Transform and Thrive: How to Win in China's Era of Uncertainties

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July 2019

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Executive Summary

"If it ain't broke, you should fix it anyway." The old adage has been turned upside down in the business world.

In China, it is time for business leaders to start fixing their companies to ensure resilience in a rapidly changing landscape—transforming preemptively. Even if everything is going well *so far*, winners will anticipate the effects of new competitors, technology disruption and new business models, tariffs and even economic slowdown ahead of time. Many Chinese businesses have expanded and become much larger in the past few years but will not be resilient enough to survive the changes in the next era. Winners focus on how their business can grow *stronger* rather than *bigger*.

Most leaders in China today face a situation in which parts of their business stand to lag behind amidst change while other parts hold massive potential. They need a dual approach, managing for operational excellence with the required details and discipline to improve day-to-day, while at the same time identifying the most attractive growth opportunities and aggressively executing on those.

In important but vulnerable Chinese sectors such as technology, electronics, and automotive manufacturing, we are seeing companies start to recognize the urgency of acting.

In this working paper we show how Alibaba Group, Carlsberg Group and HSBC have mastered transformation and come out stronger in turbulent times. The findings presented here are the result of our latest research and experience working with more than 750 corporate transformations across different industries over the past decade.

Business has been riding a wave of largely uninterrupted growth in China for more than three decades, but for most companies the breakneck pace that has allowed them to thrive is now slowing down. What has led to success in past years will no longer be enough to continue to win.

A host of well-known macro-economic challenges are reshaping China's economy, especially tariff changes, higher costs and the credit squeeze. Most companies are feeling the heat.

Even the fastest growing companies in nearly every sector are facing a slowdown in which revenue growth is expected to decline. As a result, they will need to trim expenses and manage for excellence and maximum cash flow—while at the same time aggressively pursuing new growth avenues.

Industries that Will Feel the Impact

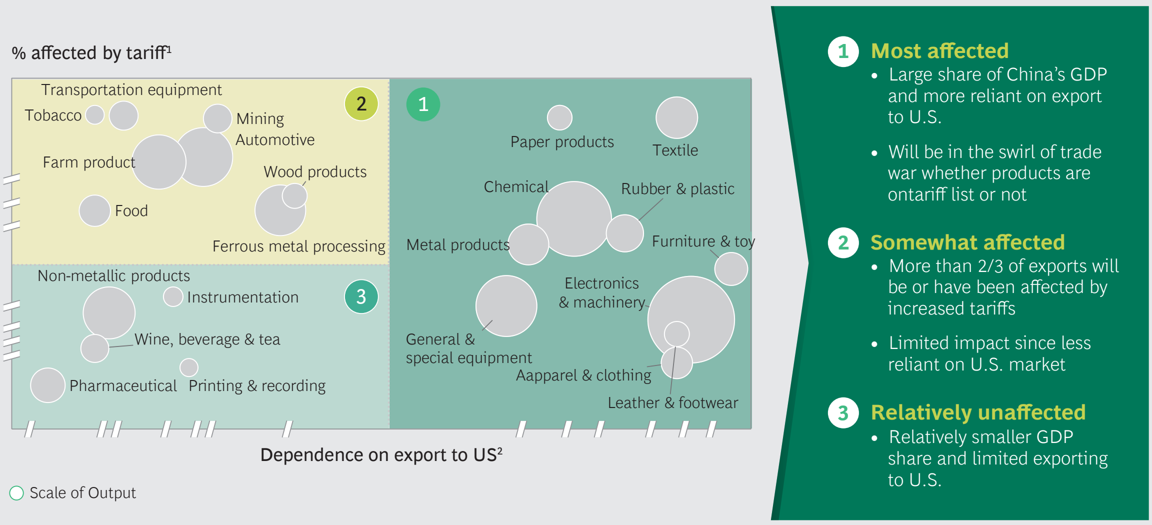
China's efforts to curb excessive debt are likely to weigh on growth, although we do not expect to see a crisis in relation to deleveraging. Household debt as a percentage of GDP has nearly tripled in 10 years, mostly from mortgages, and has had a dampening effect on the real estate market and consumer products. Notably, automobile sales plunged in 2018 for the first time since the 1990s and continued to decline in 2019.

