set challenge as well. Many invest significantly in their China R&D units<sup>5</sup> while continuing to regard them as cost-saving satellites of the home-office “mother ship.” Even when multinationals establish supposedly auto-

<sup>5</sup>Eighty percent of global executives in a recent McKinsey survey reported that the best way to position their companies to meet innovation goals was to establish satellite R&D units that operate as a network. Sixty-three percent of respondents said that their R&D organizations already include satellites. For more, see Marla M. Capozzi, Peet Van Biljon, and Jim Williams, “Organizing R&D for the future,” *MIT Sloan Management Review*, 2013, Volume 54, Number 3, pp. 19–20.

nomous R&D units in China, many lack the support and skills to become intellectual-property creators, not just consumers. The experience of another medical-product company we studied—this one a multinational—highlights the challenge.

The leaders of the multinational's China R&D group thought they'd identified a lucrative niche for a new, low-cost medical-diagnostic product—but were denied funding by the head office back home. The general manager of the China business fought what he thought was a shortsighted decision, winning permission to proceed if his business unit could finance the new product itself. His unit ultimately did just that, in part by promoting the product to customers and collecting advance orders. Once launched, it was highly successful—at first in China but soon in other countries too as the company's sales reps got wind of its popularity and began offering it in their own regions.

Fast-forward about 18 months, when the company decided to revise



Workers at the Fiat SpA and Guangzhou Automobile Group Co. (GAC) manufacturing plant in Changsha, the capital city of Hunan Province, assemble door panels for Viaggio vehicles.

the product. Rather than entrust its development to the China R&D team, the company assigned it to the main R&D group at headquarters and used the China team for support. The product flopped when new and technically elegant features and other changes insisted on by the Western group proved too expensive for customers or irrelevant to them.

**A success story.** The experience of a global lighting manufacturer suggests how some companies are overcoming the challenges. With global consumer preferences shifting toward new applications of a decades-old technology, the company identified a huge market opportunity in LED lighting. The market was also hugely competitive—Chinese and Taiwanese players were piling into the lower-end consumer segments—so a well-designed product clearly wouldn't be enough. Hitting a low price point and rapidly establishing scale would also be necessary.

The multinational briefly considered using its world-class global R&D unit to develop the product. But senior executives worried that the group's insular, engineering-centric culture would lead it to "overspec" the offering with costly features. Leaving it to the company's China unit, on the other hand, was too risky: that group couldn't generate unique customer insights and didn't have enough experience working with supplier networks upstream or with the company's global supply chain downstream to compete on cost and speed. The obvious compromise—combining the groups in a more traditional way by playing to the strengths of each—might mean suffering the usual time-zone delays while reinforcing the "silo" cultures the company's leaders wanted to break. It ultimately chose to view the project as an experiment for improving both units, so that the one in China would become more independent and the effort's benefits could be leveraged globally.

To get there, company executives quickly assembled a mixed R&D team in China comprising representatives from the marketing, procurement, supply-chain, and quality groups. For ten weeks, the team worked closely to develop an idea-generation and decision-making process that could not only create a winning, scalable design but also build skills and develop processes the company could use globally. The team collaborated to create and test customer insights,

complementing the work with teardowns of competitors' products. It also conducted shop-floor walkthroughs with suppliers and met with a variety of manufacturing experts to learn how the product could incorporate cheaper, more modular designs.

A set of simple rules proved critical to breaking old habits and unlocking good ideas: to ensure that the team never fixated on one part of the value chain at the expense of another, it consistently asked a handful of total-cost-of-ownership questions when it made its most important decisions. This approach helped spark improvement ideas in unusual areas, such as product packaging: the team found a way to give one of its products a more prominent shelf appearance—a locally important factor because of high levels of competition—while lowering logistics and other costs through the efficient use of materials.

As the effort picked up steam, it became popular with other managers in the China business. The company trained some of these “evangelists” as change agents to maintain momentum at the end of the pilot. This effort ultimately helped the company to lower the costs associated with the product line by an additional 20 percent beyond initial expectations. Further, the effort positions the company well for future cost-reduction opportunities that should arise as the industry matures.

### 3. Tame supply-chain complexity

While the effects of value-chain complexity vary by manufacturing subsector, most Chinese consumers are changing faster than supply chains are adapting. Indeed, supply chains in the country—both multinational and domestic—are generally set up for a low-labor-cost environment that is quickly disappearing.

Now that long cycles characterized by so-so levels of transparency and cross-functional collaboration are proving insufficient, companies will have to start by revisiting their demand planning. Consider the experience of a large consumer-electronics company whose processes were proving unsuited to the new demand patterns associated with some of its high-end products. Poor or delayed forecasts were disrupting operations and leading to excess inventories, while also upsetting customers downstream.

