

Hong Kong Manufacturing SMEs: **PREPARING FOR THE FUTURE**



Funded by SME Development Fund



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Foreword

On behalf of the Federation of Hong Kong Industries, I would like to present this report to Hong Kong manufacturing SMEs. As the third study under our “Made in PRD” Research Series, this study aims to provide them with practical guidance on dealing with the challenges emanating from reduced demand in international markets in the aftermath of the global financial crisis, and, in particular, recent changes in the PRD operating environment.

Since the FHKI embarked on the “Made in PRD” Research Series in 2001, two reports have been released in 2003 and 2007, respectively. They looked into the emergence and growth of the PRD as a production hinterland of Hong Kong industries, the economic synergy between Hong Kong and the PRD, and the pivotal role played by Hong Kong manufacturers in driving the industrial, economic and technological development of this rapidly evolving region. Their findings and recommendations not only helped local manufacturing and servicing companies in formulating business strategies, but also provided a direction for furthering the Hong Kong/PRD synergy and harnessing the business opportunities this would bring to our industries. We were gratified to see that a number of the measures recommended in our previous reports had been adopted by the authorities. These measures have greatly facilitated the production operations of our manufacturers and fostered the industrial growth of the region.

Since the publication of our last research report, the PRD business environment has become more challenging following a series of changes in government policy and the global financial tsunami. First, the shifts in processing trade policy at the national level have deepened. Second, steps to restructure and upgrade the PRD industrial landscape have been speeded up, driving low value-added, labour-intensive, polluting and resource-depleting industries against the wall. Then, in the midst of this restructuring, the global financial crisis broke out, hitting many export-oriented factories in the PRD.

While orders from major overseas markets have begun to pick up gradually with the crisis receding in the second half of 2009, they have remained off the pre-crisis levels by a significant margin. Aside from industrial policy shifts and demand contraction, Hong Kong manufacturing SMEs are faced with other pressing challenges due to changes in the operating environment in the PRD. These include worker shortages, labour cost escalation, appreciation of the Renminbi and stronger regulatory pressure.

In order to offer Hong Kong manufacturing SMEs expert advice on overcoming these challenges and enhancing competitiveness, the FHKI commissioned Professor Michael Enright and his research team in February 2010 to undertake the present study. Professor Enright is one of the world’s reigning strategy gurus and has published books and papers extensively on the PRD industrial development.

In this report and the accompanying “SME Advisory Kit”, there are detailed analyses of the policy, economic and operating issues confronting Hong Kong manufacturing SMEs, as well as recommendations on strategic options which they may adopt to tackle these issues according to their individual circumstances. This report also examines the present situations of five industry sectors of importance to Hong Kong, namely, garments, consumer electronics, toys, watches and clocks, as well as mould and die manufacturing. Case studies of Hong Kong firms in these sectors that are adjusting to the current challenges are provided as real world examples that others may wish to follow.

It is worth noting that the “SME Advisory Kit” is specially designed as a handy reference guide for manufacturing SMEs in preparing for the future. It sets forth the major external and internal challenges they commonly face and gives guidance on how to map out strategies and action plans to address these challenges. There is also a list of key sources of information and support available to manufacturing SMEs.

Based on the findings of this study, the FHKI is drawing up recommendations to the SAR and Guangdong Governments on ways to enhance support for Hong Kong manufacturing SMEs operating in the PRD, so as to maintain the vibrancy and competitiveness of the PRD manufacturing base. Our recommendations will cover areas including industrial upgrade and transformation, clean production, domestic sales, sourcing workers, and regulatory compliance. We look forward to their positive response to our recommendations.

Finally, I would like to express gratitude to the SME Development Fund administered by the Trade and Industry Department for funding this research project. I also wish to thank the sponsors for their generous support and members who participated in the project for their valuable input and advice.

Cliff K. Sun BBS, JP

Chairman

Federation of Hong Kong Industries

October 2010

Executive Summary

Hong Kong manufacturing firms in general and small and medium-sized enterprises (SMEs) face enormous challenges. A global economic downturn, rising costs, increasingly challenging regulatory and legal environments, increasing competition, and the overall direction of policy in the Chinese Mainland have combined to create a very difficult situation for Hong Kong manufacturing SMEs. The Hong Kong companies interviewed for this study indicate particularly difficult challenges associated with market declines, the bargaining power of customers, labour availability and cost, more stringent regulatory and administrative requirements, competitive asymmetries, the emergence of capable Chinese competitors, and policies to alter the industrial structure of Guangdong at the expense of traditional industries. The interviews also indicated that many Hong Kong SMEs suffer from a number of internal problems or inefficiencies including lack of a clear strategy, shortcomings in basic management techniques, a failure to differentiate, gaps in succession, difficulty in finding capable managers, difficulties in obtaining finance, and lack of knowledge of SME support programmes that do exist.

Many of the insights from the interviews with regard to the external environment echo and amplify the results of a series of surveys and reports focusing on Hong Kong manufacturing firms that have appeared over the last few years. In these surveys and reports, Hong Kong manufacturing firms have reported that the most difficult challenges they face involve costs, labour rules, changes to export processing rules, shortages of power or water, and changes in tax rules. The surveys and reports also indicate a number of strategies and approaches that Hong Kong manufacturing firms have taken, or plan to take, in order to meet the challenges they face. These approaches include improving technological capabilities, improving business processes, developing own designs or brands, shifting locations within China, shifting to locations outside of China, or outsourcing production. Several interviewees noted that such shifts are not at all easy and may be outside the present capabilities of many if not most Hong Kong SMEs. If all else fails, a number of companies report that they may opt to shut down, potentially ending the contribution that they make to the Hong Kong economy and the economy of South China in general.

More detailed analysis of the electronics, watch and clock, garment, toy, and mould and die industries provides additional insights into the challenges that Hong Kong manufacturing SMEs face and the strategies that some firms are using to meet these challenges. We note that a variety of strategies are being used successfully by different firms to deal with the challenges they face. There appears to be no single recipe for success for Hong Kong's manufacturing SMEs. Instead, successful companies continually assess the present and future state of their industry, understand the advantages and disadvantages of different locations, identify defensible market niches, gear their strategies in an internally consistent way to meet the needs of customers in the relevant niches, manage internal operations effectively, and find ways to get the most out of the workforce.

In terms of dealing with the external environment, our results indicate that it is important for SMEs to develop cost reduction strategies, differentiation strategies, labour market strategies, business model strategies that determine the precise scope of the firm, geographic market strategies, and regulatory and policy-related strategies, and that they consider exit or consolidation strategies. These strategies are not mutually exclusive. In fact, companies will have to make choices in all of these areas and they may choose to keep the status quo in some areas while making changes in others. We do note that the managers interviewed for this project were in general agreement that across the board status quo strategies (i.e. changing nothing) was unlikely to lead to success for most of Hong Kong's manufacturing SMEs.

Cost reduction strategies may include improving efficiency within the factories; automating production processes; improving efficiency in logistics, distribution, and other activities; outsourcing business processes; relocating to other places in China; relocating to other countries, mostly probably in South or Southeast Asia; and relocating along with similar firms (group action instead of individual firm action). **Differentiation strategies** include improving product quality, improving services to customers, moving from Original Equipment Manufacturing (OEM) to Original Design Manufacturing (ODM) or Own Branding Manufacturing (OBM) production, tailoring strategy to serve particular niches, and supplying high value market segments. **Labour market strategies** may include engaging in more active recruiting, understanding that high turnover is costly, increasing wages, providing better working environments, instituting effective performance evaluation schemes, shifting production to sources of labour, developing managerial talent from the Chinese Mainland, bringing in managerial talent from elsewhere, and sharing the wealth with management talent.

Business model strategies include shifting from manufacturing to outsourcing production, becoming a trader or agent for other companies, becoming a subcontractor, and forward integrating into retailing or selling direct to end customers. **Geographic market strategies** include expanding to new OECD markets, the Chinese Mainland, and other developing country markets. **Regulatory and policy-related strategies** include strategies to deal with environmental and product safety regulations, strategies to deal with administrative requirements, strategies to deal with policies to restructure or upgrade local economies, strategies to leverage policies in support of SMEs, and relationship management strategies to ensure good relations with government. **Exit or consolidation strategies** include selling out or shutting down, changing lines of business completely, and consolidating the sector by acquiring other firms or investing to beat them in the market place and grow organically.

In terms of dealing with internal managerial challenges, it is important that SMEs pay sufficient attention to selecting businesses in which to compete; formulating compelling strategies or business plans, understanding customers; understanding competitors; developing clear competitive advantages; financing operations and financial management; administering the firm; keeping up to date on market, technological, and managerial developments; marketing and selling to existing and potential customers; and reducing dependence on individual customers and suppliers; as well as dealing with additional challenges that may arise.

In order to **select businesses** in which to compete, SMEs should link to the knowledge and skill set of the SME owner and managers, understand the ease of entry, understand where the firm can be unique, focus on industries where the SME has a “good idea,” and focus on industries where there are unmet market needs. In **formulating compelling strategies or business plans**, SMEs should develop a clear vision, identify clear target markets and customers, identify what customer needs are to be met, determine what the firm can be best in, set clear goals for the company, identify the key functional policies necessary to carry out the strategy, think through different alternatives to get where the company needs to go, identify and arrange the resources necessary to carry out the strategy, implement the strategy properly, and understand when to change strategy. To **understand customers**, SMEs should use the “order” as starting point, think about new ways to create value for the customer, explore ways of expanding business with existing customers, anticipate developments within customer companies, and reassess the attractiveness of customers from time to time. **Understanding competitors** involves learning about competitors from multiple sources, assessing the different types of competitors, reverse engineering competitor strategies, reverse engineering competitor cost positions, tracking competitor initiatives and building competitor profiles, and remembering not to underestimate competitors.

Without clear competitive advantages there is no way an SME can beat its competitors. **Developing clear competitive advantages** requires the SME to develop superior vision, superior knowledge, superior resources, superior capabilities, or developing combinations of advantages. In order to succeed in **marketing and selling to existing and potential customers**, SMEs should focus marketing on firm advantages, focus on high-value issues of customers, understand the 80/20 rule (for most SMEs 80 per cent of sales come from 20 per cent of customers), estimate the cost of acquiring and serving particular customers, understand the value of “post-sales marketing,” use a range of marketing tools, and ensure that payment and credit terms are well understood and due diligence is performed on customers. Success in **financing operations and financial management** involves developing strong relationships with banks, establishing credit lines, considering SME support programmes, using asset-backed financing when necessary, instituting strong cash management policies, keeping enough cash in the business, institute a minimum cash balance policy, assessing creditworthiness of customers carefully, pursuing payment aggressively, taking advantage of terms on payables, understanding key financial ratios and reports and using them as management tools, and periodically “stress testing” the SME’s financial position.

In **administering and managing the firm**, SME management should ensure legal and regulatory compliance, implement suitable workplace safety regulations to minimise on-the-job risks, provide ongoing training for staff consistent with the needs of the business, seek cost-reducing business processes, develop strong human resources policies, use IT effectively, set up strong sales procedures, set up strong purchasing procedures, and set up strong monitoring and control functions. **Keeping up to date on market, technological, and management developments** involves using customer meetings, the business press, the trade press, industry associations, government agencies, consultants, and others to stay up to date and not fall behind customers or the competition. **Reducing dependence on individual customers and suppliers** involves diversifying the customer base, seeking guarantees from customers that demand exclusivity, and identifying multiple suppliers for key inputs. **Meeting additional challenges** that SMEs face involves enhancing firm reputation and goodwill, seeking outside advice when necessary, managing government relations carefully, developing long-term relations with key customers and suppliers, doing forward-looking risk analysis, and planning for succession.

The challenges and strategies available to Hong Kong manufacturing SMEs lead to many questions that the SMEs need to be able to answer about their business:

- Which strategy or strategies will the SME use to deal with cost pressures?
- Which strategy or strategies will the SME use to differentiate itself to gain some pricing flexibility?
- Which strategy or strategies will the SME use to deal with labour market pressures?
- Which strategy or strategies will the SME use for its business model development?
- Which geographic markets will the SME focus on?
- Which strategy or strategies will the SME use to deal with regulatory and policy-related issues?
- If exit or consolidation strategies are appropriate, which strategy or strategies will the SME use?

In order to answer these questions, the SME will have to answer several other questions about their business and business environment. These include:

- What is the competitive balance among Hong Kong firms, between Hong Kong and Chinese firms, between Hong Kong and foreign firms operating in China, and between Hong Kong firms operating in PRD and firms operating in other locations?
- What are the sources of advantage and disadvantage for each type of firm? What are the specific sources of advantage and disadvantage for the individual SME?
- What is the specific cost structure of their own business in the PRD (or wherever they are located) versus other places today, and how is the comparison evolving?
- Does the sector in which the SME competes have a future in Southern China, or should new locations be sought urgently?
- What are the customer segments that are available to the firm and what are the customer requirements in the different segments?
- For companies operating in the Chinese Mainland, how is their sector perceived by the Municipal, Provincial, and Central Governments? Does it get favourable, unfavourable, or neutral attention?
- To what extent are environmental or product safety regulations important in the sector?
- What new business models or activities might be open to the firm?
- Which of the external issues is most pressing for their business?
- Does the firm have a clear strategy targeting specific types of customers, with plans to satisfy their needs, with specific competitive advantages, and with the resources necessary to carry out the strategy?
- Does the firm have a clear view of what it can and will do better than competitors?
- Does the firm have the managerial, administrative, and operational capability to carry out the strategy effectively? If not, how can these capabilities be obtained?
- Does the firm have sound financial, marketing and sales, administrative, control, and risk management processes in place?
- Who will manage the firm into the future?
- When might it be necessary or beneficial to engage in collective action with respect to supply chain development, relocation, or other issues?

It will be very difficult for Hong Kong's manufacturing SMEs to survive and thrive if they do not have good answers to these questions. On the other hand, developing good answers to these questions is the first step in facing and meeting the challenges that confront Hong Kong's manufacturing SMEs.