Industries that rely on the export market might see a negative impact if forecasts for a global slowdown materialize. The electronics sector stands to take a particularly large hit from U.S. trade tariffs, particularly over the long term if tariffs make higher retail prices necessary, as consumer electronics such as computers and smartphones are a major contributor to China's GDP and the U.S. trade deficit. Footwear and apparel makers that assemble their products in China are also at risk of seeing sales drop if they have to raise their prices or if the global economy declines, as are makers of textiles, paper products, chemicals, metal products, rubber and plastic, furniture and toys, and equipment. (See Exhibit 1.)

Big Opportunities in Disruption

The uncertainties in China today present an important incentive for companies to transform preemptively, anticipating future scenarios and maximizing their operational excellence now. From there, they must continue striving to optimize the business to fund

EXHIBIT 1 | Impact of U.S. Trade Dispute on Chinese Industries



Sources: US Census Bureau; UIBE GVC; Guotaijunan; BCG analysis.
[1]Defined as trade value of the products that export from China to US and affected by tariff/total export value from China to US, by industry.
[2]Defined as value of the products export to US/GDP, by industry.

the journey and produce cash flow that allows them to invest aggressively in new growth areas that are coming to the surface.

In "Transformations that Work—and Why," the BCG Henderson Institute defines transformation as "a fundamental reboot that enables a business to achieve a dramatic, sustainable improvement in performance and alter the trajectory of its future."

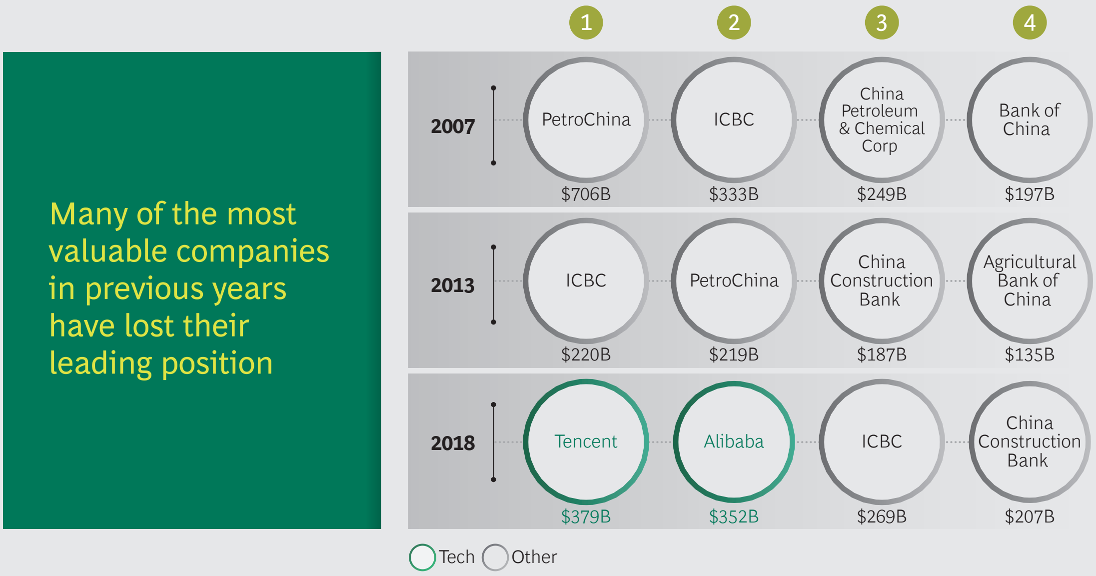
The Time to Act Is Now

It pays to be paranoid, always questioning whether what you're doing is good enough, even when your company is winning. Certainly, in China there is no guarantee that today's largest companies will be in first place tomorrow. (See Exhibit 2.)

When the economy begins to slow down, companies that think ahead and embark on a transformation strategy will have an advantage over slower-to-act competitors. Those competitors might even become inexpensive acquisition targets.

