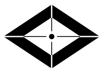


BEYOND OFFSHORING

Assess Your Company's Global Potential

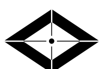
by Diana Farrell

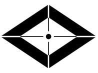
How global an industry becomes depends on the interaction of production, regulatory, and organizational factors. Companies that read the landscape correctly will capture dramatic revenue growth.

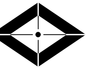
In the past few years, most companies have become aware that they can reduce their costs significantly through offshoring – moving jobs to lower-wage locations. But this practice is just the tip of the iceberg in terms of how globalization can transform industries, according to a recent comprehensive study by the McKinsey Global Institute. By streamlining their production processes and supply chains globally, rather than just nationally or regionally, companies can dramatically lower their costs and drop their prices to increase demand for their products, attract new customers, and even enter new markets.

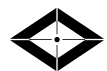
To date, however, few businesses have recognized the full scope of performance improvements that globalization makes possible, much less developed proactive strategies for capturing these opportunities. Indeed, organizations' narrow focus on offshoring is obscuring the bigger picture – that this trend is just the latest in the evolution toward a truly global economy.

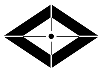
More than 100 years ago, the prospect of reaching huge pools of new customers in foreign markets lured large trading companies out of their home territories. In the 1980s, manufacturers based in North America, Europe, and Japan built plants and hired workers in low-wage countries, then exported the finished goods back home. In the 1990s, companies in a handful











of industries, such as consumer electronics, pushed globalization even further by relocating their component production and final assembly to countries with the strongest cost advantages. Now, globalization is beginning to transform the service industries.

Thanks to plummeting telecommunications costs and the digitization of some paper-based business processes, many service jobs and back-office functions are now being performed remotely. Data entry, transaction processing, and call-center customer support have been the obvious candidates, but even high-skill jobs in software development, manufacturing design, and pharmaceutical research are being migrated to low-wage countries.

Service businesses currently employ 83% of all U.S. workers and represent a similar share of the GDP. By contrast, manufacturing now accounts for less than 11% of all U.S. jobs. The situation is similar in other developed countries. The IT research firm Forrester projects that by 2015, U.S. companies will move 3.3 million service jobs to low-cost countries, including 8% of IT jobs. This all sounds ominous – until you consider that in the U.S. services sector, more than a million people change jobs *every month.*

Although most managers are focused on globalization (particularly the offshoring opportunity) as a lever to reduce costs, they should be viewing it as a means to generate new revenues, as well. Organizations that can capture the full potential of globalization will see dramatic revenue growth, while those that can't will lose market share.

How Global Are You?

To realize the full potential of globalization, you first need to assess where your industry falls along the globalization spectrum; not all sectors of the economy face the same challenges or opportunities at the same time. To measure how global your industry is, calculate the ratio of the annual value of global trade (which includes trade in product components as well as final goods) to the annual value of industry sales. Ratios over 100% indicate industries that are very global. Consumer electronics, for instance, boasts a trade-to-sales ratio of 118%, which means the industry generates 18% more value from the trade of components and finished goods among global business partners than from the sales of final goods to consumers. (For an overview of where the five industries we studied fall along the globalization spectrum, see the exhibit "How Global Is Your Industry?")

In the past decade, consumer electronics companies have been under competitive pressure to innovate quickly and cut costs aggressively. The end result? A globally disaggregated, specialized, low-cost value chain. For example, the PC on a U.S. worker's desk today might have been designed in Taiwan, assembled in Mexico (using components from South Korea, China, and Thailand), and marketed and sold in the United States by a company that focuses most of its attention on marketing and selling the computer under its brand name, rather than on designing, sourcing, and manufacturing the machine.

The consumer electronics industry was ripe for globalization. It uses small, lightweight, high-value components that are cheap and relatively easy to ship. It can exploit large economies of scale, particularly when producing the standardized components used in multiple electronics products. Equally important, in most countries there are few governmental or organizational barriers – protectionist restrictions, tariffs, or union opposition – to prevent consumer electronics companies from shifting various production processes from one nation to another.

But not every industry is ready for such high levels of globalization. On the globalization spectrum, the apparel, automotive, and steel industries fall somewhere in the middle: They all have much to gain but face some daunting obstacles.