Issues for Hong Kong Manufacturers in the PRD

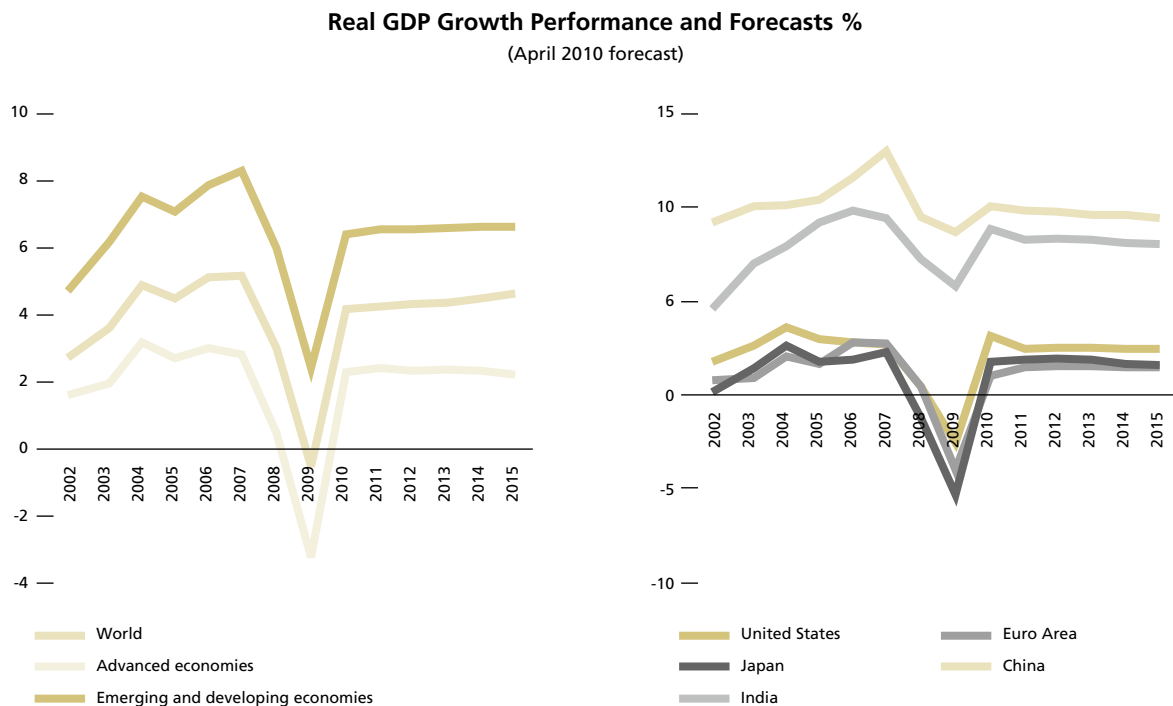
Hong Kong manufacturing firms are facing extremely challenging times. Slowdowns in global markets have resulted in disruption of traditional markets and trade patterns. These difficulties have added to the challenges that the Hong Kong firms were facing even before the global downturn. Several issues have emerged in recent years that are making it more difficult for Hong Kong manufacturers operating in the Pearl River Delta. An appreciating currency, labour shortages, rising wages, higher material costs, and other cost increases are affecting the region's cost position. At the same time, several changes in regulatory and legal structures, such as changes in export processing, labour and environmental rules in China have made it more difficult for Hong Kong firms, particularly SMEs. Changes in the competitive environment, particularly the rise in capabilities of firms from the Chinese Mainland, have altered the landscape for Hong Kong manufacturing SMEs.

Finally, changes in the overall policy framework towards the Chinese economy in general, and the Pearl River Delta economy in particular, have created additional challenges as well. The combination of challenges will require creative strategies and solutions going forward if Hong Kong manufacturing firms are to be able to survive and thrive in the new environment.

THE GLOBAL ECONOMIC ENVIRONMENT

The global economic environment has had a significant impact on Hong Kong manufacturing SMEs. The global economic downturn that started in 2008 has had a major impact on demand in the traditional export markets for the Hong Kong firms. In addition, the downturn has exacerbated the difficulties that Hong Kong manufacturing SMEs face when dealing with powerful, concentrated retailers in major markets.

Exhibit 1.



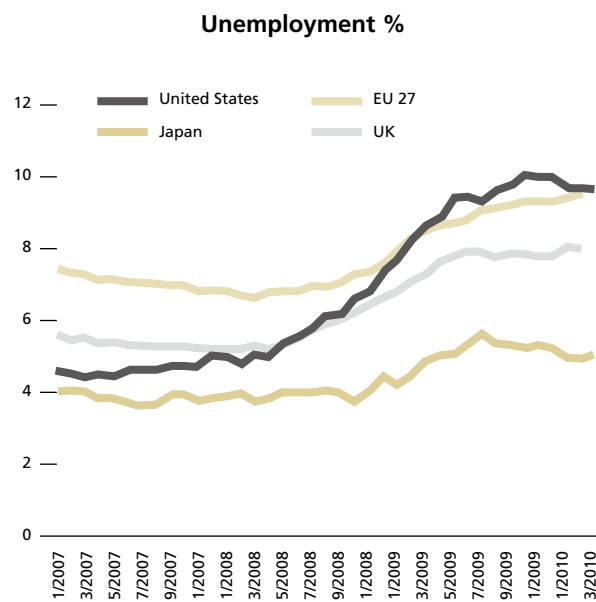
Source : IMF

Exhibit 2.



Source : World Federation of Exchanges

Exhibit 3.



Source : National sources

Influence of Demand

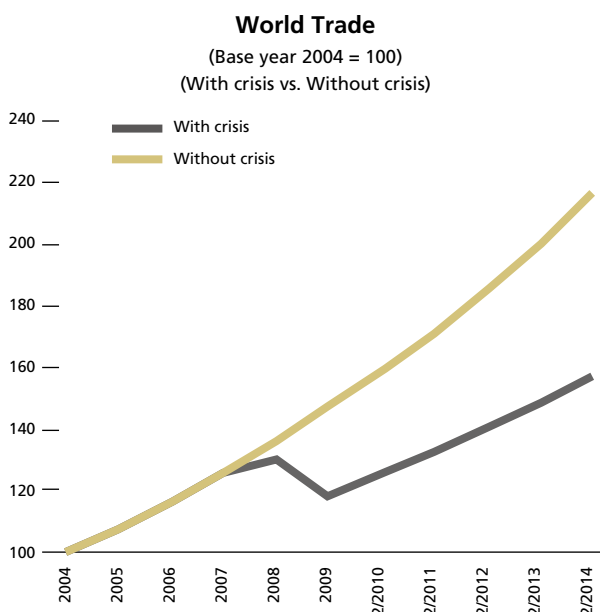
The global economic downturn that started in 2008 has had an important impact on Hong Kong manufacturing SMEs. Globally, world GDP growth in 2008 slowed down to 1.7 per cent from 3.9 per cent in 2007, and world GDP in 2009 was 2.2 per cent lower than in 2008. World trade growth in 2008 slowed down to 3.6 per cent from 7.5 per cent in 2007, and world trade in 2009 was 9.3 per cent lower than in 2008. Major markets, like the US, EU and Japan went into recession in the last half of 2008 and remained depressed throughout 2009. Only in the last part of 2009 and first part of 2010 did global output and trade begin to rebound (see Exhibit 1). Stock market values peaked in October 2007 and have still not nearly rebounded to their pre-crisis levels (see Exhibit 2). Unemployment in key economies reached very high levels that are expected to persist for a significant period of time (see Exhibit 3).

While the IMF and others gradually increased their forecasts for global GDP growth in 2010, uncertainty surrounding public finance in Greece and other European countries has raised the spectre of a prolonged period of slow growth in the OECD countries, with high levels of government debt, higher taxes, higher interest rates, more bank deleveraging, and higher inflation. Even with a return to growth, it is projected that the US will only reach 2008 levels of GDP in 2010, Western Europe in 2013, and Japan in 2014.¹ Similarly, US imports are not expected to reach 2008 levels until after 2013, Western Europe until after 2011, and Japan until 2013.² The result is that the world economy is likely to generate on the order of US\$100 to 120 trillion less in GDP over the next eight to 10 years than it would have if it had continued on the same trajectory that it experienced in the 2000 to 2007 period. World trade is also expected to have a trajectory far different than that before the crisis (see Exhibits 4 and 5).

¹ EIU, "Global Outlook," May 2010.

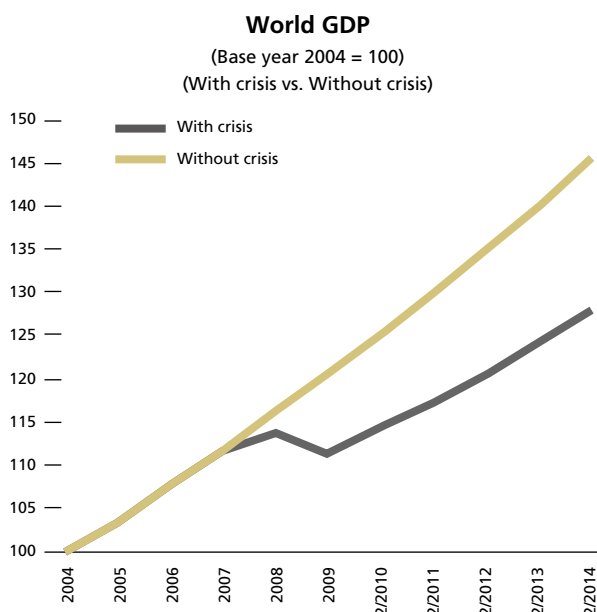
² EIU, "Forecast," 2009. IMF, World Economic Outlook Database, April 2010.

Exhibit 4.



Source : EIU; Enright, Scott & Associates, Ltd.

Exhibit 5.



Source : EIU; Enright, Scott & Associates, Ltd.

Developing countries, particularly those in Asia and Latin America, have been the bright spot in the world economy over the last few years. Stimulus packages and domestic growth in places like China, India, Indonesia, and Brazil have resulted in continued growth in East Asia and Latin America. However, as central banks around the world continued to flood markets with liquidity into mid-2010, fears have grown that China, India, and Brazil in particular are getting into an asset price bubble, which could eventually burst with negative impacts on those and other economies.

The global slowdown had a dramatic impact on China's exports and those of Guangdong Province. China's export growth has slowed down from 21.9 per cent in the first half of 2008 to 13.6 per cent in the last half of 2008, and further declined to -15.9 per cent in the year of 2009.³ It was projected that China's exports would not reach 2008 levels until 2012.⁴ In Guangdong, export growth has slowed down from 13.1 per cent in the first half of 2008 to 6.5 per cent in the last half of 2008, and exports in 2009 were 11.5 per cent less than in 2008. The downturn slowed Guangdong's GDP growth from 14.7 per cent in 2007 to 10.1 per cent in 2008 and 9.5 per cent in 2009.⁵ Reports surfaced of millions of job losses in PRD factories and of some firms that closed up without honouring their obligations to workers.⁶

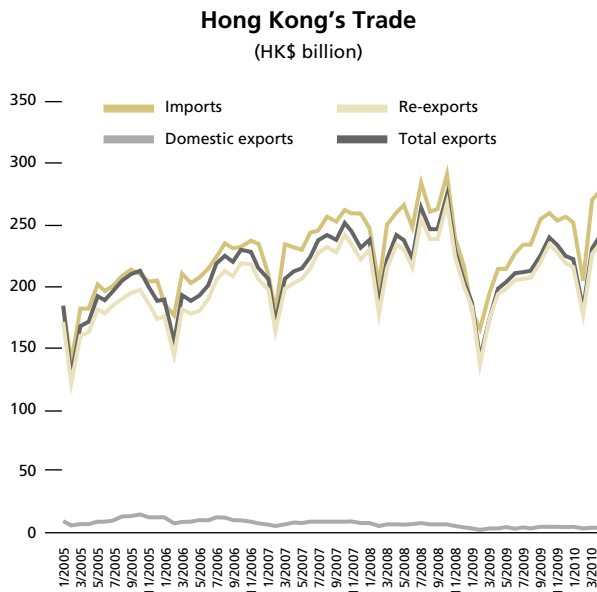
3 IMA-Asia, "Asia Pacific Executive Brief," April 2010.

4 EIU, "Forecast," 2009.

5 Statistical Bureau of Guangdong Province.

6 "China's workers head home jobless," The Straits Times, 15 November 2008.

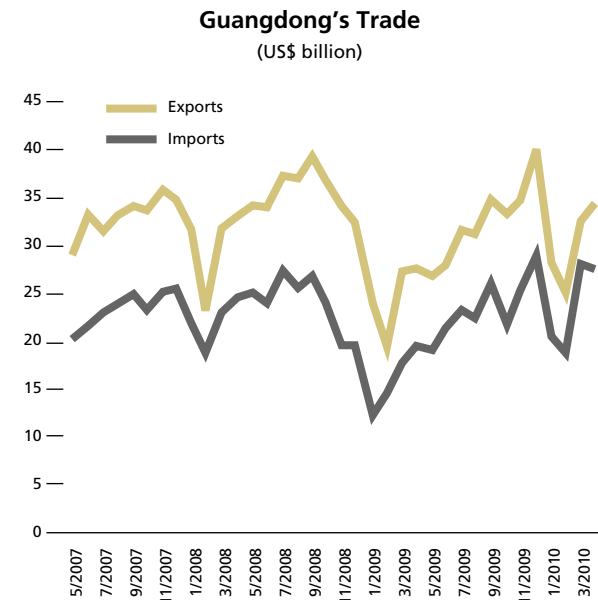
Exhibit 6.



Source : Hong Kong Census and Statistics Department

The onset of the global economic crisis prompted numerous initiatives in China. The Central Government announced a RMB 4 trillion (US\$576 billion) national stimulus package. In addition, Guangdong Province announced its own stimulus package of RMB 2.3 trillion (US\$331 billion). Policies designed to limit price increases in the property sector were replaced by policies to encourage the sector. Other favourable policies including subsidies for the purchase of autos and home appliances led to substantial growth in these sectors. Policies that had limited bank lending, particularly in coastal areas, were reversed, as were reductions in export tax rebates and other restrictions on export-oriented industries. The policy initiatives helped China weather the global downturn, with comparatively strong GDP growth of 8.5 per cent in 2009, and even faster rates in the first few months of 2010.

Exhibit 7.



Source : Guangdong Customs

Guangdong's exports in the first few months of 2010 were similar to those of the same period in 2008 (see Exhibit 6). Hong Kong also saw its trade decline in the last part of 2008 and through much of 2009. By March and April of 2010, however, Hong Kong's trade figures had returned roughly to the same levels they had achieved in March and April of 2008 (see Exhibit 7). Despite the rebound, international markets remained weak and the outlook for the region's trade has been uncertain.