Our research found that companies that transform preemptively showed a growth in value created, reflected in total shareholder return (TSR) that, on average, was 6% higher over a three-year period than the TSR of companies that had transformed reactively. Further-

EXHIBIT 2 | Top Four Publicly Traded Companies in China (by Market Cap)



Source: Standard & Poor's.

more, preemptive transformations were accomplished in 15% less time, at 20% lower costs, and with 20% fewer changes needed in the leadership.

In our report "Unpacking the U.S.-China Tech Trade War" we recommend that companies analyze how increased technology restrictions and tariffs from the U.S. might affect their value chains in terms of revenue, costs and asset allocation, then create a playbook of actions to take under various potential scenarios. A company can protect its supply chain by prequalifying new suppliers, for example, or change the economics through automation or a shift to more flexible, regional approaches to manufacturing supply chains.

A durable-goods company with a preemptive strategy began reviewing the implications as soon as the US began indicating it would raise tariffs on products imported from China. By doing so, the company was able to set up more than two dozen cross-functional mitigation projects, so that they had a 9- to 12-month advantage over competitors that had been simply waiting for the U.S. and China to make a deal that would bring back the previous status quo.

What Makes a Transformation Successful?

None of what we've said should minimize the formidable challenges and risks that come with transformation. It's an expensive undertaking, and can distract everyone from the day-to-day business. We have found, however, that the transformations that increase a company's value tend to have at least five elements in common—the five primary drivers of success:

- Efficiency drive to fund the journey
- Revenue growth
- Long term orientation and R&D investment
- Leadership
- Formal transformation programs

Efficiency drive to fund the journey. Typically, corporate leaders start looking at how they can retrench when the economy slows down. Our research has found that leaner spending is necessary to fund the transformation and make it viable in the short term—certainly during the first year. China is becoming a high cost environment, and if a company doesn't have a cash generating operation, it will not have the strength to keep transforming. But simply cutting costs is not enough to boost value. Create an organization-wide plan to fund the journey. (See Exhibit 3.)

Cut costs and right-size non-core areas so that you can create a more efficient organization. Achieve excellence in operations by creating transparency and applying best practices in areas such as procurement, production processes, and logistics to boost margins and cash generation. Allocate capital out of the non-core functions and into such areas as R&D, innovation, talent acquisition, M&A opportunities, and precision marketing—the engines that will contribute to future revenue growth.

PSA, the parent company of Peugeot, Citroën, Opel, Vauxhall Motors, and DS Automobiles, which is partly owned by Dongfeng Motor Corporation, went through two massive cost-driven turnarounds in just 5 years. First PSA was able to turn around from near-bankruptcy after a capital injection from Dongfeng. Then, only three years later, PSA had gained the financial muscle to buy Opel from General Motors. Though GM had lost over $20 billion on Opel over 20 years, PSA was able to turn a profit of nearly US$1 billion in the first year.

Revenue growth. In an era when companies must adapt to a new environment, it's particularly critical to view preemptive transformation as a strategy for continued growth—not just a temporary turnaround strategy. You cannot cost-cut your way to greatness.

EXHIBIT 3 | Funding the Journey

PRIMARY LEVERS	CATEGORIES	COMMON TOOLS	TYPICAL IMPACT
COST REDUCTION	Procurement	Create transparency, better manage categories and suppliers, and improve procurement	Cuts procurement costs by 5% to 20%
	Supply chain	Improve logistics, optimize the network, and streamline the product portfolio	Reduces operating expenses by 10% to 30%
	Personnel cost	Increase efficiencies where possible. Outsource or offshore when cost advantageous	Potential cost reduction of 20% to 40%; part of savings should be reinvested in new capabilities
	Non personnel cost	Cut spending on travel, utilities, facilities, IT, and services	Lowers overhead costs by 20%
REVENUE	Pricing	Revamp pricing model, reduce discounts, and develop new pricing capabilities	Raises revenue by 2% to 8%
	Sales force effectiveness	Improve customer targeting and enable the sales learn	Increases revenue and profit by 10% to 15%
	Marketing	Optimize spending and implement data analytics	Reduces marketing costs by 10% to 20%; boosts sales volume by 3% to 8%
ORGANIZATIONAL SIMPLICITY	Streamlining management structure	Trim the number of layers and increase the spans of control	Shrinks indirect labor costs by 15% to 30%; improves accountability, decision making, and operational agility
CAPITAL EFFICIENCY	Net-working-capital improvement	Reduce inventory and handle payables and receivables more efficiently	Increases working capital by 20% to 40%
	Fixed-asset productivity	Sell assets, outsource functions, and increase overall equipment effectiveness	Lowers capital expenses by 20% to 30%; increases EBITDA by 2% to 8%
	Project portfolio optimization	Analyze net present value, prioritize projects, and eliminate failed projects	Improves relative TSR by 20% to 40%

Source: BCG analysis.
Note: EBITDA = Earnings before interest, taxes, depreciation, and amortization; TSR = Total shareholder return.

Case Study: Carlsberg Saves $300 Million and Reinvests for Growth

Carlsberg, a 170-year-old global consumer goods company, had been stagnating for several years, owing to heavy debt and challenging market conditions. The company's sales volumes were declining in several markets, and EBIT margins trailed behind those of its competitors.

In 2015, Cees 't Hart joined the company as CEO with a forceful idea of a strategic transformation aimed at restoring growth, focusing on premium products, and reorienting the company toward more attractive market segments. The company's considerable debt burden complicated the challenge, but Hart addressed that by launching a comprehensive two-year program. The goal was to save approximately $300 million and reinvest half of that in strategic measures that would boost growth, employee engagement, and new capabilities.

The transformation had two key components to fund the journey. First, Carlsberg reduced costs by streamlining the organization, improving operations, and increasing the efficiency of production processes. Procurement measures led to additional savings, as did steps to reduce complexity. Next, the company boosted short-term revenue growth by adjusting its mix of products, optimizing revenue management, and applying a systematic lens to promotions.

In addition, Hart set out to reconnect with Carlsberg's original purpose so that the organization could draw strength from its foundation and heritage.

This comprehensive approach allowed the company to reduce debt significantly, raise EBIT margins, and position itself to invest in the future. The share price shot up during the first two years, reaching an all-time high and—in terms of shareholder returns—beating Carlsberg's main peers.

In the past, rapid growth in China has laid the groundwork for expansion, but now many industries would do well to re-calibrate their business units with a focus on strength—i.e. growth engines—rather than size as they seek future revenue growth. Focusing on strength might mean cutting back or eliminating weaker product lines, re-purposing human resources, or emphasizing value-added products or services.

M&A activity is an important component of any visionary growth strategy. We anticipate that there will be interesting opportunities ahead to acquire other businesses at lower prices. This is a particularly powerful strategy for companies with strong operational performance and the ability to lift the performance in acquired units.

Long term orientation and R&D investment. We have found that the companies most likely to realize outsized gains in value creation following a transformation are those that make significant commitments to R&D. Investing in digital initiatives and new business

Case Study: How Alibaba Created New Growth Engines

When Jack Ma started Alibaba with 17 friends in 1999, he announced that their competitors were not going to be in China, but in Silicon Valley. In less than two years Alibaba had become a global company. The timing was inopportune, however. The company was burning through its cash, and in 2001, with dot.com companies everywhere collapsing and investors cutting their losses, Ma had to lay off the high-salaried international staff. It was a difficult time, but after making dramatic cuts in operating expenses and bringing the organization back to Ma's hometown of Hangzhou, Alibaba's founders took stock of their overly-ambitious expansion and began looking at how they could re-invent the fledgling company.

At the heart of Alibaba's transformation was a new emphasis on core values. All employees were trained to embody a set of values that included placing the client's needs first, teamwork, embracing change, integrity, passion, and dedication. In performance reviews, cultural fit counted equally with job performance, and even those who brought in great sales figures could be dismissed if they weren't compatible with the culture and collaborative with the team.