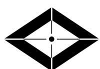
The apparel industry has a relatively high trade-to-sales ratio (77%) – and is therefore fairly global – for two reasons. First, labor accounts for the bulk of the industry's production costs, which makes it attractive for manufacturers to move parts of their production processes to low-wage locations. Second, clothing is lightweight, which makes it cost-effective for companies to transport finished goods to consumers, no matter the distance. But the industry has been constrained by the Multifiber Arrangement (MFA), an international system of quotas and import restrictions that protects textile and clothing producers in more than 30 developed countries and handicaps the world's lowest-cost apparel makers. The result has been inflated prices and distorted trade patterns across the industry.

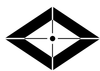
All this will change when the MFA quotas expire January 1, 2005. There will be a complete upheaval in garment manufacturing, an industry that employs 40 million people worldwide. Large buyers in the United States

An In-Depth Look at Globalization

The McKinsey Global Institute recently completed a comprehensive, yearlong study of globalization in which my colleagues and I looked closely at four major developing economies (China, India, Brazil, and Mexico) and five important and diverse industries (automotive, consumer electronics, food retailing, retail banking, and IT/business-process offshoring). Complementing this work were studies we have conducted over the past ten years examining the apparel and steel industries in multiple countries. We analyzed macroeconomic and company- and industry-specific data, and we conducted more than 150 interviews with executives and industry and country experts.

Diana Farrell *is the director of the McKinsey Global Institute, McKinsey & Company's economics think tank, in San Francisco.*



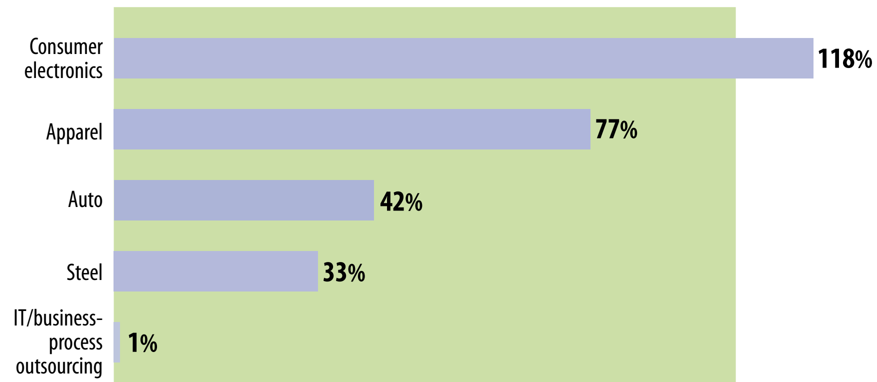


and Europe will begin to consolidate their purchases with just a few countries. Among those countries, China is expected to be the biggest winner, while smaller garment-producing nations are in for a struggle. In the United States, where employment in apparel manufacturing fell from about 929,000 in 1990 to about 293,000 in 2004, as many as 70% of the remaining jobs could disappear over time after the MFA is lifted.

However, some segments of the apparel industry will be easier to globalize than others. Fast-fashion retailers like H&M, Old Navy, and Zara, which focus on selling trendy clothes that go out of style quickly, need to locate their production processes close to the regional markets they sell in. Indeed, those companies are willing to pay slightly higher labor costs in exchange for greater speed and flexibility. Meanwhile, retailers that deal in basic apparel – where speed to market isn't as critical – can optimize their cost savings by locating their sourcing and sewing operations in low-wage countries.

How Global Is Your Industry?

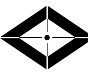
An easy way to measure the degree of globalization in your industry is to calculate the ratio of the annual value of global trade (which includes components shipped to multiple countries as part of the production process, as well as finished goods) to the annual value of industry sales. Ratios over 100% indicate industries that are highly global.



In the automotive industry, which has a trade-to-sales ratio of 42%, globalization has been slow because component parts aren't standardized. Many of the parts are bulky and, therefore, expensive to ship. These factors make it difficult for auto manufacturers to disaggregate their supply chains the way PC companies have done. The industry also faces some regulatory and organizational barriers to globalization. These include import restrictions and tariffs on auto parts in many developing countries, aggressive government incentives for manufacturers to locate their production processes where the cars will be sold, and strong unions in developed nations.

Globalization of the steel industry, which has a trade-to-sales ratio of 33%, has been hampered by the capital intensity of steel mills, high tariffs and government-mandated cleanup costs, the industry's relatively low share of labor costs compared with its total costs, and the expense of transporting the finished products. While regulatory change alone wouldn't eliminate all those constraints, it could significantly reduce the cost of steel and accelerate global trade. For example, if the state of California had not been required to use domestic steel only, construction costs for the earthquake-damaged Bay Bridge in San Francisco could have been reduced by an estimated $400 million.