Influence of Retail and Buyer Market Structure

The global economic downturn has exacerbated the impact of the development of powerful and concentrated retailers and buyer industries. The vast majority of Hong Kong SMEs sell their products either directly on to retailers or to OEM customers who then resell the goods under their own names. The global economic downturn has caused these buyers to push their suppliers particularly hard. Some have pulled orders, some have delayed payments, some have rejected shipments on questionable grounds, and some have shifted orders to competitors or other locations.

The pressure felt by the Hong Kong SMEs is due in part to the concentration of buyers. In many OECD economies, a handful of chains dominate the retail industry. These chains are known to be particularly difficult and often price-sensitive buyers. The pressure is also due in part to the fact that relatively few Hong Kong SMEs have sufficient capabilities to really distinguish themselves from their competitors. In the absence of such distinguishing features, such as unique designs, unique technological capabilities, unique ability to service customers, or unique ability to assess markets, the Hong Kong SMEs are often left to compete on the basis of price, a difficult situation particularly in the midst of an economic downturn.

COST AND RELATED ISSUES

Even before the onset of the global economic crisis, Hong Kong manufacturing firms, particularly those operating in the Pearl River Delta region, had been experiencing cost pressures from several directions.

RMB Appreciation

One factor often mentioned as increasing costs for Hong Kong manufacturing SMEs operating in the Chinese Mainland is the appreciation of the RMB. The RMB appreciated by 3.3 per cent against the US dollar in 2006, 6.9 per cent in 2007, and 6.4 per cent in the first six months of 2008. From July 2008 until May 2010, the RMB was basically flat against the US dollar (its value versus the US dollar changed by 0.4 per cent in that period). The RMB appreciated by 4.8 per cent against the Japanese yen in 2006 and by 0.8 per cent in 2007, before depreciating against the yen by 13.7 per cent in 2008, appreciating by 1.9 per cent in 2009, and

appreciating by 0.5 per cent in the first five months of 2010. The RMB's value changed -7.3 per cent against the Euro in 2006, -4.2 per cent in 2007, +11.3 per cent in 2008, -1.8 per cent in 2009, and +11.2 per cent in the first five months of 2010. In terms of countries that could become competitors for export-oriented light manufacturing industries, the RMB's change against the Indian rupee was +1.2 per cent in 2006, -4.5 per cent in 2007, +33.2 per cent in 2008, -4.6 per cent in 2009, and -3.8 per cent in the first five months of 2010. The change against the Vietnamese dong was +0.03 per cent in 2006, +9.3 per cent in 2007, +15.7 per cent in 2008, +7.0 per cent in 2009, and +2.2 per cent in the first five months of 2010.⁷ Exhibit 8 shows the appreciation of the RMB versus selected currencies over the past few years.

International pressure for China to allow the RMB to appreciate grew substantially in 2009 and early 2010. Countries like India and Brazil joined the US and European countries in calling for an appreciation. In testimony before the US Congress, economist Fred Bergsten claimed that RMB was undervalued by approximately 25 per cent on a trade-weighted basis and 40 per cent versus the US dollar.⁸ Even though there was some reduction in pressure towards the middle of 2010 as China's trade surplus fell, it is expected that the RMB will eventually appreciate against major world currencies significantly.

The Hong Kong Trade Development Council estimated in 2007 that Hong Kong firms operating in the Pearl River Delta had local content ranging from 20 per cent to 45 per cent of total costs, and averaging 30 per cent. This meant that an appreciation of the RMB against the currency of trade settlement (usually US dollars) by 10 per cent would on average impose a three per cent increase in total costs.⁹ This means that in US dollar terms, RMB appreciation added just 5.4 per cent to the costs of Hong Kong firms in the PRD from 1 January 2006 to 1 May 2010. This is far lower than one might expect given the discussion in Hong Kong about the RMB and the fact that in some surveys of

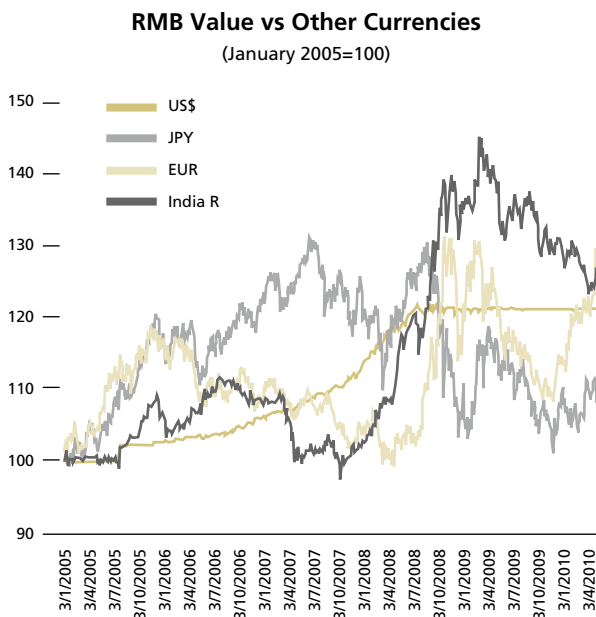
7 Interbank exchange rates from www.oanda.com, calculations by Enright, Scott & Associates. Data in May 2010 is as of 20 May 2010.

8 C. Fred Bergsten, "Correcting the Chinese Exchange Rate: An Action Plan," Testimony before the US House Ways and Means Committee, 24 March 2010.

9 Hong Kong Trade Development Council, "Cost Escalation and Trends for Export Price Increase," 3 September 2007.

Hong Kong manufacturing firms RMB appreciation was listed as the most important issue increasing the costs of Hong Kong firms. However, among Hong Kong manufacturing SME managers interviewed for this study, there is anxiety regarding possible further appreciation of the RMB. In the toy sector, for example, the increased costs resulting from the appreciation of RMB have been absorbed by the manufacturing firms, and particularly by Hong Kong manufacturing SMEs. Further appreciation, particularly of the magnitude contemplated by many analysts, could reduce profit margin to the point where the very survival of many Hong Kong SMEs could be at risk.¹⁰

Exhibit 8.



Labour Availability

Traditionally, the export industries of Guangdong have had a hard time finding sufficient workers to meet growing demand. For example, Guangdong labour officials reported a shortage of 2.5 million workers in 2006. In 2007, the demand for unskilled workers grew by 9.5 per cent and that for technicians by 20.4 per cent.¹¹ While demand for workers fell dramatically with the onset of the global economic crisis in the second half of 2008,

by May 2010 labour shortages had returned, with some sources estimating that there was a shortage of two million workers in the PRD.¹² While some analysts believed that this shortage was likely to be frictional in nature (i.e. it would take time to attract workers back into the region after the economic downturn saw many lose jobs), many company owners and managers operating in the PRD believe that the labour shortage could become permanent.

Some analysts have claimed that China is starting to run short of the 18 to 28 year-old and single cohort from rural areas that has been the dominant source of migrant labour for the factories of the Pearl River Delta region. They note that China has on the order of 120 million people aged 18 to 28 years characterised as rural residents and an estimated 100 million rural migrants already working off the farm, leaving a relatively smaller number to add to the migrant workforce. In addition, farm prices rose by over 30 per cent in the 2002 to 2007 period. After a short period of decline in 2009, the produce price of agricultural products increased 6.7 per cent in the first three months of 2010 on a year-on-year basis and the produce price of farming products increased by 13.7 per cent in the first three months of 2010 on a year-on-year basis. In the first quarter of 2010, the per capita cash income of the rural population increased by 11.8 per cent year-on-year, or 9.2 per cent growth in real terms,¹³ affecting the willingness of people to leave for the cities. In addition, the spread of China's development to inland provinces, the large scale stimulus package that favoured inland areas, and the rapid growth of China's service sector have provided competing opportunities for workers that might have otherwise gravitated to the coastal factories.

¹⁰ ESA Project Interview, 2010-04-19.

¹¹ Guangdong Labor and Social Security Office.

¹² Chloe Lai, "Delta firms urge hukou reform amid labor shortage," South China Morning Post, 17 April 2010.

¹³ NBSC, "Further Expanding Momentum of China's Economic Recovery in the First Quarter of 2010," www.stats.gov.cn.

The implication is that there may be a permanent shortage of the types of workers generally employed by Hong Kong manufacturing SMEs in the PRD going forward. This concern was echoed by the managers interviewed for this study. Interviewees indicated that the global economic crisis made an already troubling situation worse because many workers without full-time employment returned to their home provinces and have not returned. Many that returned in 2009 could not find work. Some managers believe that many of the disappointed workers will not come back again.¹⁴ Interviewees also pointed to the success of the Chinese Government's stimulus package in creating employment in interior provinces that have been the sources of migrant labour.

Interviewees also expressed the view that the impact of an increasing male-female ratio and the one child policy is now being felt in the manufacturing sector. Many assembly manufacturing industries employ young female labour, and there are now fewer and fewer young females available for work in general. In addition, young women now have better educational opportunities and can become doctors, lawyers, teachers, and hotel workers, occupations that have higher status than jobs in manufacturing. The growth of the service sector and office employment in China is absorbing many

people that would have gone into manufacturing in the past. Even within the manufacturing sector, the growth of the Yangtze River Delta, the Bohai Rime, and other parts of China creates competition for workers. As a result, there are many more options for young Chinese workers today than there were 15 to 20 years ago when manufacturing in the PRD was the only option for many to get out of subsistence agriculture in the interior of China.

Wage Increases

Labour costs in the Pearl River Delta grew substantially from 2002 to 2008 due to rises in the minimum wage and greatly expanded demand for workers. During this period, exports and industrial output from the Pearl River Delta and Yangtze River Delta regions grew in excess of 20 per cent per year and 15 per cent per year respectively. Average migrant worker wages in China went from around RMB 780 per month in 2004 to RMB 1,000 per month in 2006. Minimum wages in the main manufacturing cities of the Pearl River Delta were raised on the order of 18 per cent from 2002 to 2006 and by another 10 per cent in 2007. During that period, many factories were paying substantially above the minimum in order to obtain workers. As a result, average wages in the main manufacturing cities of the PRD grew by over 20 per cent from 2002 to 2006 and another 10 to 15 per cent in 2007.

By 2008, the PRD was no longer considered a particularly low cost location for unskilled or semi-skilled labour. According to the International Labour Organisation (ILO) and Business Monitor International (BMI), in 2008, monthly wages in manufacturing were on the order of US\$57 in India,¹⁵ US\$69 in Vietnam,¹⁶ US\$87 in Indonesia,¹⁷ and US\$290 in China.¹⁸ Since the minimum monthly wages were US\$161 in Guangzhou, US\$161 in Shenzhen, US\$134 in Dongguan, US\$134 in Foshan, and US\$140 in Zhuhai,¹⁹ the figures indicate that most manufacturing workers in China earned well above the minimum. Taking the apparel manufacturing industry as a specific example, labour costs in 2008 were US\$0.22 per

14 ESA Project Interview, 2010-04-07.

15 BMI estimated number, "Country snapshot: India demographic data," India Defence & Security Report, Q1 2010.

16 Minimum monthly wage in Ho Chi Minh City and Hanoi as reported in Pacific Bridge Inc., "New Minimum Wage Levels for Foreign Enterprises in Vietnam," 3 March 2009. www.pacificbridge.com.

17 ILO, Labour Force Survey (for persons aged 15 years and over).

18 ILO, Labour Force Survey (for state-owned units, urban collective-owned units and other ownership units).

19 Department of Human Resources and Social Security of Guangdong Province, "Guangdong's new minimum wage standards will be implemented starting 1 May 2010." www.gd.lss.gov.cn.

hour in Bangladesh, US\$0.33 per hour in Cambodia, US\$0.38 in Vietnam, US\$0.44 per hour in Indonesia, and US\$0.51 per hour in India, while they were US\$0.55-0.80 per hour in China's inland and US\$0.86-0.94 per hour in China's coastal area,²⁰ further suggesting that China is no longer the low cost location for manufacturing that it once was in relative terms.

While wages in the Pearl River Delta stagnated for a while with the onset of the global economic crisis and export downturn in 2008, in 2010 several Guangdong jurisdictions announced additional minimum wage increases on the order of 20 per cent.²¹ Even with these increases, there were signs of increasing dissatisfaction with wages by workers in the Pearl River Delta region. Foxconn provided a 70 per cent rise for workers in some of its PRD facilities after a number of suicides occurred among its workers in May 2010. In late May 2010, Honda was forced to rise the wages of many of its employees by more than 20 per cent to satisfy workers who had struck over the objections of the officially recognised trade union. These instances pointed towards increasing wage pressure over and above the statutory increases. It should be noted that Foxconn has indicated that it is likely to move on the order of 300,000 of 400,000 jobs out of Guangdong in order to have easier access to lower cost labour. It was not clear whether this would start a trend or not.

In addition to wage rates, jurisdictions in China in general, and Guangdong in particular, have become more active in expanding the coverage of the social security system to more and more workers. The various insurance schemes now cost employers an amount that is 20 per cent to 30 per cent of the wage bill.²² Interviewees for the present study also confirmed that rising social security costs and the introduction of separate social security charges are an issue for manufacturing firms in the PRD. The cost increase is unwelcome and the separate charges, all of which are administered by separate bureaus and have separate record keeping requirements are seen as being extremely burdensome, particularly for SMEs.²³

20 www.emergingtextiles.com.

21 "Guangdong raises minimum wage by 20% amid China inflation fears," *Financial Times*, p.1, 19 March 2010.

22 Enright, Scott & Associates estimates based on official sources.

23 ESA Project Interview, 2010-04-07.

24 The minimum wage for Huadu, Panyu, Nansha, Conghua, and Zengcheng Districts of Guangzhou as of mid-2010 were RMB 960 per month for full-time employees and RMB 5.52 per hour for part-time employees. www.gzlss.gov.cn.

