

The three ways to relocate

by

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For several years, American and European manufacturers have been suffering increased competition coming from countries with low cost factors, particularly China. Today, there are few industries that are not being faced with the move towards globalisation. The phenomenon is no longer merely affecting the traditional industries such as textiles and toys. It extends to the automobile and aircraft industries and to globalised services. For the Europeans, this pressure is currently amplified by the strong Euro.

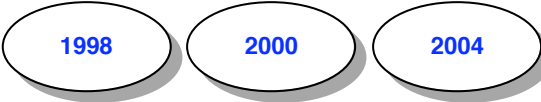
Once aware of this fact and its causes, a western manufacturer is often tempted to choose between two radical strategies: to retain production units in Europe at all costs in order to follow a business model with which he is familiar and to maintain an innovation strategy as a source of differentiation; or to subcontract the whole of production to Chinese, Indonesian or Dominican manufacturers whilst focusing on brands and distribution.

A more segmented approach is preferable and makes it possible to develop a business model based on the traditional strengths of the leaders in developed countries (innovation, marketing and technology) whilst enjoying the advantages linked to the low cost factors in emerging countries.

There are three effective ways to relocate that correspond to particular situations: the subcontracting of specific or on-the-shelf finished products; relocation exclusively to a country with low cost factors; and partial production exclusively in a country with high cost factors with stripping down of the value chain and manufacture of the low-tech elements in countries with low cost factors.

- Figure 1 -

How the Chinese share of worldwide production has grown



	1998	2000	2004
Textiles	21%	26%	37%
Household electrical	17%	21%	35%
Steel	15%	15%	22%
Naval construction	3%	6%	17%
Electronics	6%	9%	19%
Computers	3%	5%	15%
Automobile	3%	5%	8%

Source : Analysis and research Estin & Co

The pressure from China

Today, the competition from and the competitiveness of China speak for themselves. It is common to look at the ratio for the hourly cost comparison, close to 100, between France (at 25 Euros) and China (at 2.5 RMB, i.e. about 0.25 Euro). In many industries, the Chinese share of global production is already more than 20% (see Figure 1).

Initially focused on the highly labour-intensive worldwide industries, Chinese competition is nowadays growing in all sectors of the market, by integrating innovations made possible by this low cost of manpower.

More and more, Chinese business leaders are seeking to develop business models encouraging innovation and added value, to distinguish themselves from local rivals that are even more competitive in terms of costs. What was lacking only recently, such as R&D, quality and logistics, is rising at a high rate.

For example, in telecommunications equipment, the Chinese leader Huawei has developed its technical expertise strongly over the course of the last ten years: in 1995, it only manufactured digital commutators for fixed lines; in 2000, it was supplying second generation mobile networks; today, it is making third generation mobile networks for China and the major western countries. The same can be seen for BOE, the Chinese leader in TFT-LCD screens.

In front of this steamroller, it is becoming necessary for European companies to quickly bring in strategies that allow them to continue their business rather than being confronted with a *fait accompli*: to close all of their production sites and buy everything on-the-shelf from the Chinese producers. Such a strategy, even though it can prove successful in the short term, is inevitably transient and risky. To base its business model on totally entrusting production (and innovation) to third party industrial outfits only lasts for a time. There comes a point when the value of the brand or of the commercial proximity can no longer be justified against significant cost differentials, this time no longer industrial but commercial.

The three ways to relocate

Put simply, three effective strategies for relocation can be envisaged. Each of them corresponds to a particular economic and technological structure for production.

1 - Purchase of finished products from Asiatic competitors

This strategy involves subcontracting all of the value stages for research, development, industrialisation and production to a manufacturer located in the countries with low cost factors. The product can be purchased ‘on the shelf’, i.e. by changing little of the specifications proposed by the subcontractor, or with specific (minor) developments decided by the placer of the order.