Compared with the above examples, the service industries are still in the early stages of structural change from globalization. Even in business-service functions such as payroll processing, IT, and transaction processing, the trade-to-sales ratio is a mere 1%. Many customer-service industries such as banking and retail, because of their very nature, often need their production processes to be close to where consumption is. This requirement has left globalization of the service industries in the hands of multinational companies such as Wal-Mart and Carrefour, which export their home-country retail business models to new markets. Some service organizations are expanding their markets by developing new business lines, such as 24/7 technical support or customer service, that are managed remotely. And some companies are sourcing their goods globally.



How Global Can You Be?

Once you understand how global your industry is, you need to define globalization's full potential for your company. Although every company is different, most are affected by the same types of internal and external forces. The challenge is to figure out how these forces will strengthen or weaken over time – and how to capitalize on that evolution. Three types of factors determine the course of globalization in an industry or a company: production, regulatory, and organizational.

Production. In this category, there are two factors that, in combination, determine an industry's potential for disaggregating its value chain: *relocation sensitivity* (how feasible and attractive it is for an industry to relocate parts of its production processes) and *location-specific advantages.*

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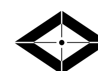
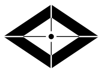




To figure out your relocation sensitivity, consider metrics such as your typical bulk-to-value ratios (the currency value per pound of production material), the ease with which your company can ensure quality standards remotely, how quickly your products or components become obsolete, the volatility of the demand for your service, and any sunk costs. Industries that make bulky items that are hard to transport, such as steel or timber, may have little incentive to move their production processes. Companies that have already made huge capital investments in developed countries may not be able to justify shutting down existing factories even if the variable costs of production in developing countries are much lower.

To determine your location-specific advantages, look at variables including labor intensity, skill requirements, natural-resources intensity, and economies of scale and scope. Labor-intensive industries, such as apparel, have a greater incentive to move production to lower-wage countries. The exception would be a business whose workforce must possess specific skills that are not available outside a few countries. Industries that rely heavily on natural resources, such as the furniture sector, may find it advantageous to locate their production processes in countries where those resources are plentiful and therefore less expensive. Industries in which components are standardized, like consumer electronics, can take advantage of economies of scale in the production of individual components such as microprocessors and memory chips.

Regulatory. Host countries' regulations can inhibit globalization in several ways. A country can impose tariffs, set quotas for imports and exports, require foreign companies to enter into joint ventures with local companies, specify minimum content from local production, ban foreign investment outright, or fail to invest in regulatory and legal infrastructures. Indeed, regulatory factors – particularly countries' efforts to restrict imports or foreign investment – are among the biggest constraints to globalization in many industries today.

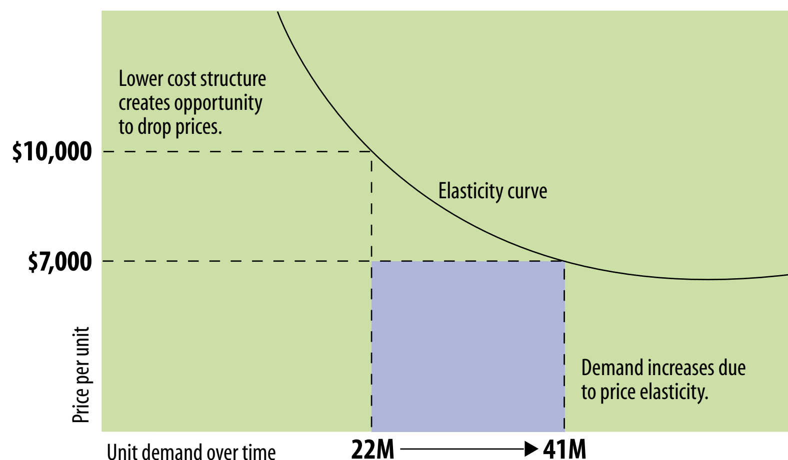
Organizational. Three organizational factors can limit globalization for a company or an industry: internal management structures, incentive systems, and unionization. For example, offshoring in many U.S. companies has been slowed by midlevel managers' reluctance to give up some responsibility for the migrated positions. Companies must realign management incentives with global, not local, performance metrics, while still allowing for local innovation and risk taking. If companies lean too far toward either extreme, they are likely to miss some important opportunities to restructure and improve.