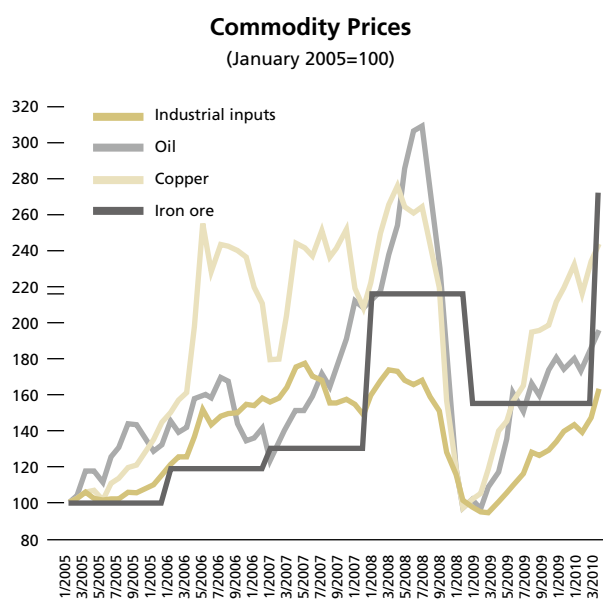
25 The Zhuhai Municipal Government has set the minimum wage for full-time employees at RMB 960 per month and the minimum wage for part-time employees at RMB 9.2, per hour, higher than that mandated by the Guangdong Provincial Government. www.zhdj.gov.cn. www.gd.lss.gov.cn.

26 On 27 May 2010, the State Council approved the expansion of the Shenzhen Special Economic Zone to the whole city. Therefore, Bao'an and Longgang districts have been included in the Special Economic Zone since 1 July 2010.

Exhibit 9. Minimum Wage Rates Mandated by Guangdong Province

Categories	2008-09		2010		Applicable Areas
	Monthly Minimum Wage (RMB)	Hourly Minimum Wage for Part-time Workers (RMB)	Monthly Minimum Wage (RMB)	Hourly Minimum Wage for Part-time Workers (RMB)	
1	860	8.3	1100	10.6	Parts of Guangzhou ²⁴
2	770	7.4	920	8.8	Zhuhai ²⁵ , Foshan, Dongguan, Zhongshan
3	670	6.5	810	7.9	Shantou, Huizhou, Jiangmen
4	580	5.6	710	6.9	Shaoguan, Heyuan, Meizhou, Shanwei, Yangjiang, Chaozhou, Jieyang, Yunfu
	530	5.1	660	6.4	Selected counties in northern Guangdong
5	1000	8.8	1100	9.8	Shenzhen SEZ
	900	8.0	1100	9.8	Shenzhen outside SEZ ²⁶

Exhibit 10.



Source : IMF

The Hong Kong Trade Development Council estimated in 2007 that labour costs accounted for 15 per cent to 30 per cent of the production costs of Hong Kong manufacturers operating in the PRD.²⁷ If so, then a 25 per cent to 30 per cent increase in wage rates would result in a total cost increase of around four per cent to nine per cent. If we assume that wage increases in the PRD have tracked changes in the minimum wage (at least in percentage terms), then since 2006, wage increases would have increased total costs by around six to 13 per cent.

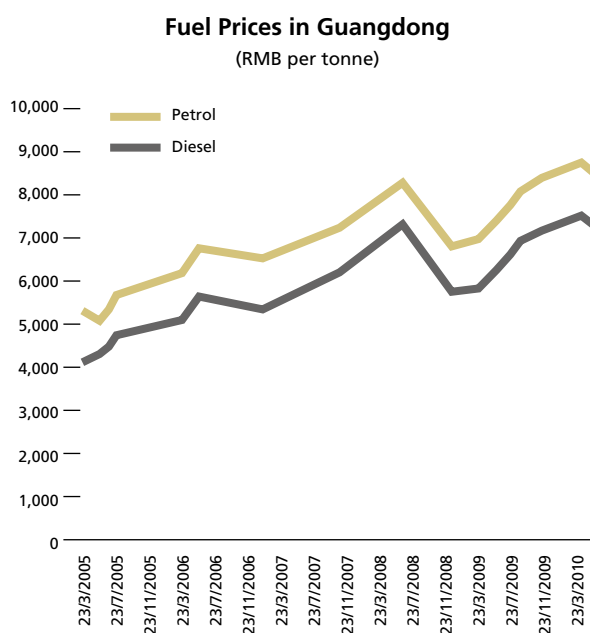
27 Hong Kong Trade Development Council, "Cost Escalation and Trends for Export Price Increase," 3 September 2007.

28 IMF, "Primary Commodity Prices," accessed May 2010.

29 CNFOL, "Overview of the Adjustment in Oil Price in China," April 2010. news.cnfol.com.

30 CNFOL, "Overview of the Adjustment in Oil Price in China," April, 2010. news.cnfol.com.

Exhibit 11.



Source : Enright, Scott & Associates and Guangdong Price Bureau

Material and Utility Costs

Industrial input and utility prices have also been rising in China. Rising global raw materials prices have affected producers all over the world. From January 2006 to July 2008, global oil prices increased by 113 per cent, copper prices by 77 per cent, and iron ore prices by 82 per cent. By May 2010, with the global economic downturn, oil prices had declined 36 per cent, and copper prices had declined eight per cent, while iron ore prices rose another 26 per cent (see Exhibit 10).²⁸ In China, local prices of fuels and petroleum products were raised on the order of eight per cent to 10 per cent during 2006 to 2007 to encourage greater production in the face of high international input prices that were causing losses in Chinese oil companies.²⁹ By the end of April 2010, the fuel prices in China had recorded another 16 per cent cumulative increase over the prices in 2007 (see Exhibit 11).³⁰

Utilities and sewage charges are also rising in the PRD. According to city officials, peak electricity tariffs rose 27.5 per cent in Foshan and Dongguan from 2004 to 2006, while sewage charges in Dongguan rose by more than 200 per cent.³¹ In 2008, the electricity tariffs in Foshan and Dongguan rose another 5.7 per cent.³² The average sewage charge in Guangdong Province has risen from RMB 0.35 per tonne in 2007 to RMB 0.68 per tonne in 2008, and further to RMB 0.9 per tonne in 2009, representing an over 150 per cent cumulative increase.³³ At the end of 2009, the provincial government further raised the guidance price for industrial sewage charge in the PRD to RMB 1.3 per tonne.³⁴ Again, the trend for input and utility prices is clearly upward in the region.

Administrative and Compliance Costs

China's national, provincial, and local governments enacted a wide range of new rules, regulations, and laws governing company operations in the 2006 to 2008 time frame. These included a new labour law, new social security rules, new environmental regulations, new export processing regulations, and several other measures designed to restructure the local, provincial, and national economies. These are described below. One of the results of these changes has been a vast increase in the cost of administration and compliance. Whereas companies once could make social security payments in a single lump sum, at present companies have to deal with several different agencies and pay several separate charges. Whereas many workers in the past did not have formal contracts, today the vast majority of workers must have formal contracts as specified in the new labour law. In addition, scrutiny by tax bureaus, environmental regulators, and other government agencies has increased. The administrative and compliance burden has grown substantially, something that is difficult for SMEs with their limited number of personnel to manage administrative and managerial tasks.

Perspectives on Cost Increases

Costs have been rising in the PRD and they will continue to do so. This is due to China's economic development, growing labour shortages, and explicit policy within China and the PRD. The questions for the Hong Kong manufacturers is whether the increases in costs render them uncompetitive in global markets versus producers operating in other locations and whether increased costs can be passed on to consumers in international markets. While in the 2004 to 2007 time frame export prices out of China were increasing on the order of five per cent per year on average, the onset of the global economic crisis and the accompanying downturn in demand has made passing on cost increases much more difficult. Thus rising costs are likely to continue to squeeze Hong Kong companies that do not find some way to distinguish themselves from the competition sufficiently to obtain some pricing flexibility.

31 Hong Kong Trade Development Council, "Cost Escalation and Trends for Export Price Increase," 3 September 2007.

32 Statistics from the Price Bureau of Guangdong Province. www.gdpi.gov.cn.

33 "Guangdong Sets Hard Targets for Its Environmental Protection," Renmin net, 24 March 2010. big5.cctv.com.

34 Guangdong Environmental Protection Bureau. www.gdepb.gov.cn.

LEGAL AND REGULATORY CHANGES

During interviews conducted for the present project representatives of manufacturing SMEs indicated that operating in the PRD is becoming increasingly hard due to the changes in policies and regulations that govern their businesses.³⁵ A wide range of legal and regulatory changes were implemented in the Pearl River Delta region in the 2006 to 2008 timeframe. Many of these served to make operating in the PRD more difficult for Hong Kong manufacturing SMEs. Of particular importance have been changes in export processing and related regulations, the new labour contract law, and changes in environmental and product safety regulations.

Export Processing and Related Regulations

In order to suppress export growth, to ease frictions with its trade partners, to rein in the rapid increase of its foreign exchange reserves, and to push the economy toward less polluting and higher value exports, China adopted a series of policies and measures in the 2006 to 2008 time frame. These included changes in export and import tariffs, adjustments in export tax rebate rates, and the issuance of a new restriction catalogue of commodities for the export processing trade. China claimed that these policies and measures will help transform and upgrade its labour-intensive and low-end manufacturing and processing industries, help balance its economic development between the coastal regions and the interior, reduce natural resource consumption, and help control environmental pollution. While some of these steps were reversed or not fully implemented due to the global economic downturn that started in mid 2008, it is likely that once the Chinese leadership determines that the crisis is over, these and additional measures will be taken to reshape China's manufacturing and export profile.

Average export tax rebates in China were reduced from 16.3 per cent in January 1994 to 12 per cent in September 2006. On 19 June 2007, the Ministry of Finance, the State Administration of Taxation, the National Development and Reform Commission, the Ministry of Commerce and the General Administration of Customs issued a circular "Adjustment of the Tax Rebate Rates for Certain Exporting Products" that would adjust rebate rates from 1 July 2007.³⁶ Export tax rebates for products including some animals and plants, selected chemicals, dyes, leather, some wood boards and related products, certain carbon welded pipes and products, a variety of nonferrous metal products, and non-motor vessels would be abolished. Rebate rates for many other products, such as garments, shoes, hats, furniture, bicycles, a wide range of machinery products, certain chemicals, plastic and rubber products, leather products, paper products, ceramics, and a variety of metal products would be reduced. The changes initially were to impact 2,831 commodities representing 37 per cent of the total number of items listed in customs tax regulations. Another 550 products were added to the list in November 2007. The Finance Ministry indicated that the cost of producing the commodities would increase as a result of the changes to the export tax rebate regime, that this would incite capital investment to move to other "high value-added and high tech" industries and that in the long run, this would help the country develop in an economic and sustainable way.

As approved by the State Council on 23 July 2007, Announcement No. 44 introduced new commodity restrictions for export processing. The new regulations, effective from 23 August 2007, covered 1,853 Harmonised System Customs Codes (HS Codes), in textiles, plastics, wood, and other low-end and labour-intensive industries, which represented 15 per cent of all the HS Codes in China.³⁷ Export processing enterprises in the coastal regions industry those categorised as type A³⁸ and type B enterprises by Chinese Customs had to put up a guarantee deposit equal to 50 per cent of the amount of duty and value-added

35 ESA Project Interview 2010-04-07.

36 www.mofcom.gov.cn.

37 www.mofcom.gov.cn.

38 Companies are categorised into four types (A, B, C, and D) based on their Customs records.

tax if they carried out export processing on goods in the new restriction catalogue.³⁹ Type C export processing enterprises had to put up 100 per cent guarantee deposits, wherever they were situated.⁴⁰ Announcement No. 44 also listed the types of firms that would and would not be allowed to engage in export processing in the specified commodities, with preferences given to companies set up in inland areas.

With the onset of the economic crisis in mid-2008, China's exports slowed. In an effort to ease the pressure on exporters and to stimulate exports, China increased export rebates in August 2008, November 2008, December 2008, January 2009, February 2009, April 2009, and June 2009. The average rebate in Guangdong went from 12.21 per cent in July 2008 to 14.28 per cent in June 2009. In 2009, the total tax rebate for Guangdong was RMB 146.55 billion, an increase of seven per cent year-on-year, and a historical high. China also adjusted its policies on the restriction and prohibition lists for export processing. On 21 November 2008, 17 furniture products were taken off the restricted list and cash deposit requirements for trading in 1,853 commodities were suspended. The guarantee deposit policy for another 122 commodities on the restricted list was suspended for type A enterprises, while those for type B and type C enterprises in Guangdong remained unchanged. On 31 December 2008, 1730 HS codes involving textile products, plastic products, wood products, and hardware products were removed from the restricted list. Those products, with an export value of US\$30 billion, accounted for 77 per cent of the total restriction catalogue. In addition, 27 HS codes involving copper, nickel, aluminium, and related products were removed from the prohibited list. Those products, with an export value of US\$1.5 billion, accounted for 30 per cent of the total prohibition catalogue. On 3 June 2009, another 79 HS codes were removed from the prohibited list. Interest rates on tariff payments made for the domestic sales of bonded goods from the processing trade were also reduced from 6.12 per cent to 0.36 per cent.

Changes to export processing and related regulations impact Guangdong and the Pearl River Delta more than other parts of China given that more than two-thirds of China's export processing facilities are located in Guangdong Province. This means that the major impact of both the imposition and then removal of restrictions fell disproportionately on Guangdong. The key question going forward is whether or when the restrictions will be re-imposed.

The Labour Contract Law

China's Labour Contract Law came into effect on 1 January 2008. The Law was created in order to formalise working relationships, to reduce the exploitation of workers, to provide better balance between employers and employees, to encourage further upgrading of the workforce, and to promote better sharing of the fruits of China's economic development. Many of the provisions mirror those found in several other countries around the world.⁴¹

39 In contrast, before the issuance of the new restriction catalogue, type A enterprises did not have to put up guarantee deposit even they carried out processing trade on the blacklisted goods in the previous restriction catalogue.

40 gbcode.tdctrade.com.

41 See Ronald C. Brown, "China's New Labor Contract Law"; Chris Devonshire-Ellis and Richard Hoffmann, "China's labor law- The reality for overseas investors," 18 January 2008; Lian Lian, "New Labor Contract Law of the PRC," *Shippers Today*, Jan/Feb, 2008.