This is, for example, the strategy adopted by Philips in bottom-of-the-range electronics. Philips televisions, DVD players and MP3 players of the first and second quartile are produced in China in the Shenzhen and Ningbo regions. Philips only makes marginal modifications to the product ranges and monitors the production in accordance with its quality policy.

The logic involves benefiting from the cost factor advantages of these manufacturers and operating leverage through the brands and the distribution networks that have been built historically. It offers value if the brand is able to continue to retain its hold on products with strong added value coming from its own innovations. In the opposite scenario, it becomes difficult in the end for a western brand to distinguish itself and to maintain the brand premium. It is therefore an effective strategy as long as it is focused on one part of production, i.e. that offering the weakest scale effects and/or the most shared technologies and know-how. It thus allows the allocation of additional resources for the portion of production handled internally and for R&D.

2 - Relocation of production to countries with low cost factors

This strategy involves transferring the industrialisation and production stages to a country with low cost factors, on an exclusive production site, whilst retaining research and development in Europe or in the United States, or by also transferring it close to the relocated factories.

The bagless vacuum cleaner manufacturer, Dyson, which has grown strongly thanks to its major innovation at the beginning of the 1990s, closed its production site in England and transferred it to Malaysia. All of the production expertise was transferred in two years, from industrialisation through production to downstream logistics. On the other hand, research and development have been retained in the United Kingdom.

The IT accessories manufacturer Logitech followed the same strategy in production and continued it in research and development. Today, for basic products (basic mice and keyboards), development is undertaken by the subcontractors. In the case of intermediate products (hi-fi and MP3 connected systems), research and development have been relocated to Taiwan and production is carried out in China. For the complex products (laser mice, webcams, remote controls), research is carried out in the United States or in Switzerland, development takes place in Taiwan and production in China.

In a generic manner, we can assume that, for products with strong effects of scale or strong technical or cultural barriers to innovation, there is a value in retaining exclusive production. In this case, it is illogical to transfer the expertise acquired through this leadership to third party manufacturers, including the Asiatic ones. This would enable them to accelerate the acquisition of their own expertise and to quickly reduce the technical differential. Moreover, this strategy makes it possible to retain an industrial activity and facilitates the development of innovation.

3 - Assembly in Europe with stripping down of the value and the purchase of low added-value modules in countries with low cost factors

Production in Europe is still possible under two conditions:

- The production must have strong effects of scale and experience and a high barrier to technical and cultural innovations or high logistical barriers. A European company, even if it has unfavourable cost factors compared with Asia, will be able to be competitive if it is of a relatively large compared with the Asian competitors. This is the case today, for example, in aircraft production.
- The whole of the supply chain must be able to be competitive in Europe. If a significant downstream costs differential exists, competitiveness on only one upstream value stage is insufficient.

For example, the production of jeans for the European market moved in 20 years from a nearby source (Eastern country, North Africa) to a growing part of Asia. The production of the fabric ('denim') is an activity with strong scale effects, requiring significant size and experience. At first sight, it shows the characteristics of products likely to be kept in Europe. Nevertheless, it is integrated in the textile supply chain and is affected by the relocation moves of the clothing businesses.

In this context, the challenge therefore involves stripping down the value chain. It involves producing or subcontracting the low-value stages in countries with low cost factors in order to focus on the stages that show the strongest organisational barriers (scale, know how, technologies, ...).