## Chinese consumers are changing faster than supply chains are adapting.

The turning point was the company's recognition that its planners were applying the same broad-brush approach to all products, regardless of their market characteristics. In response, the company's leaders created a tiered approach to detach planning activities for some basic appliances whose demand patterns were well understood (rice cookers, for example) from plans for faster-moving products with less certain demand. For the basic products, the company developed a streamlined, "good enough" planning approach. For the high-end goods, it crafted specific plans by product line.

Its results, including an overall improvement in forecast accuracy to more than 65 percent, from 35 percent, have been impressive. Inventory fell from more than 55 days to 30 days, and the company increased its proportion of on-time deliveries to more than 95 percent, from 60 percent. What's more, the changes in the company's planning approach made the work more interesting for its employees, as many of them subsequently received training in advanced forecasting techniques. Consequently, employee turnover among the planning teams went down dramatically—from 50 percent before the effort to just 20 percent afterward. In a second phase, currently under way, the company extended this approach for high-end products to others with similar demand characteristics.

Significantly, the company is separating what had been a monolithic China supply chain into nimbler "splinters" that can better manage complexity. Products with steadier demand go to market in the traditional manner: via coastal distribution centers and large drop-ship orders to retail partners. Higher-end ones travel via smaller regional distribution centers located closer to demand inland. For some products, this approach allows the company to experiment with postponement strategies—finalizing product assembly closer to demand—that help reduce costs and inventory levels (in the case of some customers, by as much as 45 percent).<sup>6</sup>

<sup>6</sup>For more, see Yogesh Malik, Alex Niemeyer, and Brian Ruwadi, "Building the supply chain of the future," *McKinsey Quarterly*, 2011 Number 1, [mckinsey.com](http://mckinsey.com).

As companies look to move their footprints closer to customers in Tier-three and Tier-four cities in China's interior, another likely change will be the long-term development of logistics hubs and assets. In this way, those companies will be better positioned to serve booming demand for online purchases (see "China's e-tail revolution," on [mckinsey.com](http://mckinsey.com)). These investments are risky, and many senior executives we know are worried about overextending their companies. Some describe what they say is a need to "go West—but not too far West." As for domestic Chinese companies with global plans, they know that getting closer to customers means Western customers as well. A few of the largest white-goods makers are thinking about expanding their assembly and test activities in the developed world, because they recognize that they can no longer adequately serve it from Shenzhen and other hubs.



China's rise to manufacturing preeminence in recent years has been amazing. Yet rising costs, more sophisticated consumers, and fundamental macroeconomic realities mean that yesterday's approaches to manufacturing are losing their relevance. For Chinese-owned and multinational manufacturers alike, the imperatives now are to boost productivity, refine product-development approaches, and tame supply-chain complexity. Those that do so can create an enduring competitive edge. ○

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# Seeking purchasing excellence in China

**Karel Eloot and Dave Rogers**

The growing sophistication of consumers, more intense competition for their business, and the escalating cost of serving them are raising the stakes for the multitude of organizations that use China as a sourcing platform. Leading multinationals and domestic companies alike are fast recognizing that the days when they could view their China sourcing units as RFQ-generating<sup>1</sup> machines are ending and that bolstering purchasing capabilities now can pay huge dividends in the years ahead.

Our research and experience in the country<sup>2</sup> suggest that the path ahead will be both different—and harder—for state-owned enterprises, although they and multinationals face shared challenges.

## **State-owned enterprises: Strengthen the basics**

For state-owned enterprises, the purchasing challenge starts with the fundamentals: talent and training. Few of these companies in China routinely hire purchasing specialists (such as category managers) who are university qualified, and even fewer hire purchasers with advanced degrees.<sup>3</sup> Moreover, few state-owned companies create capability-building programs to bolster the skills of these employees or do much to consider their professional development. Currently, many state-owned companies provide only basic orientation programs for purchasing staff and have no or few formal mechanisms thereafter to help employees share knowledge or refine their skills. Best-practice programs, such as job rotations, are practically nonexistent.

<sup>1</sup>Request for quotation.

<sup>2</sup>In addition to our experience working with companies in China, this article draws on findings from an ongoing, proprietary global benchmarking effort to identify global best practices in purchasing, as well as a series of in-depth interviews we recently conducted with chief procurement officers at 14 leading multinationals and state-owned enterprises in China.

<sup>3</sup>By contrast, our global benchmarking research finds that among top purchasing organizations, almost 90 percent of the purchasing staff holds at least an undergraduate degree. Among the others, only 62 percent do.

The relative dearth of talent in the purchasing units of many state-owned enterprises contributes to another problem: many of them commingle important operational and strategic roles inside the sourcing function. Such companies fail to recognize that these roles require different skills—the former focusing on speed and process integrity, the latter on long-term market analysis and selection of suppliers. Commingling such roles can be disastrous for the bottom line. For example, at one heavy-industry state-owned enterprise that combined the two kinds of purchasing roles, sourcing leaders chose suppliers according to the convenience of the staffers who tracked the orders rather than any strategic reason. The result was much higher costs and time-consuming delays. Only when the company segregated the roles and began working on the capabilities of each did decision making begin to improve.