One of the major provisions is that all employees must be given a written contract within 30 days of employment. The new Law allows for fixed term contracts, open-ended contracts, and project-based contracts. Workers have to be offered an open-ended contract if they have been continuously employed for 10 years or more, if they are employed beyond two fixed period contracts, or if they have been working without a contract for a year. The new Law contains a long list of restrictions on employer behaviour. These include a prohibition on coercion in general, on compelling overtime, on unlawful termination, on provision of unsafe working environments, on excessive overtime, among others. The Law provides for layoffs to be explained to workers and unions and allows for layoffs only in cases where there are major difficulties or changes in the firm's operation. Minimum severance pay is set at one month's salary per year employed up to a maximum of 12 months' salary. For employees with salaries above three times the local average salary, severance is set at three times the average monthly salary times number of years worked up to a maximum of 12 months' payment.

42 Circular on the Publishing of the Standard Contract of Guangdong Province (Yue lao she[2007] no. 154), www.gd.lss.gov.cn.

The Labour Contract Law enshrines an important role for labour unions. Unions are framed as the representative of workers for collective bargaining, termination cases, and other disputes. In specific sectors they are given the sole right to negotiate with employers. The Law, in fact, sees a three-part system, with unions as full members along with the employer and employee. Local governments of Dongguan, Guangzhou, Shenzhen, and Zhongshan have published standard contracts to be used in those cities. Firms in other cities use forms published by the Guangdong Provincial Government. Some of the articles in the Labour Contract Law are stated in the contracts as well: the standard working time shall be no more than eight hours per day and 40 hours per week; the largest amount of overtime work shall be no more than one hour per day in general circumstances and no more than three hours per day or no more than 36 hours per month in special circumstances. Workers are guaranteed at least one day of rest a week.⁴²

Overall, in the new Labour Contract Law, the rights of workers have been enhanced, particularly where it comes to abuses committed by employers. The new Law also makes temporary, seasonal, and contract-based work more difficult and has a clear bias towards open-ended contracts. Employers believe that this will sharply reduce flexibility and increase costs. Non-Chinese companies have indicated that they believe that labour abuses or perceived labour abuses by non-Chinese firms are more likely to be prosecuted than abuses by Chinese firms, giving the latter a strong competitive advantage.

Managers from Hong Kong companies interviewed for the present project viewed the Law as particularly problematic in that it makes seasonal labour fluctuations difficult to deal with, reduces the amount of overtime that workers can do in spite of the fact that most workers prefer to do significant overtime, and makes it harder to hire casual workers. The Law makes it more difficult to hire seasonal workers, which creates difficulties for industries with large seasonal fluctuations in

demand and production (such as industries in which a large portion of sales are made for the Christmas period). The overtime limits were also viewed as problematic, since workers wanted to work more overtime to earn more money. Some managers indicated they knew of cases in which companies offered unpaid voluntary work on Saturdays and then separately paid workers a bonus to compensate. It was reported that companies that did not engage in such practices could lose workers to companies that allowed the workers to effectively work more overtime and earn more money. Several interviewees claimed that companies that did not find a way around some of the labour regulations are at a competitive disadvantage versus Mainland companies and others that ignore or stretch the law. Some interviewees wondered how their own companies could survive alongside Chinese manufacturing firms that operate in the same place and compete in the same markets but have the ability to avoid some costs or regulations. The Law is also seen as compounding the problems of finding workers and escalating wages that have hit the garments, toys, and electronics sectors particularly hard.⁴³

Environmental and Safety Regulations

China as a whole has suffered from significant environmental degradation associated with its industrial development. According to the World Bank, China is home to 16 of the world's 20 most polluted cities. The Pearl River Delta has also been affected by pollution. Guangdong has historically been considered a laggard in environmental protection in China and several of its cities, most notably Dongguan, Foshan, and Guangzhou, have air quality that is poor even by Chinese standards. In 2008, over 90 per cent of the cities in Guangdong Province had an acid rain problem, and nine cities including Guangzhou, Shenzhen, Foshan, Jiangmen, Maoming, Zhaoqing, Huizhou, Dongguan, and Zhongshan, most of which are located in the PRD, are considered to be severely polluted by acid rain.⁴⁴ In addition, in 2008, only 53 per cent of Guangdong's waste water was properly treated. Efforts to address environmental concerns

are improving in Guangdong, albeit slowly. In 2008, RMB 4.7 billion, or 1.4 per cent of fiscal revenue in the province was invested in environmental protection, compared to RMB 2.64 billion (0.95 per cent of fiscal revenue) in 2007.⁴⁵

In 2006, the Guangdong Government announced an Environmental Protection Initiative that targeted the chemical, petrochemical, smelting, electroplating, tanning, printing and dyeing, cement, papermaking, nuclear and radioactive, and hazardous waste treatment industries. Environmental impact assessments were also expected to become tougher on polluting facilities. In 2006, 150,000 factories in Guangdong were inspected for pollution and roughly 2,100 were closed down.⁴⁶ Guangdong has set up strict guidelines for polluting industries to move to "eco industrial parks" specially designed to accommodate and deal with effluents. Foshan has been designated as an "environmental demonstration city", while Dongguan is seeking this status. In the first 10 months of 2006, Shenzhen officials claimed to have refused permission or caused to move from Bao'an District 1,260 firms due to environmental and energy consumption concerns.⁴⁷ In 2008, Dongguan officials claimed to have shut down 173 factories that did not meet environmental standards, involving electroplating, printing and dyeing, paper making, and tanning. Additionally, more than 600 firms considered as highly polluting were targeted for movement to designated locations.⁴⁸

43 ESA Project Interview, 2010-04-07.

44 Gazette of Environment Situation in Guangdong Province 2008.

45 Guangdong Statistical Yearbook 2009, p.184. Guangdong Environmental Protection Bureau. www.gdepb.gov.cn.

46 Ivan Zhai, "2,000 polluting factories shut down," South China Morning Post, 7 February 2007.

47 "Shenzhen keeps 1,300 firms out of city," China Daily, 29 November 2006.

48 "Dongguan Shut down 173 Highly Polluting Factories," Guangdong Environmental Protection Bureau, May 28, 2008. www.gdepb.gov.cn.

In preparing for the Asian Games to be held in Guangzhou in November 2010, the Guangdong Government has urged the PRD cities to tighten pollution control measures and announced that factories in the PRD might be forced to temporarily shut down in October 2010 in the lead up to the Games.⁴⁹ In November 2006, the Hong Kong Productivity Council launched an initiative to help Hong Kong invested enterprises in the Pearl River Delta adopt cleaner production methods. Some factories reduced harmful effluents by 30 per cent or more within the first year of operation. In April 2008, the Hong Kong Government launched a five-year Cleaner Production Partnership Programme, with funding support of more than HK\$93 million by the Government, offering subsidies to Hong Kong firms in the PRD for assessment, implementation, and certification of clean production. The Hong Kong Productivity Council is responsible for implementing the Programme in collaboration with other environmental technology service providers. By 31 December 2009, there were 435 funding approvals issued and another 91 applications were under review.

49 "Guangdong Enhance Pollution Control for Asian Games," Hong Kong Economic Times, 10 February 2010. www.hket.com.

50 "PRD will restrict Cement, Ceramics, and Glass Industries," Xinhuanet, 9 November 2009. finance.ifeng.co.

51 "Enhancing Chemical Safety and Drug Value," Hongkong Industrialist, July 2007.

Specific industries that are considered polluting and/ or energy intensive are being targeted for upgrading, relocation, and/ or closure in the PRD. The ceramics industry, for example, is viewed as labour-intensive and energy-consuming, and therefore inconsistent with the Central Government's new emphasis. The industry will not receive preferential export policies or exemption from environmental controls. Guangdong, which accounted for roughly half of China's ceramics exports will bear the brunt of the policy changes in the sector. In 2009, the Guangdong Government announced that it will further restrict the development of the cement, ceramics, and glass industries in the PRD by shutting down or moving existing operations and limiting capacity expansions.⁵⁰ Measures to support safe management in the chemical sector were extended in 2006 and earlier guidelines began to be enforced.⁵¹

Relocating polluting industries has proven difficult. One such example is the electroplating industry. The Federation of Hong Kong Machinery and Metal Industries estimated that there were about 300 Hong Kong funded electroplating firms in the PRD in 2007 and that about 150 Hong Kong funded electroplating firms with a total of 10,000 workers would be affected by the stringent environmental policies. Three electroplating industrial parks have been approved by Guangdong's Environmental Protection Bureau for Jiangmen. The first, in Xinhui, is expected to start construction in October 2010 at the earliest. The other two electroplating industrial parks in Jiangmen are still in the planning stage.

In recent years, China has become more concerned about product safety. The main focal point in the Pearl River Delta region has been the toy industry. In 2007, 1,454 of the 1,725 toy factories inspected in Guangdong were found to have safety flaws. Roughly 764 toy factories in Guangdong lost their export licences or had them suspended over product quality concerns and 690 were ordered to renovate plants and improve quality standards. A total of 774 people were arrested.⁵² Since Guangdong is the dominant toy producer in China, it was expected that the toy safety issues would hit the province more than other locations in China. In the first quarter of 2009, EU announced 143 toy recalls, 134 of which focused on products made in China. During the same period, US and Canada announced 13 toy recalls, all of which involved products made in China.⁵³ In mid-2009, the EU and US enacted their new toy safety directive and toy safety standards respectively, which made the situation for toy exporters in Guangdong even more difficult.

The garment and textile industry is another sector with increasing product safety concerns. In 2009, the EU announced 122 garment and textile recalls involving China-made products, a 184 per cent increase over 2008, and the US announced 33 garment and textile recalls related to China-made products, a 57 per cent increase over 2008.⁵⁴ Environmental and product safety issues are likely to have a disproportionate effect on the Pearl River Delta going forward. The Central Government seems intent on enforcing rules and regulations on export-oriented, foreign-invested facilities that it considers as adding limited value to China's economy. At present the Pearl River Delta is disproportionately represented in these industries.

The Hong Kong manufacturing managers interviewed for the present project indicated that Hong Kong firms had to follow all the relevant regulations and this put them at a competitive disadvantage versus Mainland companies and other companies that do not. This led to expressed fears that the additional costs incurred in following the appropriate regulations might place some Hong Kong companies at such a disadvantage that their viability could be under threat. To the Hong Kong managers, the issue frequently was not the nature of the rules and regulations, but rather the potential for asymmetric enforcement leading to competitive disadvantages.

52 "Guangdong toymakers lose export licenses," China Economic Review, 2 November 2007. "764 toy factories in Guangdong hit with export ban," The Standard, 2 November 2007. 44 Gazette of Environment Situation in Guangdong Province 2008.

53 HKTDC, "Analysis of Toy Recalls," 18 June 2009.

54 Hong Kong General Chamber of Textiles, "Increasing Recalls of Mainland Textiles by US and EU," 16 April 2010. textileschamber.org.

COMPETITIVE ENVIRONMENT

The competitive environment for Hong Kong manufacturing SMEs in the PRD is changing in several ways. Hong Kong manufacturing firms operating in the PRD face increasing competition from Mainland companies, either within the PRD or in other regions of China, such as the YRD, Shandong province, and other areas that are trying to attract manufacturing companies.⁵⁵

For the past 30 years, Hong Kong firms have transferred the factories, management practices, culture, skills, and connections to China and have helped companies and managers in Mainland China to improve their capabilities in communication and their quality assurance systems. In addition, increasingly Chinese firms are hiring employees from Hong Kong firms as well as consultants from Singapore firms, Korean firms, and other firms where they think that this will support the development of their business.⁵⁶ As a result, the gap between Hong Kong firms and Chinese firms has become smaller and Chinese firms are less willing to play a junior role to Hong Kong business interests.⁵⁷ Many Mainland Chinese companies that once were partners or contractors to Hong Kong firms now have the skills, the technology, the capital, the critical industry mass, the supply chain, the domestic market, the know-how, the contacts, and the government support to go it on their own. Consequently, the main competitors of many Hong Kong firms are Chinese companies, usually the spin-offs founded by Chinese managers once hired and trained by the Hong Kong companies.⁵⁸ It is difficult for Hong Kong SMEs to avoid this phenomenon.

Since fewer Hong Kong people are interested in going into manufacturing, the Hong Kong firms often have to hire Mainlanders for management positions even if this practice can eventually create competitors. In addition, many Hong Kong firms set up supply or subcontractor relations with Mainland firms and this too can create competitors.

To the extent that Mainland competitors are able to run a less expensive operation than their Hong Kong counterparts, they can quote lower prices and win business from Hong Kong companies. The cost differentials are such that if Hong Kong companies have even a few Hong Kong staff then this can already provide a cost disadvantage that makes it difficult for the Hong Kong firms to compete against Mainland counterparts.⁵⁹

Hong Kong manufacturing company managers interviewed for this project indicated that Chinese firms were viewed as being more competitive because of their ability to skirt the law without incurring penalties. According to the Hong Kong managers, Hong Kong companies need to follow the letter of the law and operate in a more ethical manner. As a result, some Hong Kong firms have seen their profit margins eroded in the face of competition from Mainland companies that are viewed as not having to meet the same manufacturing and business standards.⁶⁰

Interviewees also indicated that Mainland companies are often more forward-looking and aggressive than their Hong Kong counterparts. They are more likely to take risks and they also have more local resources in the form of local bank support, “free capital,” or government support.⁶¹ Several interviewees for the present study indicated that indigenous Chinese firms learn very fast to “play the game,” making them formidable competitors.⁶² Mainland company owners are seen as being increasingly knowledgeable and capable, close to the ground, and closer to local officials. They are also often willing to put up with very low manufacturing margins, and will engage in practices such as copying the designs of other companies to

55 ESA Project Interview, 2010-03-25.

56 ESA Project Interview, 2010-04-09.

57 ESA Project Interview, 2010-04-09.

58 ESA Project Interview, 2010-04-07.

59 ESA Project Interview, 2010-04-07.

60 ESA Project Interview, 2010-04-07.

61 ESA Project Interviews, 2010-04-07, 2010-04-09.

62 ESA Project Interview, 2010-03-26.

keep costs down rather than investing in developing their own designs. On the other hand, interviewees viewed Hong Kong firms and Hong Kong managers as more conservative and less connected. For instance, the senior management of Hong Kong firms tend to live in Hong Kong rather than Mainland China and they do not commit sufficiently to learning about China to maximise their ability to leverage Chinese manufacturing or develop the China market.⁶³

CHINESE MAINLAND POLICIES AFFECTING OPERATIONS IN THE PEARL RIVER DELTA

Economic and industrial policies within the Chinese Mainland, particularly those focused on Guangdong Province and the Pearl River Delta, have a critical impact on Hong Kong manufacturing SMEs. Of particular note have been policies for economic restructuring in the PRD, the NDRC Plan for the Reform and Development of the Pearl River Delta, and the Hong Kong-Guangdong Cooperation Framework Agreement.