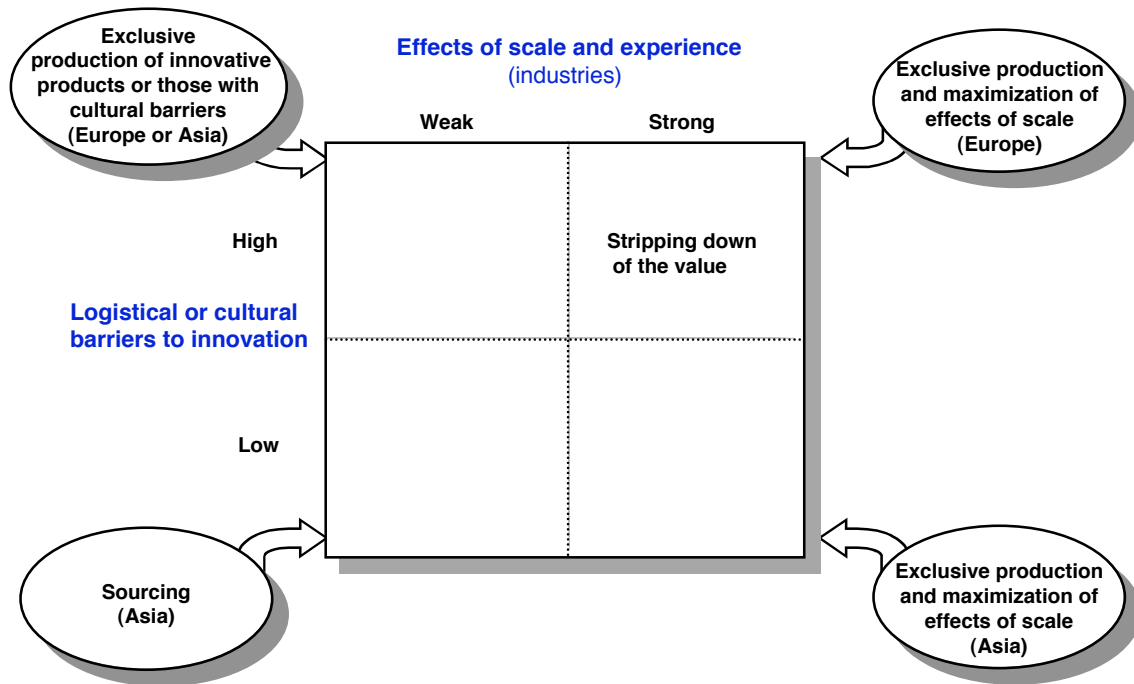
For example, for a long time now a large proportion of the components for Rolex watches have been coming from Asia. The core mechanism and the assembly are completed in Switzerland. Similarly, the Japanese car industry benefits from the cost advantages in the countries of South East Asia for all of the production stages with low added value.

This strategy requires substantial experience in order to maintain control over all of the variables necessary for its success: quick adaptation of specifications; quality control; reliability of supply; differential batch sizes; integration of modules; etc. Consequently, there is a value in launching this process sufficiently early, and this includes industries that are not now under pressure in this field ...

- Figure 2 -

Successful production strategies are part of a segmented logic

ILLUSTRATION



Source : Analysis Estin & Co

What conclusion can be drawn?

Today, the successful production strategies are part of a segmented logic (see Figure 2). It is becoming increasingly necessary to differentiate strategies according to the nature of the products.

For some, the sourcing strategy is unavoidable. It must be introduced quickly in order to benefit from the opportunities that it offers and to free up resources to invest in other products or in other stages of the value chain.

For others, the stripping down of the value chain is crucial. It allows the industrialist to focus on the stages with high added value and a significant lowering of overall costs. Again, the speed of implementing the strategy is at least as important as the end vision of this strategy. Intensive analyses of the characteristics (economic, technological etc.) of each business are fundamental to defining the options in order to avoid going around in counter-productive circles or having damaging periods of stagnation.

Moreover, the industrial strategy requires the inclusion of the innovation strategy in an integral manner. Major industrial moves often lead to a loss of expertise and know-how. Thus they reduce the relevance of their capacity. Innovation strategies must therefore be defined and modified in association with the location of the production units, with more effective and better-controlled processes.

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Estin & Co is an international consultancy in strategy based in Paris, London, Geneva and Shanghai. The firm assists the boards of major European and North American Groups in their growth strategies, as well as private equity funds in the analysis and value improvement of their investments.