Even modest organizational improvements can pay off quickly. Another state-owned company, an automaker, recently conducted a short series of intensive coaching and feedback sessions for its procurement staff. One goal was to equip purchasers with much better information ahead of negotiations, since relatively few employees understood the manufacturing costs associated with various components they sourced or the broader internal cost implications of their sourcing decisions. Within a few weeks of completing the sessions, the procurement team—armed with a better understanding of the critical cost drivers of components—had identified a new set of alternative suppliers and negotiated better terms with existing ones. The effort reduced the automaker's spending by 14 percent in categories such as injection tooling and glass.

## **Multinationals: Come together**

Multinational companies in China tend to score better than state-owned ones on the basic talent dimensions of purchasing. Yet raw talent isn't enough. Our experience and research suggest that only a little more than half of the savings that companies can achieve from better purchasing are attributable to highly skilled buyers. The rest comes from deep collaboration with other functions to make sure that good sourcing practices and thinking spread throughout the organization.

Many multinationals struggle on this dimension—in some cases because functions other than purchasing are not as developed as they must be to get the full savings. The China-based engineering units of some multinationals, for example, face the same talent challenges the state-owned companies do: employees don't have the product or process knowledge that would help them engage with procurement experts to make appropriate trade-offs (for example, about local-sourcing decisions).

Yet even when functional groups are strong, multinationals may unwittingly establish organizational impediments that hamper meaningful cross-functional collaboration. For example, in many multinationals the purchasing unit in China reports both to the leadership there and to the global functional chief to maintain consistency or control. However, dual-reporting relationships can send mixed signals to purchasers and encourage “silo” behavior, particularly when the real decision making happens in the functional group back at company headquarters. Similarly, multinationals that don’t empower their China organizations with decision-making authority give them few incentives to collaborate, particularly when companies choose suppliers and specifications on a global basis and dictate the details to their satellite units.

The experience of a global equipment maker suggests the potential for greater collaboration *and* empowerment in the purchasing function. Heightened competition and softening demand in the wake of the economic crisis prompted the company’s leaders to launch an aggressive initiative to lower purchasing costs in China. Recognizing that the size of the savings targets exceeded what the local purchasing group could achieve alone, the company’s sourcing leaders created a series of cross-functional teams. Each was assigned one of the equipment maker’s five major spending categories, which represented five final-assembly modules for the company’s products.

Team leaders (many drawn from other functions, such as R&D, marketing, and sales) were empowered to come up with new ideas. Most started by working with their teams to identify cost-reduction opportunities in areas that did not require major design changes. The teams spotted opportunities to introduce new suppliers, to bypass others by sourcing some subcomponents directly (cutting out the middleman), and to address inefficient internal processes that imposed additional costs on suppliers, thus increasing the company’s costs as well. These moves alone lowered those costs by 5 percent—a substantial proportion, given the relative maturity of the products in question and the fact that previous cost-reduction efforts rarely generated savings of more than 1 to 2 percent.

In a second phase of the effort, the teams focused on technical cost-saving ideas—for example, helping to improve standardization and process efficiency among key suppliers. To this end, the teams brought in some of the company’s technical experts and held a series of structured supplier assessments and workshops to share ideas. The cross-functional teams, working closely with internal stakeholders and suppliers, generated more than 250 new cost-cutting ideas that together are expected to deliver an additional 10 percent in savings.

## A shared challenge

One area where both multinationals and state-owned enterprises tend to underperform in China is the extension of purchasing's value-chain impact beyond purchased goods—in essence, getting a more effective contribution from the function at each stage of value creation. On this measure, multinational companies do tend to be much further along the course than state-owned ones. Yet both struggle to engage procurement in broader areas, such as product development or marketing, where supply-base know-how leads to lower costs and even better design decisions. Too often, companies in China fail to bring the sourcing team together with R&D or marketing until late in the design process. This oversight contributes to poor decisions about cost-benefit trade-offs and missed opportunities to increase a company's leverage with suppliers.

Although this issue is not unique to China, the strength of functional silos and deeply ingrained hierarchical views of the workplace make it a particular concern there. By contrast, top companies look for ways to give purchasing a louder voice in upstream product-related discussions. They also work hard to wipe out the “just buy what I tell you to” mentality that often creeps into cross-functional interactions when purchasers are seen as operating outside traditional areas.

Yet even the simplest new products can benefit from early purchasing input as part of a broader design-to-value effort. For instance, a leading packaged-food company recently sought to launch a bottled-water product in China but worried that costs were too high to meet the target retail price. Rather than abandon or delay the effort, the company turned to its procurement department, which helped to meet the target by, in part, identifying simple packaging changes that lowered the product's costs by 5 percent. ○

<sup>4</sup>See Ananth Narayanan, Asutosh Padhi, and Jim Williams, “Designing products for value,” October 2012, [mckinsey.com](http://mckinsey.com). A shorter version of this article, “Designing products for value in emerging markets,” appeared in *McKinsey Quarterly*, 2012 Number 4.

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