Policies for Economic Restructuring in the Pearl River Delta

Economic policies and plans for the Pearl River Delta will have a dramatic impact on Hong Kong manufacturing SMEs that operate in the region. China's 11th Five Year Programme (2006-2010) reflected the Central Government's view that the nation's development needed to be adjusted to emphasise the quality of growth, reduce regional imbalances, reduce speculation in the property market, improve the environment, reduce dependence on low value-added production, and improve the position of workers. Guangdong Province and the Pearl River Delta region were chosen to play a leading role in innovation, knowledge, and creativity-based economic development in China. This national role included channelling technology, funds, and know-how into China's interior; acting as a base for foreign private investment into China's interior; and fostering the development of modern service sectors on par with those found in advanced economies.

Another goal was to move labour-intensive, low value-added, and/or polluting industries out of the inner areas of the Pearl River Delta into other parts of the region, other parts of Guangdong, or other parts of the country. One sign of how seriously the new directions have been taken is the fact that the Central Government has designated specific cities in interior provinces that it hopes will become the homes of some of the industries moved out of the Pearl River Delta (and Yangtze River Delta as well). These include Chenzhou (in Hunan Province), Wuhan (Hubei), Xinxiang and Jiaozuo (Henan), Hefei and Wuhu (Anhui), Taiyuan (Shanxi), Nanchang and Ganzhou (Jiangxi), and another 22 cities.

However, in the newly published policies by the State Council on using foreign capital,⁶⁴ highly polluting, high energy-consumption, and resource-intensive projects, as well as projects in industries running at overcapacity, will be strictly restrained all over China. Foreign-funded enterprises are offered income tax breaks to increase their investment in China's central and western regions, particularly in eco-friendly and labour-intensive companies.

63 ESA Project Interview, 2010-04-07.

64 Several Opinions of the State Council on Further Fulfilling the Work of Using Foreign Capital (Guo fa [2010] no. 9), 6 April 2010.

Guangdong Province's priorities in implementing China's 11th Five Year Programme were set out by Guangdong Governor Huang Huahua in the province's 2008 Work Report.⁶⁵ They included fostering indigenous innovation, branding, and intellectual property creation; developing modern service and high-technology industries; reforming traditional industries; improving the sophistication of manufacturing; boosting infrastructure investment; and fostering industry clusters and large-scale local firms. Emphasis also was placed on increasing rural investment and enhancing rural services; reducing energy consumption and pollution; and strengthening domestic demand. Foreign trade and investment would be directed towards restructuring the economy, and ways would be sought to extend development beyond the Pearl River Delta region and to further cooperation with Hong Kong and Macao while building linkages with Pan-Pearl River Delta provinces. In addition, at the Second Plenary Session of the 10th Guangdong Party Committee in January, Wang Yang, Communist Party Secretary for Guangdong Province, emphasised the need for Guangdong to adopt a global vision for its development in order to maintain its leadership within China. This is due to China's increasing linkages with the rest of the world, its strong position in international trade and investment, China's position as a recent member of the World Trade Organisation, and Guangdong's history as an outward looking part of the country.⁶⁶

65 Huang Huahua, "Guangdong Government Work Report," 17 January 2008.

66 "Plan Guangdong's development with a 'global vision'," 3 March 2008. www.newsgd.com.

NDRC Plan for the Reform and Development of the Pearl River Delta

In November 2008, the National Development and Reform Commission (NDRC) issued the "The Outline Plan for the Reform and Development of the Pearl River Delta (2008-2020)". The NDRC Plan, designed to provide a roadmap for the region's development, called for greater autonomy in economic decision-making, the acceleration of infrastructure construction, greater openness, closer economic linkages with Hong Kong and Macao, and the creation of world class bases for modern manufacturing and service industries.

The NDRC Plan called for stable and fast growth, growth in consumer demand, improved living conditions, upgraded industrial structure, more independent innovation, improvements in the environment, social security coverage for both urban and rural areas, and universal availability of public services. In terms of industrial policies, the focus will be on modern services and high-technology industries, innovation in core technologies and consolidating the role of enterprises in innovation. Priority also will be given to modernising infrastructure, optimising the geographic distribution of economic activities around the PRD, enhancing regional economic integration across the entire Pearl River Delta region, and encouraging accelerated development of areas surrounding the region. The Plan calls for closer cooperation with Hong Kong and Macao, closer cooperation with Taiwan, deeper cooperation with the Pan-Pearl River Delta region, and enhanced cooperation with ASEAN and other international economic regions. The Plan also focuses on resource conservation and environmental protection, upgrading social services, and institutional reform.

While much of the NDRC Plan repeated earlier programmes and policies, there are a number of new or newly emphasised points. These include the indication that more autonomy will be given to the region, the emphasis on the service sector, the focus on building strong firms, commitments to several

specific infrastructure projects, a commitment to build dual city integrated sub-regions (Guangzhou-Foshan, Shenzhen-Hong Kong, and Zhuhai-Macao), a commitment to build over 100 research centres in the region, placing environmental issues at the core of Pearl River Delta development, and direct statements about the administrative improvements needed in the region.

In 2009, Guangdong Governor Huang Huahua reaffirmed that “Despite the challenges from the financial crisis, Guangdong will unswervingly follow the opening up policy, continue the economic reforms and realise the Outline of the Plan for Reform and Development in the PRD”.⁶⁷ The Guangdong Government’s 2010 Work Report issued in January of that year indicated that implementing “The Outline Plan for the Reform and Development of the Pearl River Delta” would be its first priority. Areas of emphasis include promoting independent innovation; transforming and upgrading traditional industries; establishing a modern industrial system; maintaining stable and relatively fast economic growth; vigorously expanding domestic demand; promoting balanced development among regions; accelerating institutional reform and opening-up; and strengthening the social system with a focus on societal well-being.⁶⁸

The Hong Kong-Guangdong Cooperation Framework Agreement

The Hong Kong-Guangdong Cooperation Framework Agreement signed in April 2010 was an important step in implementing the cooperation called for in the NDRC document. The overall thrust of the Agreement was to enhance the joint development of Hong Kong and Guangdong, enhance Hong Kong’s position as a financial centre, capitalise on the competitiveness of Hong Kong’s service industries and Guangdong’s manufacturing industries, facilitate the flow of key factors across the boundary, implement a regional environmental regime, and promote the cooperative development of Hong Kong and the cities of Guangdong into a world-class metropolitan cluster.

Numerous specific programmes were mapped out in the main text of the Agreement. One of the striking features of the Agreement was that while it contained extensive discussion of Hong Kong service industries and how these could support development in Guangdong, it contained far less material on Hong Kong manufacturing industries and firms.

In the main text of Agreement, the fourth chapter is “Manufacturing industries and innovation and technology.” On these aspects, Hong Kong and Guangdong are to fully develop individual advantages and jointly accommodate the global industrial transfer, improve innovation capability, push up the transformation and upgrade of traditional manufacturing industries, and cultivate strategic emerging industries, and thus to build an advance manufacturing basis with core competitiveness in the world.

67 Remarks by Governor Huang Huahua at the Press Conference of the ICCFED 2009, www.iccfed.gd.gov.cn.

68 Guangdong Government Work Report 2010.

One important area of cooperation is on the restructuring and upgrading of the export processing trade. The Agreement calls on Hong Kong and Guangdong to engage in:

- i assisting Hong Kong-owned processing enterprises to extend their production chain, encourage them to establish research sections, improve innovation capability, build their own brands, and increase value-added.
- ii supporting Hong Kong-invested enterprises in opening up the Mainland domestic market and build brands in the domestic markets.
- iii encouraging Guangdong and Hong Kong investors to participate the construction of recycling industrial parks and industrial relocation parks in the development zones designated by the nation. Promote Hong Kong-invested enterprises to invest in Guangdong's industrial relocation parks if these enterprises have such needs.

The major initiatives on manufacturing industries for 2010 include:

- i The two places will carry out the policies that promote the development of manufacturing industries, including Direction of Guangdong Province for the Operation of Original Premise Transformation of Enterprises Engaged in Processing with Supplied Materials without Production Suspension, and Guiding Opinion of Guangdong Province on the Work of Promoting Foreign Invested and Processing Trade Enterprises to Expand Domestic Sales. Fulfilling the Cooperation Agreement of Guangdong and Hong Kong on Promoting the Conversion and Upgrading of Hong Kong-invested Processing Trade Enterprises.

- ii Guangdong will hold the Guangdong Exposition of Products by Foreign-invested Enterprises (for Domestic Sales) to facilitate foreign-invested enterprises in Guangdong to build connections and cooperate with purchasing groups, commercial circulation enterprises, and retailers to expand into domestic markets.

In addition, the Agreement called for Hong Kong and Guangdong to pioneer the introduction of electric vehicles to Hong Kong, Guangzhou, Shenzhen, and others and to foster the research and development, manufacturing, general application and development of the auto parts industry for electric cars in the Greater PRD Region.

Guangdong Initiatives for SMEs in Response to the Economic Crisis

Since the onset of the financial crisis, Guangdong Province has also instituted a series of policies to support SMEs. On 2 December 2008, the Guangdong Government issued the "Opinions on Promoting the Stable and Healthy Development of SMEs" (Yue fu [2008] no. 104) in an attempt to ease the financing difficulties of SMEs and to strengthen fiscal and tax support for SMEs. In 2009, the Guangdong Government started to arrange RMB 2.2 billion to subsidise technology upgrades and innovation by SMEs, to expand the export capabilities of SMEs, and to provide other services and support for SMEs.⁶⁹

In January 2009, the Guangdong Government published policies aimed at helping SMEs funded by investors from Hong Kong, Macao, and Taiwan combat the financial crisis.⁷⁰ These included increased fiscal support; reductions or exemptions from taxes and fees; simplified administrative procedures; support for independent innovation; ensuring supplies of water, electricity, and natural gas; and support for labour training efforts. A commitment was also made to try to secure Central Government support for policies to support Hong Kong, Macao, and Taiwan invested SMEs. In April 2009, Guangdong outlined a series of measures intended to help SMEs expand into domestic

⁶⁹ Opinions on Promoting the Stable and Healthy Development of SMEs (Yue fu [2008] no. 104)

⁷⁰ Circular on Several Policies and Measures of Guangdong to Support Hong Kong, Macau, and Taiwan-invested Enterprises to Combat the International Financial Crisis to Speed up Conversion and Upgrading (Yue fu ban [2009] no. 3, 16 January 2009)

markets.⁷¹ This included helping SMEs to join the marketing networks of leading enterprises, making use of Guangdong commercial associations to provide SMEs with greater access to national marketing networks, to provide special funds for SMEs that have national “famous products,” and to support SMEs to help them develop products and services that are suitable for China’s rural markets.

In January 2010, the Guangdong Government instituted a strategy to help SMEs expand domestic sales and develop advanced manufacturing capabilities.⁷² In March 2010, the Guangdong Government published a policy to further support the development of SMEs by unifying market entry standards and opening the market for private enterprises to industries with high profit, such as power, telecommunication, petrochemicals, and finance.⁷³

Perspectives on the Direction of Policy for the PRD

The most striking feature of the NDRC document is that it starts with a short description of the success of the PRD and its development over the last 30 years and then has a much longer section deriding the development model that generated this success in the first place. The PRD past development model is criticised as being low-value adding, low-technology, labour-intensive, resource-intensive, overly dependent on exports and foreign companies, and environmentally and socially unsound. The rest of the document outlines an approach for a radically different economic model geared more to replace the previous model than to build on and extend its successes.

The NDRC document and the subsequent discussions on PRD development give a mixed message to Hong Kong and its firms. On the one hand, further cooperation and interaction with Hong Kong is viewed as important for the PRD development. On the other hand, the policy direction appears to provide little space for Hong Kong manufacturing SMEs in traditional industries. Indeed, Guangdong’s Party Secretary Wang Yang

has been quoted as saying that it is time for “emptying the cage for new birds to come in.” This would involve letting go or pushing out many of the Hong Kong and Taiwan invested SMEs that have been lynchpins of Guangdong’s development since the 1970s.⁷⁴

While aiming to combat the financial crisis, it is clear that the Guangdong Government remains committed to its plans for industrial restructuring and upgrading. A trial of programmes for the transformation and upgrading of export processing enterprises was begun in Dongguan in 2008. In April 2010, the programme was extended to the rest of the PRD with the exception of Jiangmen.⁷⁵ These cities will promote processing trade enterprises to make breakthroughs in independent innovation, indigenous brand development, research and development, domestic market penetration, establishing and improving marketing networks, and industrial upgrading.

71 Opinions on Helping SMEs to Expand into Domestic Markets (Yue jingmao zhongxiao ju [2009] no.326, 23 April 2009)

72 Decision of Guangdong Provincial Party Committee and Government on Implementing the Strategy of Expanding Domestic Demand (published on 15 January 2010)

73 Opinions on the Implementation of Opinions of the State Council on Further Promoting the Development of Small and Medium Enterprises (Yue fu [2010] no. 39, 25 March 2010)

74 Cong Cao, “Emptying the cage for new birds to come in,” UPI Asia, 17 February 2009.

75 Circular on the List of Key Cities to Deal with the Transformation and Upgrading of Processing Trade Enterprises (Yue ban han [2010] no. 198, 12 April 2010).

According to the Hong Kong manufacturing company managers interviewed for this study, it is clear that the emphasis in Guangdong will be on high-technology manufacturing and high-end services at the expense of more traditional industries. According to the interviewees, 10 years ago the Guangdong Government was accommodating to traditional industries but not anymore, and these industries are viewed as being on the way out.⁷⁶ Industries that are considered to be highly polluting, highly energy consuming, resource-intensive, and low value-added are all out of favour. For many Hong Kong companies, one trouble is that the Guangdong Government seems to view sectors as either “good” or “bad” in their entirety, not necessarily taking into account whether a specific company uses advanced technology, advanced design, or green production techniques.

