

Seeking Alpha α

Can China Manufacturers Make the Transition from Products to Services?

by: Brian Schwarz

August 05, 2009 | about: [CAF](#) / [FXI](#) / [GXC](#) / [PGJ](#)

Although it might seem counter-intuitive, China's manufacturing sector has emerged strengthened by the global economic downturn and the world's factory is moving up fast on the services front as well. As I mentioned in a previous post, so says a recent [report](#) from PricewaterhouseCoopers (PwC) on the relative attractiveness of emerging markets for foreign investors.

China's manufacturing sector has shot up from 14th position in PwC's index in 2008 to become the fourth most attractive destination in 2009, beaten only by Malaysia, Chile and Bulgaria, which are all much smaller economies. Of the so-called BRIC countries -- Brazil, China, Russian and India -- China was the only one to improve its position.

This strength hides some deeper concerns in the sector. The fact is cost advantages at Chinese factories are disappearing as more companies search for ways to create value by adding services.

Citing a recent report from the American Chamber of Commerce in China, **Richard Brubaker**, founder and managing director of [China Strategic Development Partners](#) in Shanghai recently wrote this passage on his *All Roads Lead to China* blog:

Even with the current economic conditions, manufacturing in China has become more expensive. Companies reported that costs are still rising – up to 15 percent in 2008 compared to an increase of 10 percent in 2007 – particularly in compensation costs for management, support staff and blue-collar workers as well as raw materials. Although labor and raw materials costs have come down from the premium levels of last summer, they are expected to rise again once market conditions improve.

Following the path of [IBM](#) and others, the key question facing some Chinese companies can they transform themselves from sales-driven manufacturers to global service suppliers?

In early 2008, the Chinese government announced plans to invest in the service sector. This investment involved capital bailouts and tax breaks, covering everything from professional services though to IT outsourcing. “And they are encouraging business leaders to become familiar with service business so that they can penetrate the international market in services in a very serious way,” says Laurie Young, a former PricewaterhouseCoopers global marketing partner.

The combination of price pressures and competition brings “margin squeeze” back into the China vocabulary as profit margins begin to erode in many industries. Concerns about inflation are also now becoming more widespread as price pressures mount, says China watcher Jack Perkowski at his *Managing the Dragon* blog.

According to a [recent article](#) in the Wall Street Journal,

manufacturers in China face rising costs as some commodity prices grow, but economists say producers may not pass on the costs to consumers because of fierce competition.

Despite sluggish exports, China's manufacturing expanded in July at its fastest rate in a year as domestic demand, a recent survey showed, highlighting the importance of the central government's huge stimulus in driving the country's economic growth. Hong Kong brokerage CLSA Asia-Pacific Markets said China's monthly purchasing managers index,

or PMI, rose to a 12-month high of 52.8 on a 100-point scale where numbers above 50 indicate an expansion. That was up from June's 51.8.

Young says Western companies will soon face a growing challenge from Chinese competitors in his fourth book, *From Products to Services: Insight and Experience from Companies Which Have Embraced the Service Economy* (Wiley). In a recent interview with *China Knowledge@Wharton*, Young noted a number of Western manufacturers, such as IBM and Unisys, have not made the transition from manufacturing to services successfully. China-based Lenovo, of course, bought IBM's struggling PC division in 2005.

As a manufacturing economy, many Chinese seem to approach services with a manufacturing mentality which doesn't help in enhancing service levels.

"In China, there's an awareness-raising process that's just beginning," says Young. "But I think what you see here in China is a government that is serious about understanding the different dynamics of the service business – what are the strategies, and how do you run it?"

In March, Shandong-based manufacturer Haier announced that it was leaving direct manufacturing and concentrating on building the company's brand and service network.

China is seeing the beginning of a government-led move to raise awareness of what Young calls "the service opportunity." Together, this spells an opportunity for Chinese companies to grow global service businesses, in addition to benefiting from an expanding domestic market.

Services, which today makeup between 70 to 80 percent of GDP in Western economies, took 25 years or so to develop. China's transition is expected to be even faster. Young concludes,

Nowadays, with the dominance of the service sector in so many Western economies, manufacturing companies older than ten or twenty years have to ask if their traditional businesses are dead dogs, and whether they should be moving into services.

Disclosure: None