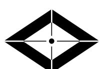
Production, regulatory, and organizational forces evolve over time, and the full potential of globalization for companies and industries changes with the geopolitical and macroeconomic environment. The development of the General Agreement on Tariffs and Trade and the World Trade Organization, for instance, has enabled rapid growth in global trade for most manufacturing products and, more recently, for services. The decline in cargo costs due to standardization of containers and more efficient transport service has encouraged more companies to ship bulky products globally. GPS technology has allowed some companies to closely monitor their road freight and achieve better logistics control, enabling them to disaggregate their value chains. And the improved quality and radically reduced costs of international telecommunications have created the offshoring opportunities we cited earlier.

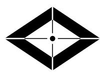
Escalating competition, steady trade liberalization, and the continual introduction of new technologies will increase the pressure on companies to globalize. Businesses that view the status quo as fixed and neglect to capitalize on emerging global opportunities will be blindsided; those that find ways around the obstacles and prepare for the next stages in their industries will win out. IKEA has pushed the envelope by creating a new

Expanding Your Market

Companies know that they can create more demand for their products and services by reducing their prices. What most fail to realize, however, is the degree to which this is true in a global setting. In the auto industry, for instance, if a manufacturer dropped its price for a certain vehicle by 30% – from $10,000 to $7,000 – worldwide demand for the product would nearly double from 22 million units to 41 million units.







TO DATE, few businesses have recognized the full scope of performance improvements that globalization makes possible, much less developed proactive strategies to capture them.

business model around low transportation costs. The modular design of its furniture (customer assembly is required for nearly all items) means IKEA can transport its goods worldwide much more cost-effectively than traditional furniture manufacturers can. Companies like IKEA shape and accelerate their industry's global evolution by identifying which of the barriers to globalization can be changed.

Standardization is a critical part of globalization in many industries, but it has been resisted by some. Standards can penetrate an industry in two ways – companies can voluntarily adopt them, or governments can impose them. Consumer electronics was transformed when a critical mass of companies, driven by competition in the industry, voluntarily embraced standards. By contrast, it's been hard for manufacturers in the wireless handset business to achieve global economies of scale: Europe mandated the GSM standard, while Japan chose the PDC standard. And in the auto industry, there's been neither regulatory nor competitive pressure to increase standardization, despite the potential scale opportunities in components like windshield wipers and headlights.

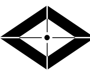
How Do You Get to Global?

After you've considered which constraints to globalization can be changed, you need to identify your options for capturing value in the new global environment. Our research demonstrates that industries and companies both tend to globalize in stages, and at each stage, there are different opportunities for creating value. Most multinational companies have invested abroad either to seek new markets and customers or to achieve greater production efficiencies. But the full profit opportunities go well beyond these objectives. Let's consider each stage of globalization.

Stage One: Market Entry. Companies enter new countries using production models that are very similar to the ones they deploy in their home markets. To gain access to local customers, these companies typically need to establish a production presence, either because of the nature of their businesses (as in service industries like food retail or banking) or because of local countries' tariffs and import restrictions (as in the auto industry).

Stage Two: Product Specialization. Companies transfer the full production process of a particular product to a single low-cost location and export the goods to various consumer markets. Different locations begin to specialize in different products or components and trade in finished goods. The North American auto industry entered this stage with the passage of NAFTA in 1994. GM now manufactures all Pontiac Azteks in Mexico and all Chevrolet TrailBlazers in the United States.

Stage Three: Value Chain Disaggregation. Companies start to disaggregate the production process and focus each activity in the most advantageous location. Individual components of a single product might be manufactured in several different locations and assembled into final products elsewhere – think PCs, for instance. Another example is the recent trend by U.S. companies to offshore some of their business processes and IT services.



Stage Four: Value Chain Reengineering. Companies don't just replicate their production processes abroad; they increase their cost savings by reengineering their processes to suit local market conditions – notably by substituting lower-cost labor for capital. Carmakers in India, for example, have tailored their manufacturing processes to take advantage of low labor costs. Not only do they use a more labor-intensive production process, but they also design and build the capital equipment for their plants locally.