Another problem is that industries do not exist in isolation. Instead, they exist in entire production chains. Singling out a single industry to be moved or closed down can therefore influence an entire production chain. The dyeing industry, for example, has been targeted as a polluting industry, but without dyeing the entire garment production chain may be at risk. Similarly, electroplating has been targeted as a polluting industry, but without access to electroplating, the electronics and other production chains are at risk.⁷⁷ Guangdong is the home of many industry clusters with nearly complete supply chains, if individual sectors are moved too quickly then the entire supply chain can be disrupted. The success of the PRD manufacturers has to do with the presence of complete supply chains, but many interviewees believe that policies in the Chinese Mainland appear not to be made with this fact in mind. All Chinese jurisdictions want high-end of manufacturing, but many do not

adequately provide for the right types of support to be put in place to accompany changes to the profile of industry.⁷⁸ This is why industry is slow to move to locations such as Indonesia that can provide 30 per cent to 40 per cent savings on wages and land. Few companies have moved there due to the lack of supply chain that supports their broader needs.⁷⁹

In any case, the upshot of the policy directions in the PRD for Hong Kong manufacturing SMEs and firms from other jurisdictions is that the firms will be welcome as long as they contribute to the development of a new-type of economy in the PRD, but less welcome if they follow traditional models or operate in traditional industries. Thus while providing some opportunities for Hong Kong manufacturing SMEs that can participate in the upgrading initiatives and develop the capabilities to contribute to the desired innovation capabilities of the PRD, the direction calls into question the continued viability of the vast majority of Hong Kong manufacturing SMEs operating in the PRD that cannot make this type of contribution.

OPERATIONAL AND STRATEGIC ISSUES

The present project has identified a number of operational and strategic issues that affect the performance of Hong Kong manufacturing SMEs.

Shortcomings in the Business Basics

Many Hong Kong SMEs are managed in a fairly haphazard fashion. Few SME managers have formal business training. Few have developed real business plans. Few have developed creative strategies. Few have committed to researching markets, understanding precisely evolving customer requirements, and finding new ways to serve the customer. Few use modern accounting, information technology, inventory management, or business process tools. As a result, many leave money on the table due to internal inefficiencies. While such firms may get by in good times, increasingly the combination of tough global markets, powerful customers, and capable competitors makes inefficiency unsustainable.

⁷⁶ ESA Project Interview, 2010-04-07.

⁷⁷ ESA Project Interview, 2010-05-03.

⁷⁸ ESA Project Interview, 2010-03-24.

⁷⁹ ESA Project Interview, 2010-04-07.

Failure to Differentiate

Many Hong Kong SMEs have not identified a specific niche and differentiated themselves to the extent that customers view them as having something unique and valuable. The absence of differentiation leaves a company open to pure price competition and to customers constantly demanding lower and lower prices regardless of costs. The key to differentiation is to identify specific customer requirements and then meet those requirements better than the competitors. If successful, such differentiation usually leads to at least a limited amount of pricing power, which provides some insulation against difficult economic times. Many Hong Kong companies have yet to develop truly distinguishing capabilities. As a result, they are vulnerable to competition from other Hong Kong companies as well as those from the Chinese Mainland.

Limited Scope of Management

Many Hong Kong SMEs have a limited scope of management in terms of numbers, geographic scope, activity scope, and market scope. Hong Kong SMEs generally have one or a small number of senior managers that are the driving forces of the company. A small number of managers means that the companies suffer significantly when new rules, regulations, and administrative requirements come into effect. In geographic terms, many Hong Kong SMEs appear to be able to manage within Hong Kong and perhaps in certain cities in Guangdong, but have a hard time managing activities elsewhere. This limits their ability to react to rising costs and shifting policies, and limits their potential to take advantage of newly emerging manufacturing locations elsewhere in China, elsewhere in East Asia, or elsewhere in the world. In many cases, Hong Kong SME managers that have operated in Guangdong for many years still do not really know Guangdong, the local officials, the local suppliers, and the local competitors nearly as well as newly emerging Chinese counterparts. While this may not have been an issue when there were relatively few capable Mainland Chinese managers and companies, it is less and less the case.

In terms of activity scope, many Hong Kong SME managers are comfortable producing for OEM customers that provide the orders and the specifications, and then distribute the products. Far fewer Hong Kong SMEs are comfortable developing their own designs, getting their own orders in overseas markets, and then distributing internationally. This of course limits the scope of what they can do in good times or bad. Finally, as relatively few Hong Kong SMEs have engaged in significant market development, they are reliant on others to carry out this process. This means that many SMEs are not in regular contact with end customers and therefore have a more difficult time anticipating or leading industry trends.

Gaps in Succession

Many Hong Kong's manufacturing companies were founded in the 1980s or earlier and rapidly expanded with the growth in South China in the 1990s. In many cases, the founder or proprietor is nearing retirement age with no apparent successor. In some cases, there are no children that can take over. In other cases, the children are pursuing other interests, or careers in industries that are considered more prestigious and less difficult, and do not wish to take over. Since the vast majority of Hong Kong SMEs are family firms with members of the family as managers, this creates a difficult situation. With no obvious successors and with difficulty in selling a company that has often been built around a single individual, for many SME owners there is no clear exit strategy. The risk is that otherwise strong companies with good franchises may fall on hard times and cease to contribute to Hong Kong and to South China.

Difficulty in Finding Capable Managers

Many Hong Kong manufacturing SMEs are finding it increasingly difficult to find capable managers for their operations. Most would like to rely on managers from Hong Kong who understand the processes as well as the business side of the operations. However, several interviewees indicated that Hong Kong people are not going into the manufacturing sector nearly as much as in the past. Instead, they are going into the financial service, professional service, or property sectors. The result is that the group of Hong Kong managers capable of managing manufacturing operations is aging and shrinking. The solution for many companies is to try to source managers from the Chinese Mainland, where 30 years of economic reform and development is generating a group of capable managers. Unfortunately, this group is also in demand from major multinational companies and growing Chinese companies too. In addition, developing a strong group of managers from the Chinese Mainland is viewed as potentially creating future competitors should these managers use the knowledge they have gained to shift to a competitor or to open their own company and engage in direct competition with their former employer. Some Hong Kong companies source managers from Taiwan, Singapore, Korea, or elsewhere, but find it can be difficult to integrate several different cultures within a small firm.

Difficulty in Obtaining Finance

While by their nature SMEs do not require huge amounts of financing, on the other hand SMEs often find it difficult to find the financing that they

do need. Personal and family capital is often used for start-up, but working capital and financing for operational needs often must come from other sources. Banks are the usual sources of financing, but SME managers report that relatively few banks truly understand the SME operations. Even those that do tend to require personal guarantees and pledges of private assets for loans to the SMEs.

Reliance on bank capital can create difficulties in times of economic hardship. In an October 2008 survey carried out by the Federation of Hong Kong Industries, one in 10 responding SMEs reported that their credit quota had been cancelled by their banks and a majority of respondents indicated that their credit terms with banks had been adversely affected. Although 80 per cent of the enterprises reported that they were still financially sound, they thought that if banks further cut off their credit and the external environment further worsened, they would face difficulties.⁸⁰

Lack of Knowledge of Support Programmes

The Hong Kong Government and related agencies offer a wide range of support programmes for Hong Kong's SMEs. The unfortunate fact appears to be that relatively few of the SMEs these programmes are designed to help actually know of their existence. As a result, the take up rate is rather low and the results not as strong as one might hope.

Perspectives on Operational and Strategic Issues

All over the world, the vast majority of SMEs that are started eventually fail. The most common reasons for failure are not changes in external markets, or changes in public policies, or even the emergence of new competitors. The most common reasons for failure involve basic flaws in the business plan (or the lack of a business plan), basic flaws in operations, and basic flaws in management. Thus while Hong Kong SMEs need to understand and adjust to global economic conditions, changing conditions in China, and a changing competitive landscape, they also need to ensure that they get the basics right in order to survive and thrive.

⁸⁰ See Federation of Hong Kong Industries, "Survey Report on SMEs Credit Status," (Chinese version only), October 2008.

The Impacts of Developments on Hong Kong Manufacturing Firms

There have been a number of reports of impacts of the developments in the Pearl River Delta on Hong Kong firms in recent years. These reports highlight the challenges faced by Hong Kong manufacturing SMEs operating in the Pearl River Delta region.

GREATER PRD BUSINESS COUNCIL/ HONG KONG TRADE DEVELOPMENT COUNCIL (JUNE 2007)⁸¹

According to a June 2007 report prepared for the Greater Pearl River Delta Business Council by the Hong Kong Trade Development Council on the impact of changes in export processing regulations, as of 2006 there were 57,500 Hong Kong invested factories controlled by 55,200 companies in the Pearl River Delta region with 9.6 million employees. In 2006, 80.7 per cent of Hong Kong's re-exports of Mainland China origin were related to export processing.⁸²

Based on a survey conducted in early 2007, the Hong Kong Trade Development Council concluded that 14,500 Hong Kong enterprises would be seriously affected due to the changes of processing trade policy of adjustment of the tax rebate rates and issuance of the new restriction catalogue for processing trade. The survey concluded that 1,500 enterprises could cease production, 375,000 Mainland production workers (out of 9.6 million employed by Hong Kong firms) could lose their

jobs, and 10,000 employees in Hong Kong could lose their jobs. If these impacts were to cascade through the economy a total of 10,000 enterprises could cease or scale down production, 2.5 million mainland production worker jobs could be under threat, and a total of 70,000 Hong Kong jobs could be in jeopardy. The report noted that Hong Kong manufacturers had already reported a drop of profit margins in export processing of 18 per cent in 2002 to 10 per cent in 2007.

In terms of factors that were affecting the investment environment in the PRD, Hong Kong companies listed rising labour costs and labour shortages of skilled workers, RMB appreciation, rising land costs and restrictions, and tightening of processing trade policies as the factors most affecting the investment environment (see Exhibit 12). It should be noted that the final details of the Labour Contract Law were announced after the survey period, though the outlines of the Law had been released earlier.

81 GPRD Business Council, "Implications of Mainland Processing Trade Policy on Hong Kong," June 2007.

82 These numbers include both direct investment enterprises and companies in other contractual forms. Other contractual forms include three forms of processing and assembly operations, compensatory trade, and any other processing arrangements or relationships into which a foreign company enters with a Mainland factory.

Exhibit 12. Factors Affecting the Investment Environment in the PRD, 2007

	Weighted Average Score	Evaluation (%)					
		1 = Most Impact, 5 = Least Impact, No = No Impact					
		1	2	3	4	5	No
Rising labour cost/ skilled labour shortage	1.78	56.2	22.9	11.2	4.4	3.9	1.4
RMB appreciation	1.96	43.9	26.8	17.3	6.1	4.4	1.5
Rising land cost/ land restrictions	2.21	25.4	19.8	25.5	11.2	6.9	11.2
Tightening of processing trade policy	2.22	26.9	21.4	25.5	9.9	7.2	9.1
Tightening of Labour Contract Law	2.27	24.6	28.4	29.5	7.9	5.1	4.5
Power/ water shortage	2.33	25.0	23.2	27.2	11.4	6.8	6.3
Adjustment in export VAT rebate	2.37	19.2	21.9	26.7	12.4	8.8	11.0
Higher environmental protection requirements	2.37	21.8	26.8	28.3	10.8	6.6	5.6
Expiry of corporate income tax concession	2.39	20.2	22.7	29.0	12.3	7.5	8.3

Note: According to Hong Kong Manufacturers.
Source: Hong Kong Trade Development Council.

HONG KONG TRADE DEVELOPMENT COUNCIL (NOVEMBER 2007)⁸³

In November 2007, the Hong Kong Trade Development Council surveyed Hong Kong firms operating export processing facilities in the PRD on the impact of changes in export processing and environmental regulations. A total of 75.1 per cent of respondents indicated that their export processing operations had been affected by the changes in export processing rules instituted in 2007 and 24.9 per cent indicated their operations had not been affected. A total of 44.5 per cent indicated that the changes had led to an increase in input costs; 30 per cent had to pay customs duty deposits on inputs; and 25.2 per cent saw an impact on the availability of inputs from suppliers (note that some companies cited multiple effects).

Despite the impacts, 78.3 per cent of the firms indicated that they would not consider relocating their operations from the PRD. The main reasons that were cited for this lack of interest in relocating out of the PRD were cost of relocation (40.9 per cent), their PRD business is still profitable (19.3 per cent), they were not aware of other options (17.5 per cent), relocation to another region would weaken firm competitiveness (16.6 per cent), and others (10.4 per cent).

⁸³ See Hong Kong Trade Development Council, "Latest Development and Strategies of Hong Kong Companies" Processing Trade Business in the Pearl River Delta- Survey Findings," 30 January 2008.

Overall, the outlook of the Hong Kong companies was mixed. In the short-term (one to two years), more respondents felt their business would see rapid decline (7.4 per cent) than rapid growth (4.8 per cent). On the other hand, more respondents believed their operations would have moderate growth (34.2 per cent) than moderate decline (28 per cent). Similarly, on a three to five year time scale, more respondents believed export processing business would rapidly decline (15.1 per cent) than rapidly grow (7.1 per cent). Slightly more respondents believed their operations would exhibit moderate growth (33.5 per cent) than moderate decline (31.5 per cent) (see Exhibit 13).

Exhibit 13. Outlook for the Business of Hong Kong Export Processors, November 2007

Prospects	Short-term (1-2 years) % of Respondents	Medium-term (3-5 years) % of Respondents
Rapid growth	4.8	7.1
Moderate growth	34.2	33.5
Unchanged	25.6	12.8
Moderate decline	28.0	31.5
Rapid decline	7.4	15.1

Source: Hong Kong Trade Development Council.

Many of the respondents indicated their companies were taking action to maintain or expand their business in the PRD. A total of 42.4 per cent indicated that they would look to increase sales in China's domestic market (presumably foregoing the tariff breaks afforded to export processing production); 42.1 per cent were looking to increase domestic sourcing of inputs (so they would not have to pay import tariffs on the inputs); 34.7 per cent would consider changing from an export-processing operation to a foreign-invested enterprise (thereby foregoing the advantages of export processing while also avoiding the restrictions associated with export processing); 22.8 per cent indicated that they would increase capital investment (presumably to automate production and to improve environmental performance); and 16.3 per cent would invest in green production (to improve environmental

performance). Note that the figures add to more than 100 per cent because some firms were undertaking more than one initiative.