Ma's global ambitions were put on hold temporarily as the company concentrated on a business-to-business (B2B) clientele, focusing on the small and mid-sized enterprise suppliers that were expanding rapidly on the heels of China's accession to the World Trade Organization. Alibaba trained a local sales team called the "Iron Army," salespeople who were expected to be self-driven and dedicated to their clients' needs, not just helping clients find buyers but also solving their problems. Incentives, which included a low base against a high commission, frequent rotation to learn new skills, and promotions for star performers, were designed to keep salespeople working hard to meet targets but also serving their clients at any cost.

The plan worked, and as the company's fortunes improved, they started a business-to-consumer (B2C) business with the online shopping site TaoBao. By the time the tech industry began to recover from the dot.com bust, Alibaba was an entirely transformed organization, with a culture that continues to encourage constant self-reflection and striving for improvement. That has included frequent re-organization of its more than 20 business units.

models is also key to effective long term success. These allocations tend to create more value than investment in capex.

Use digitization to enable further cost efficiencies and personalize client or customer services. Continue to gather data that can be analyzed and leveraged to constantly improve operations, products and services. A large real estate developer in China, for example, expanded its internal digitized systems to create an ecosystem of related business. The company developed an online real estate sales and service platform, so that customers can buy properties then continue to access information about property management and maintenance services.

Leadership. The right leadership team, capabilities, and performance management are of course critical. We've seen that, on average, transformations lead to higher value creation when they are executed by new management teams, although there is a higher variance in outcomes. What this means for incumbent management teams is that they need to be open-minded—and paranoid enough to constantly question what they can do better.

Furthermore, while the transformation may be run under a consolidated agenda, pre-emptive change generally works best when it relies on a culture that encourages new

Case Study: HSBC Simplifies the Organization

In the wake of the financial crisis of 2008, HSBC faced rising costs and regulatory challenges. From the 1990s to 2006, the bank made a series of acquisitions and grew its balance sheet fivefold. It ended up with operations—many of them standalone entities with their own processes and IT systems—in 88 countries. The result was a complex operating environment and few economies of scale.

When Stuart Gulliver (who started at HSBC at age 21) took over as CEO in 2011, a position he held until 2018, he immediately launched a turnaround, starting with rapid streamlining and simplification measures to fund the journey. The company reduced its head count by more than 20% and the number of countries where it operated from 88 to 67. Despite this geographic contraction, HSBC still covers 90% of global trade and capital flows, more than just about any other bank in the world. In all, these measures saved $4.7 billion by the end of 2016 and close to $6 billion in savings, mostly from middle- and back-office functions, by the end of 2017. In terms of operations, HSBC improved its capital performance, reducing risk-weighted assets by nearly $300 billion.

HSBC also restructured the organization to eliminate excess management layers and give leaders the right level of accountability. The structure consists of four global businesses supported by a set of globally run support functions. That has led to significant efficiencies. "It is only now, running businesses as single global verticals, that you can negotiate your procurement in ways that derive full economies of scale," Gulliver told Euromoney, a trade publication, in 2017. "We used to have countless separate contracts with IT companies, with the people managing our properties, with every supplier in fact."

More important, the company is making a big bet on digital, investing $2.1 billion from 2015 to 2020. Digital initiatives include automating back-office functions, improving the customer journey with mobile platforms, and creating an intelligence unit to spot financial irregularities among customers. HSBC also announced a partnership with Google Cloud for analytics and machine-learning capabilities. And the bank has a dedicated innovation unit to help it stay attuned to the movements of fintech players and digital-only competitors.

The turnaround won praise from investors and analysts, and in 2017 Euromoney named HSBC the world's best bank.

ideas, employee participation, and consensus building, rather than a heavy-handed, top-down approach. "Jazz leadership" describes the most effective style for leaders in the '20s. A winning organization should be structured like an orchestra, but its innovation and high-level decision-making should resemble the practices of a jazz ensemble. Each player should perform according to his or her strengths, without restrictions on their role. Today, in the fast-evolving and unpredictable business environment, traditional command and control leadership is neither feasible nor effective; leaders should be agile, welcome new diverse ideas and able to improvise to reach new heights.

Formal transformation programs. Our research shows that the most successful transformations take place under a formal, structured program that the company defines at the beginning of the process. We recommend one full umbrella program, often with a time horizon of 2-3 years or more, that factors in the entire company, as opposed to a collection of smaller programs for each business unit.

Our research also found that larger programs, with restructuring costs of at least 2% of sales, led to an increase in value creation that was five percentage points higher, on average, than that of companies that enacted smaller-scale changes.

The Transformation Process

We have organized the overall process into three distinct phases: rapid assessment, 100-day impact, and realization of full value. (See Exhibit 4.)

EXHIBIT 4 | A CEO's 3-Step Transformation Framework to Win Tomorrow

Assess full potential

- Analyze company's situation
- Articulate a compelling purpose for the transformation program
- Define a formal transformation program
- Launch no-regret initiatives that can generate results in 3-10 months

Begin to capture value

- Deliver impact of quick wins and prepare to launch longer-term initiatives
- Reduce costs while launching measures to boost revenues and improve capital efficiency
- Establish agile teams and build agile culture
- Implement digital quick-wins

Ensure disciplined execution of initiatives

- Execute initiatives to boost innovation, revenue growth, and long-term value creation
- Build capabilities among senior and front-line leaders through coaching and training
- Energize the organization through multi-way dialogue and change management
- Empower and equip HR team to act as a transformation partner

Source: BCG analysis.

In the rapid assessment phase, senior leaders take stock of what can be accomplished—and how to fund the journey. At this stage they should set targets and acquire the tools needed for a successful new operating model. Short-term no-regret initiatives, designed to provide flexibility in uncertain scenarios, are appropriate at this stage and set the tone for what is to follow. At the same time, this is when leaders must let all stakeholders know about the purpose of the transformation and put a long term formal program into place.

Somewhere between two and three months into the transformation, prepare to assess the 100-day impact. At this point there should be some improvement in earnings and a positive market response, key indicators that the company has begun to capture value. This is the time to plan longer-term moves for growth, build an agile culture, implement digital initiatives that will allow for quick wins, and strengthen your performance management, and well as get down to business with cost reductions and organizational efficiency.

After one to two years, and into the future, you should be able to gauge your success in the realization of full value phase. This is when you ensure continued disciplined execution of initiatives throughout the organization, building a culture of sustainable high performance and cost excellence. By then there should be an operating model in place that has changed the cost base and can make speedy changes as new initiatives and new technologies create more efficiencies—so that you can continue to reallocate capital to the company's growth engines.

A transformation is a complex undertaking, and the majority fall short of expectations for achieving their full target value, coming in on time or doing both. But the economic uncertainties in China today, especially when combined with the increasing pace of technological change and volatility, all point to a need for corporate leaders to be vigilant in determining what risks they might face in the next few years and acting preemptively.

Fundamental to a successful execution is the realization that you can never afford to declare the job completed. After you incorporate a formalized preemptive transformation program and the goals have been realized, it will be time to segue into more action to keep boosting efficiency and allocating capital to the company's most promising growth engines. Preemptive transformation is based on a constant sense of urgency that requires building permanent transformation capabilities and strengthening the adaptability of the organization.

For Further Reading

Advantage in Adversity: Winning the Next Downturn
An article by Boston Consulting Group
February 2019

Preemptive Transformation: Fix it Before it Breaks
An article by Boston Consulting Group
August 2018

Unpacking the U.S.-China Tech Trade War
An article by Boston Consulting Group
June 2019

The Transformations That Work—and Why
A focus by Boston Consulting Group
November 2017

The Comeback Kids: Lessons from Successful Turnarounds
A report by Boston Consulting Group
November 2017

Transformation: Delivering and Sustaining Breakthrough Performance
A book by Boston Consulting Group
November 2016

The Truth About Corporate Transformation
A media article by MITSloan Management Review
March 2018

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Acknowledgements

The authors would like to thank Khushal Puri, Gao Bo, Gu Li, Peter Toth and Zhan Hui for their contributions to this working paper, and Jan Alexander for her assistance in writing the working paper.

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