Stage Five: Creation of New Markets. This final stage represents the expansion of the market. Stages three and four together have the potential to reduce costs by more than 50% in many industries, which gives companies the opportunity to substantially lower their sticker prices in both old and new markets and to expand demand. (See the exhibit "Expanding Your Market.") The McKinsey Global Institute estimates that if a carmaker dropped the unit price of a vehicle by 30% – from $10,000 to $7,000 – demand would nearly double over time, from 22 million to 41 million units sold (factoring in typical price elasticities). The value of new revenues generated in this stage is often greater than the value of cost savings in the other stages.

The five stages aren't necessarily a rigid sequence that all industries follow; companies can skip or combine steps. In consumer electronics, product specialization and value chain disaggregation (stages two and three)

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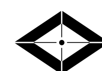
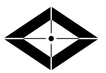
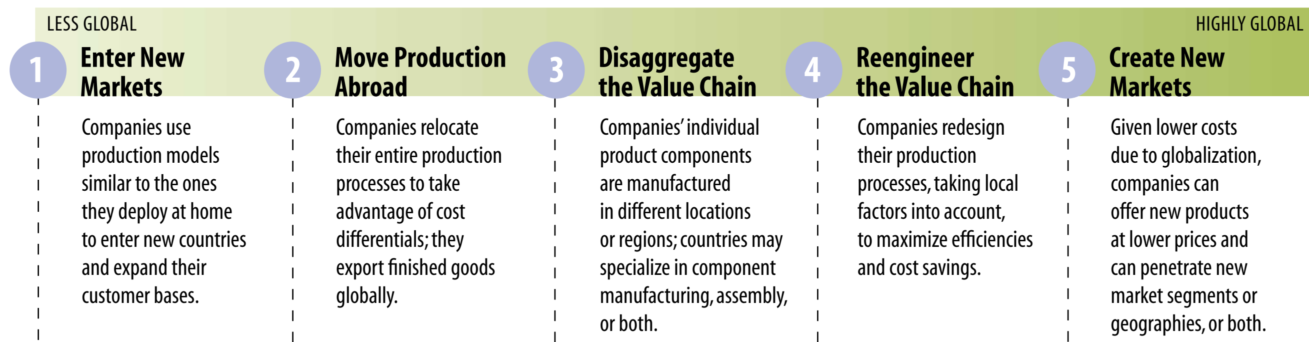




The Five Stages of Global Restructuring

Industries and companies tend to globalize in phases; at each stage, there are different opportunities for creating value. In the first three stages, value comes from basic improvements to typical business practices. In the last two stages, it comes from true process innovations and market expansion. The stages are not necessarily sequential.



occurred together as different locations started to specialize in producing different components (Taiwan focused on semiconductors and China on computer mouses and keyboards). And many consumer-electronics multinationals that were initially attracted by China's huge customer base have started to take advantage of the country's low costs to produce goods for export as well (stages one and two). (For an overview of this section, see the exhibit "The Five Stages of Global Restructuring.")

What's It Worth to You?

If you want to shape rather than react to your industry's evolution, you'll need to size up the opportunities that emerge for your business at each stage of globalization. This means determining the potential cost savings you could capture from global industry restructuring and identifying the new market opportunities this restructuring can create.

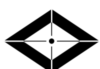
The first, and most obvious, cost-saving opportunity is in labor. The wage differentials between developed and developing nations are so large that they invariably offset any extra capital investments or management costs required to relocate jobs. For every data-entry worker who is paid $20 an hour in the United States, there is an equally qualified competitor in India who's paid $2 an hour. U.S. companies can typically cut their total costs by 45% to 55% by outsourcing their business processes to India.

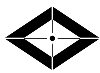
Companies can also reduce their costs by reengineering their production processes to substitute low-cost labor for high-cost capital. An offshore payments processor, for example, might hire people to input checks manually into a computer system rather than purchase an expensive license for imaging software. Certain auto manufacturers in China use robots for only 30% of the welding done in car assembly compared with 90% or more in U.S. or European operations. Indian auto plants are even more labor-intensive than plants in China; tasks such as painting, materials handling, and welding are done manually – with no discernable loss in the quality of the finished product.

Companies can also reduce costs by utilizing their capital equipment more intensively – running round-the-clock production shifts, for example, even if that means paying more for off-hours. Obviously, this option wouldn't make sense in a high-wage environment, where overtime premiums would offset any capital savings. By adding shifts, companies can reduce their operating costs 30% to 40%.