The Trade Development Council indicated that in the face of shrinking profit margins among the Hong Kong export processing companies, that total cost increases on the order of six per cent to 12 per cent due to labour cost increases, RMB appreciation and other cost increases could put many of the firms in peril. What they did not report were that many companies had been able to raise export prices three per cent to four per cent per year in the last two years and that average re-export margins for goods taken from the Chinese Mainland to Hong Kong and then re-exported from Hong Kong were on the order of 25 per cent to 30 per cent,⁸⁴ implying that many Hong Kong invested enterprises had far more staying power than the survey results might indicate.

HONG KONG TRADE DEVELOPMENT COUNCIL (FEBRUARY 2008)⁸⁵

In February 2008, the Hong Kong Trade Development Council released a report entitled "Offshore Trade and Production: Development and Implications." The report used data obtained from a survey undertaken in 2007. While the main thrust of the report was on modes of trade, it also investigated production conditions in the Pearl River Delta.

According to the report, 91 per cent of responding companies produced or sourced goods in the Chinese Mainland. Of these, 59 per cent had or sourced production only in Guangdong, 30.5 per cent in Guangdong and other parts of China, and 10.5 per cent only in other parts of China. Only 24.8 per cent of respondents reported that their companies were selling to the Chinese Mainland, but another 50.9 per cent indicated that they planned to do so in the next three years. The lowest ratios of sales into the 44 per cent of the responding companies (manufacturing and trading companies were surveyed and 52 per cent of respondents were

trading companies) had production operations in the PRD. These companies identified rising labour costs/ lack of skilled labour as the major problems in manufacturing in the PRD, trailed by RMB appreciation, rising land costs/ restrictions on land use, tightening policies on outward processing trade, and expected tightening of the Labour Contract Law. When asked what strategies they would take to tackle these problems, 53 per cent said they would develop better quality products, while 45 per cent said they would enhance product design and innovation, and 37 per cent indicated they would relocate PRD production.

Exhibit 14. Strategies of Hong Kong Companies for Tackling the Problems in Manufacturing in the PRD, First Quarter 2007

Strategies	% of Respondents
Develop better quality products	53.1
Enhance product design and innovation	45.1
Relocate existing PRD production to other places	37.3
Improve efficiency by better inventory control	36.7
Automate the production process to lower wage costs	35.9
Develop own brand products	35.0
Shift registration from "outward processing" to "wholly owned" or "joint venture"	24.6
Develop related products in other industries	22.7
Implement green manufacturing system	18.0
Invest in high-tech product development	17.8
Give up manufacturing and focus on sourcing and marketing	12.2
Take no action	8.7

Source: Hong Kong Trade Development Council.

⁸⁴ Enright, Scott & Associates Ltd. estimate

⁸⁵ See Hong Kong Trade Development Council, "Offshore Trade and Production: Development and Implications," 5 February 2008.

Among the respondents with a relocation plan, 37 per cent said they would move their existing production in the PRD to pan-PRD provinces other than Guangdong, 34 per cent to other Guangdong areas outside the PRD, 21 per cent to YRD, and six per cent to rest of the Mainland. The remaining three per cent even considered to move outside the Mainland.

Even with a substantial number of companies planning some relocation of production or sourcing, only 8.3 per cent of respondents indicated that their companies would decrease overall management and planning in Hong Kong while 27.2 per cent indicated they would increase it. The projected “increases in Hong Kong” also outweighed the projected “decreases in Hong Kong” for finance and accounting, product design and development, sales and marketing, quality control, and trade finance and insurance. The projected “decreases in Hong Kong” outweighed the “increases” in human resources, purchasing raw materials, manufacturing, production management, arrangement of logistics, and trade documentation.

86 Federation of Hong Kong Industries, “PRD Business Environment Survey,” March 2008.

FEDERATION OF HONG KONG INDUSTRIES (MARCH 2008)⁸⁶

According to a March 2008 report of the Federation of Hong Kong Industries, the business environment for members operating in the Pearl River Delta had undergone changes related to export processing regulations, the Labour Contract Law, the appreciation of the RMB, inflation in China, and rising material prices. The firms rated the Labour Contract Law as providing them with the most difficulty, followed by appreciation of the RMB, changes in export processing rules, labour shortages, and shortages in utilities.

In terms of impact on costs, 84 per cent of respondents indicated that RMB appreciation had resulted in a five per cent to 10 per cent increase in costs in the previous two years (see Exhibit 15). The vast majority of respondents (75.3 per cent) indicated that the impact of inflation from 2007 to 2008 had resulted in an increase of five per cent or more (40.7 per cent indicated more than 10 per cent). More than half (51.2 per cent) of the respondents indicated that the new Labour Law would result in a rise in costs of above 10 per cent. Around 30 per cent of respondents had experienced labour disputes in the first two months of operation of the Labour Contract Law.

Exhibit 15. Estimated Cost Impact on PRD Operations, Percentage of Respondents, 2008

Estimated Impact	RMB Appreciation (2006 to 2008)	Inflation (2007 to 2008)	Labour Contract Law (2007 to 2008)	Total Impact (2007 to 2008)
No obvious impact	1.9	1.2	2.5	
Rise in cost around 1-5%	13.6	23.5	16.7	5.6
Rise in cost around 5-10%	84.0	34.6	28.4	22.4
Rise in cost above 10%		40.7 (average rise around 17.2%)	51.2 (average rise around 21.8%)	70.2 (average rise around 20.5%)
No comment	0.5		1.2	1.8

Source: Federation of Hong Kong Industries.

The RMB appreciation and inflation figures were consistent with reported movements in these areas, while the Labour Contract Law figures were consistent with the expense of setting up more formal labour systems and adjusting for severance payments and loss of flexibility under the new law. It should be noted, however, that the value added in typical export industries in Guangdong is on the order of 25 per cent to 40 per cent, and therefore the increases in individual elements do not necessarily correspond to similar increases in total production costs. In fact, a majority of respondents indicated that their total operating costs had risen on the order of 20 per cent in 2007.

Nearly half (46.9 per cent) of FHKI survey respondents indicated that expansion of the list of industries restricted for export processing would shrink their profit margins and another 36.4 per cent indicated it would reduce their cash flow. Another 14.8 per cent indicated that they would avoid manufacturing or exporting affected products. Only 17.9 per cent of respondents believed this would have little impact on their firm.

Despite concerns for their future registered by respondents, 48.8 per cent would not consider relocation to China's western provinces, while 43.8 per cent might do it in the long-run. As seen in Exhibit 16, more than half of the respondents expected to adopt automation to reduce labour costs. More than half also expect to upgrade the value and value-added in their products. Over one-fifth (20.4 per cent) expected to close down their businesses in the PRD. Most of the companies that expected to close their businesses had no specific timetable for doing so.

Respondents were also asked to estimate the percentage of firms in their industries that shut down in the previous year and how many might shut down in the next one to two years. Roughly a third of the respondents believed that less than 10 per cent of companies in their industry had closed; roughly one-third believed that 10 per cent to 20 per cent had shut down, and approximately 24 per

cent believed the percentage was higher than 20 per cent. Roughly a third of respondents indicated that they believed 10 per cent to 20 per cent of companies in their industry would close in the next one to two years, while roughly a third believed the percentage would be 20 per cent to 30 per cent and approximately 17 per cent thought the percentage would exceed 30 per cent closures (see Exhibit 17).

Exhibit 16. Reactions to Cost Increases in South China

Reactions (Multiple responses allowed)	% of Total Respondents
Relocate factories to other parts of Guangdong	17.9
Relocate factories to mid and western regions of China	11.1
Move factories to Southeast Asian countries such as Vietnam	14.2
Adopt automation to reduce labour cost	59.3
Outsource the labour intensive processes	30.9
Upgrade the production and develop value-added products	58.0
Close down business	20.4

Source: Federation of Hong Kong Industries.

Exhibit 17. Estimates of Firm Shutdowns in the PRD by Hong Kong Managers

Estimated Percentage of Closures	Past Year % of Respondents	Next One to Two Years % of Respondents
Less than 10%	32.7	14.4
10% to 20%	36.5	33.8
20% to 30%	15.7	30.6
Above 30%	8.2	16.9
No comment	6.9	4.3

Source: Federation of Hong Kong Industries.

In terms of future outlook, 0.6 per cent of respondents said they were optimistic and would increase investment, 64.8 per cent indicated that they would be cautious and adjust to the policy environment, 32.1 per cent said they were pessimistic and would gradually reduce investment, and 2.5 per cent had no comment.

87 Hong Kong Trade Development Council, "Beyond Cheap Labor: Building a Competitive Edge through Adding Value," 5 September 2008.

HONG KONG TRADE DEVELOPMENT COUNCIL (SEPTEMBER 2008)⁸⁷

In March and April of 2008, Hong Kong Trade Development Council conducted a survey on the impacts of the changing PRD business environment on Hong Kong manufacturers and traders. According to the survey report issued in September 2008, RMB appreciation had the greatest impact on Hong Kong companies in the PRD, followed by wage rises and the implementation of the Labour Contract Law (see Exhibit 18). Survey findings also showed that SMEs had been impacted by the Labour Contract Law even more than larger firms that can more easily absorb the impact of labour cost increases (see Exhibit 19).

Exhibit 18. Challenges Faced by Hong Kong Companies in PRD

Challenges (1 = the largest impact and 5 the smallest)	Severity of Impact	% of Enterprises Affected
Appreciation of RMB	1.66	97.4
Rise in wages	1.76	97.4
Implementation of the Labour Contract Law	1.86	96.5
Inadequate labour supply	2.08	95.9
Power / water shortage	2.35	94.4
Implementation of the new Enterprise Income Tax Law	2.40	95.1
Tightening of processing trade policies (e.g. Increases in restricted and prohibited categories)	2.40	92.6
More stringent environmental requirements	2.46	94.9
Rising land cost / more land use restrictions	2.72	88.8

Source: Hong Kong Trade Development Council.

Exhibit 19. Impacts of the Labour Contract Law on Enterprises of Different Sizes

	Overall Average	2007 Turnover		
		Equal or Less Than HK\$10 million	HK\$10 million to HK\$50 million	More Than HK\$50 million
Estimated % increase in direct labour cost	23.5	24.8	23.4	21.5
Estimated % increase in HR admin cost	21.3	24.1	20.3	17.6

Source: Hong Kong Trade Development Council.

In spite of these challenges, the majority of Hong Kong companies still gave positive responses to questions of investment with a total of 53.3 per cent of them planning to upgrade their technology or raise their product value-added, while 29.9 per cent planned to increase the mechanisation level of their production. However, 3.1 per cent of the companies surveyed were planning to shut down their PRD operations. Most enterprises that claimed they would shut down were smaller in size, with 72.5 per cent having a turnover of HK\$10 million or less in 2007, 15.7 per cent having a turnover of between HK\$10 million and HK\$15 million, and none having a turnover exceeding HK\$100 million.

Exhibit 20. Hong Kong Companies' Choice of Response to Challenges

Response	% of Respondents
Raise mechanisation level	29.9
Upgrade technology and raise product value added	53.3
Suspend PRD expansion	14.0
Scale down existing PRD operations	22.5
Shut down existing PRD operations	3.1
No plan yet	19.3

Note: *Multiple answers allowed.

Source: Hong Kong Trade Development Council.

FEDERATION OF HONG KONG INDUSTRIES (MAY 2009)⁸⁸

In a March 2009 survey, the Federation of Hong Kong Industries found that the major difficulties for Hong Kong manufacturers since the global financial crisis began was shrinking orders, followed by dwindling profit margins, rising operation costs, high payment default rates, and sharply rising financing costs. Manufacturers reported that they had experienced on average a 30 per cent reduction in profit compared with the previous year. Operating costs were estimated to have increased 17 per cent on average, with labour costs, raw materials costs, and appreciation of the RMB the primary contributors to the rise in costs.

Half of the manufacturers surveyed said they had encountered payment defaults or delays from their customers equal to approximately 20 per cent of their business turnover. Respondents also had suffered cuts to their bank credit lines on the order of 30 per cent, and 25 per cent of manufacturers said that their interest expenses had increased by 30 per cent. About 20 per cent of the manufacturers surveyed indicated they had experienced problems in obtaining bank loans.

The survey found that, in light of the poor economic climate, manufacturers in general have taken measures to mitigate the financial distress including postponing all new investment projects (41 per cent), outsourcing production (19 per cent), investing in new products or equipment or to upgrade (17 per cent), relocating production facilities to Mainland cities other than the PRD (10 per cent), relocating production facilities back to Hong Kong or overseas (four per cent), and through merger or acquisition (one per cent) (see Exhibit 21).

Exhibit 21. Measures Taken to Mitigate the Effects of the Economic Downturn

Measures	% of Respondents
Postpone all new investment projects	41
Outsource production	19
Invest in new products or equipment to upgrade	17
Relocate production facilities to Mainland cities outside the PRD	10
Relocate production facilities back to Hong Kong or overseas	4
Merger and Acquisition	1

Source: Federation of Hong Kong Industries.

⁸⁸ Federation of Hong Kong Industries, "Survey on Hong Kong Enterprises in the PRD," May 2009.

In terms of Government actions taken to support SMEs during the global economic crisis, the three most popular actions taken by the Hong Kong Government were the market promotion fund scheme for SMEs which 62 per cent of respondents found useful, the coverage expansion of ECIC (Hong Kong Export Credit Insurance Corporation) schemes which 56 per cent of respondents found useful, and the HK\$100 billion guarantee scheme which 51 per cent of respondents found useful.

Most of the measures released by the Mainland Government were well received by manufacturers. The suspension of the minimum wage increase was rated as useful by 83 per cent of respondents, and the reduction of administrative levies was rated as useful by 82 per cent of respondents. Other measures considered useful by manufacturers were the deferral of payment for social insurance contributions (76 per cent), suspension of the requirement for cash payment of customs guarantee (69 per cent), an increase of export tax rebate rates (66 per cent), the expansion of SME loan guarantee schemes (52 per cent), and financial support given to enterprises to upgrade and transform (52 per cent).

⁸⁹ Federation of Hong Kong Industries, extract documents for "Survey on Hong Kong Manufacturers' PRD Operations in the Post-financial Crisis Environment," November 2009.

FEDERATION OF HONG KONG INDUSTRIES (NOVEMBER 2009)⁸⁹

With some signs of economic recovery visible in the latter half of 2009, the Federation of Hong Kong Industries conducted another survey between October and November 2009 to get an update of the situation of Hong Kong's PRD-based enterprises. Manufacturers reported that business had improved during the period July to September 2009. