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BOOZ ALLEN / AMCHAM SHANGHAI STUDY FINDS COMPANIES ADOPTING CHINA AS BOTH A GROWTH MARKET AND MANUFACTURING HUB ARE TWO-THIRDS MORE PROFITABLE THAN OTHERS

Full Global Integration of China with Global Supply Chains and Boosting Operational Excellence are Keys to Countering Rise in Currency, Labor Costs

SHANGHAI / BEIJING / HONG KONG, March 4, 2008 - The advantage of China solely as a low-cost, manufacturing-for-export market is diminishing. Companies that integrate China into their global supply chains as a source of competitive advantage are far more successful than companies that pursue narrower objectives in China, finds a study jointly conducted by management consulting firm Booz Allen Hamilton and the American Chamber of Commerce in Shanghai (AmCham Shanghai).

More specifically, companies that pursue China as both a growth market and a market for lower-cost labor and sources, and integrate these operationally, enjoy significantly higher profits than companies pursuing just one of those objectives. **Companies that employ dual sourcing and sales strategies report an average profitability rate two-thirds higher than those focused on just one of those objectives (29.6 percent compared with 17.8 percent).** Despite the returns that this approach can generate, only one out of four companies is able to combine a strong in-country market growth effort with their manufacturing and sourcing operations.

The first annual study, titled "China Manufacturing Competitiveness 2007-2008," found that while a stronger Chinese currency and rising wages were putting pressures on manufacturing margins, failures to deploy operational best practices and to fully leverage China as both a growth market and source of labor and products are also limiting profits.

"The manufacturing philosophy employed by many foreign multinationals in China in recent decades is in need of an overhaul," said Ronald Haddock, Vice President, Booz Allen. "China's changing cost and currency structure have shifted, forcing companies to rethink how they structure their Chinese operations and how they perceive China in their overall global strategy. At the same time, China is increasingly a major source of product and business model innovation. We're seeing globalization at work and China's role has changed."

More than half of the surveyed foreign-owned or foreign-invested companies manufacturing products in China believe that the country is losing its competitive edge in manufacturing to other low-cost nations. As a result, nearly one in five manufacturers surveyed has concrete plans to relocate or expand China operations to other countries, with Vietnam and India seen as the top alternatives to China.

Among the study's key findings:

- **Operations management is a factor:** The study found that three out of four companies lack fundamental best practices in their China operations, including integrating the dual functions of export platforms and domestic market penetration. Survey respondents cited a number of best practices that have yet to be fully applied in China. Just 11 percent

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reported fully applying integrated planning systems such as enterprise resource planning (ERP) software and material requirement planning (MRP). Even fewer companies – only 7 percent – had fully deployed analytical inventory calculation tools and processes, and 4 percent employed best practices for supply chain risk management.

- **Declining competitiveness:** More than half, or 54 percent, of companies surveyed believe that China is losing its competitiveness to other low-cost countries. Seven out of 10 respondents cited the rising renminbi as a major reason for China's decline, while wage inflation was cited by 52 percent of those polled. Wages for white-collar managers and blue-collar workers have jumped 9.1 percent and 7.6 percent, respectively. Staff retention is also a major concern, with 33 percent of respondents citing it as a reason for lost competitiveness.

At the same time that costs are increasing, China is lagging behind global standards in many operational dimensions, most notably in logistics infrastructure, trade environment, access to technology, management capabilities, and protection of intellectual property.

- **Companies eyeing Vietnam and India:** Nearly one in five companies surveyed (17 percent) say they have concrete plans to relocate at least some of their China-based operations to other countries. Although 88 percent of these corporations say that they originally chose China for its lower labor costs, they are finding that cheaper labor and tax benefits have made alternative locations more attractive. Among these corporations, Vietnam is the top alternative to China, according to 63 percent of this group, while 37 percent say India is their first choice.

Among all respondents, when asked to compare China to alternate countries, they cited lower labor costs in those other countries as the largest differentiator, at 3.7 out of a scale of 5, indicating that China's reputation as a source of cheap manufacturing labor is diminishing. However, the alternative countries lag China in market potential and infrastructure.

- **Majority staying in China:** Despite the rising costs of manufacturing in China, 83 percent of manufacturers said they will maintain their operations in the country. China's vast domestic market was cited by 78 percent of respondents as the reason to maintain the status quo, while 39 percent were unwilling to establish a new supply chain, motivating them to remain in China.

"China's phenomenal economic growth and market reform story, together with a dynamic and challenging business environment, will continue to put pressure on manufacturing companies," said Brenda Foster, President, AmCham Shanghai. "They will have to focus on continually improving their competitiveness and devoting more resources to innovation as they pursue their strategies and plans in China."

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Study Methodology

Booz Allen and the American Chamber of Commerce in Shanghai surveyed 66 foreign-owned or foreign-invested manufacturers in China, representing more than 10 percent of the 600 Manufacturers' Business Council members in Shanghai (including some of the largest foreign-owned or foreign-invested manufacturers). Online survey questions, on-site visitations, and in-depth interview methods were all deployed. Of the companies surveyed, 81 percent were wholly owned by foreigners, 10 percent were joint ventures between multinationals and Chinese partners, and 9 percent were categorized as "other."

The manufacturers' industries included consumer, industrial, healthcare, and materials. The study was conducted between September and November of 2007. The countries of origin of these manufacturers included the United States and several in Western Europe. Approximately 30 percent of the respondents have an additional major presence in China beyond their manufacturing footprints, including representative offices, regional or global headquarters, regional or global procurement centers, and regional or global R&D centers.

About Booz Allen Hamilton

Booz Allen Hamilton has been at the forefront of management consulting for businesses and governments for more than 90 years. Providing consulting services in strategy, operations, organization and change, and information technology, 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 19,000 employees on six continents, the firm generates annual sales of \$4 billion. Booz Allen has been recognized as a consultant and an employer of choice. In 2008, for the fourth consecutive year, *Fortune* magazine named Booz Allen one of "The 100 Best Companies to Work For," and for the past nine years, *Working Mother* has ranked the firm among its "100 Best Companies for Working Mothers."

To learn more about the firm in Greater China, visit the Booz Allen Greater China Web site at www.boozallen.com.cn. To learn more about the best ideas in business, visit www.strategy-business.com, the Web site for *strategy+business*, a quarterly journal sponsored by Booz Allen.

About AmCham Shanghai: The Voice of American Business in China

AmCham Shanghai is the largest and fastest growing American Chamber in the Asia-Pacific region with more than 3,700 members, including 1,700 corporate members. The Chamber hosts more than 250 events each year and has 22 active industry committees. AmCham Shanghai's mission is to create a better business environment for U.S. companies and to help foster China's overall economic development. For more information on AmCham Shanghai, please visit www.amcham-shanghai.org.

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