Finally, companies can hire local engineers in low-wage environments to design and build cheaper capital equipment or manage other fixed costs of doing business. Some business-process service providers in India are developing their own software instead of purchasing expensive licenses from branded global software companies. Maruti Udyog, an Indian carmaker, designed its own robots for its assembly lines, which cost the company a fraction of what Suzuki, its Japanese partner, paid a third-party vendor for similar machines. Companies can maintain the same level of automation as they do in high-wage countries – at a much lower cost – by taking advantage of local engineering talent.

Ultimately, companies can save as much as 70% of their total costs through globalization. Offshoring accounts for about a 50% savings, task redesign and training con-





tribute another 5%, and the remaining 15% comes from process improvements. (See the exhibit “The Full Potential of Globalization.”) But there’s more to the globalization equation than costs. By saving money, companies can lower their prices and offer new or improved products or services to existing customers and to new lower-income customer segments. After establishing lower-cost offshore call centers, U.S. financial institutions found that they could profitably provide personalized phone support to even their small-account customers. One airline relocated its accounts-receivable and collections functions to India – and reaped an additional $75 million in previously lost payments. Because the airline’s collection costs are lower, it can now track down and handle delinquent accounts more profitably. A leading U.S. PC manufacturer has established a customer service center in India – and has significantly increased the number of customer problems resolved on the first call (both by phone and via e-mail).

In developing countries, new market opportunities abound in the burgeoning middle classes. In China, local consumer-electronics companies have designed more affordable air conditioners aimed at very low-end market segments. In the Indian auto industry, Tata Motors is targeting the domestic market with the Indica, produced for a fraction of the cost of similar compact cars in the developed world.

Revenues from these kinds of opportunities will often exceed the cost savings from globalization. By our estimates, the global auto industry could lower its costs by $150 billion annually and earn $170 billion in additional revenue ($100 billion in developing markets and $70 billion in developed markets) by introducing lower-cost cars.

What Are the Risks?

No one company – whether it’s seeking new revenues or lower costs – has a template for operating successfully in all developing markets. Indeed, the landscape is littered with companies that attempted to expand abroad and failed. Growth through global expansion can be risky. In the consumer electronics industry, shareholder returns are driven by a company’s degree of globalization. But in the retail and auto industries, there is little correlation between the percentage of revenue that companies generate outside their home markets and the companies’ total returns to shareholders.

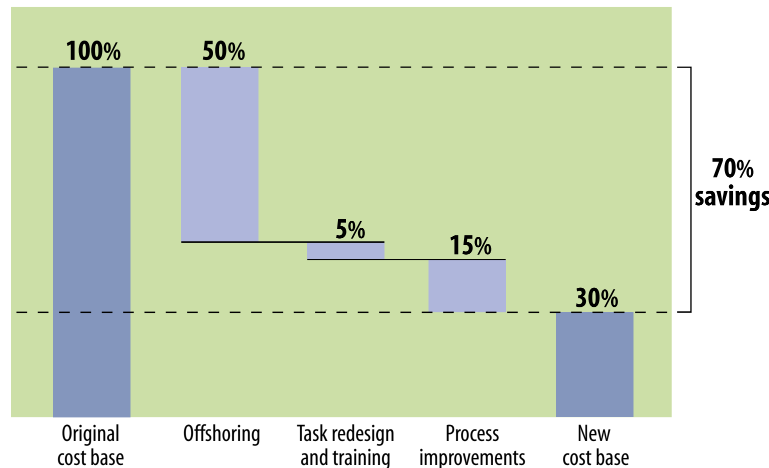
The experiences of French retailer Carrefour and U.S. retailer Wal-Mart in Brazil and Mexico illustrate the need for both optimism and caution in the pursuit of globalization. Carrefour succeeded in Brazil but not Mexico, while Wal-Mart’s experience was the reverse. Success in food retailing requires a balance of strong local knowledge and global capabilities. The former can be achieved through partnerships or acquisitions or over time. The latter can be built through the transfer of talent, technology, and best practices.

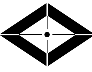
Carrefour successfully introduced the hypermarket store format – large stores that carry groceries as well as department store merchandise – in Brazil in 1975. Because of the variety of products they carried, Carrefour’s stores had a particularly strong value proposition during Brazil’s hyperinflation of the 1980s and early 1990s. Consumers could make all their purchases in one place immediately after receiving their paychecks. Because Carrefour was an early mover in Brazil, it was able to acquire local knowledge before competitors arrived. Recently, however, the company has intentionally been less aggressive in global acquisitions and greenfield growth than other players. In Carrefour’s joint venture with multiformat Mexican retailer Gigante, there were disagreements about what mix of formats the stores would use. The JV failed, and since then Carrefour has chosen to grow slowly through organic expansion.

As the first international retailer in Mexico, Wal-Mart was very successful. It acquired Cifra, a leading Mexican retailer, and spent a great deal of time coaching the acquired management team. Wal-Mart shared its U.S. business processes, technologies, and best practices with the team. Few executives from the United States were transferred, however;

The Full Potential of Globalization

Companies can save as much as 70% of their total production costs through a combination of offshoring, task redesign and training, and process improvements.





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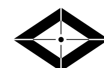
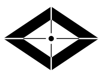




ORGANIZATIONS that can realize the full potential of globalization will see dramatic revenue growth. Those that can't will lose market share.

Wal-Mart's senior management in Mexico today is made up almost exclusively of former Cifra managers, with a few additions hired to fill skills gaps, such as in global operations. But Wal-Mart couldn't repeat this experience when it entered Brazil, which offered no suitable acquisition target among leading domestic retailers. Wal-Mart's initial, smaller-scale joint venture there failed. And slow, organic expansion has not yet given Wal-Mart the scale necessary to offer lower prices than its competitors.

These examples illustrate that while there is huge potential in globalization, not every company that globalizes is able to successfully capitalize on this strategy. A few companies will lead the charge; for others, change will become a matter of survival.

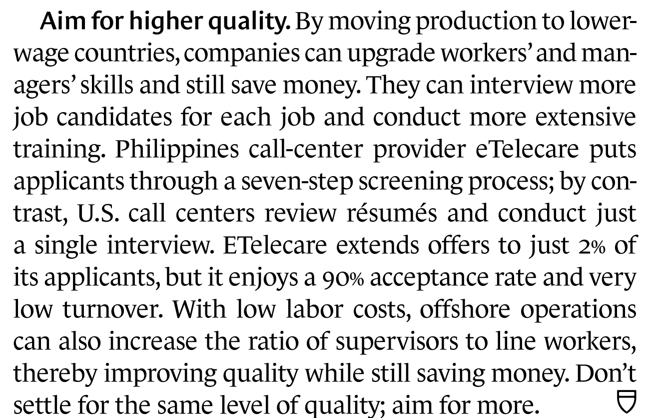
How to Win

To ensure success as your industry restructures along global lines, you'll need a sound strategy, consistent execution, and new ways of viewing your business and managing your people. Here are some lessons drawn from the experiences of companies that have done so successfully.

Abandon incremental thinking. Globalization creates opportunities for step changes in performance. A company's goals need to reflect this. The leading companies in an industry will replace their traditional, incremental targets for performance improvement with much higher expectations; the laggards will fall further behind. So adopt bold performance targets sooner rather than later.

Use global assets effectively and efficiently. The right mix of capital and labor will be very different in developing countries than in developed countries. Companies can get the best mix by doing three things: increasing labor resources to better use expensive capital, improving shift utilization, and developing cheaper capital equipment where appropriate. Doing just one of these things won't be enough.

Tailor your best practices to local conditions. Successful global companies must leverage the best practices they learn globally in ways that fit conditions in the host country. In Mexico, Wal-Mart uses the same trademark "everyday low price" strategy it uses in the United States–focusing on low, nonpromotional prices and comparing its prices to those of the leading nearby competitors. But the retailer has also done extensive local market research, and, as a result, Wal-Mart prices only the "most notable products" below those of its key competitors. Bear in mind that one size does not fit all.



Aim for higher quality. By moving production to lower-wage countries, companies can upgrade workers' and managers' skills and still save money. They can interview more job candidates for each job and conduct more extensive training. Philippines call-center provider eTelecare puts applicants through a seven-step screening process; by contrast, U.S. call centers review résumés and conduct just a single interview. ETelecare extends offers to just 2% of its applicants, but it enjoys a 90% acceptance rate and very low turnover. With low labor costs, offshore operations can also increase the ratio of supervisors to line workers, thereby improving quality while still saving money. Don't settle for the same level of quality; aim for more.

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To order, see page 151.

"Whoa! Sorry, Ed. Is there a power control on these laser pointers?"

CHRIS WILDT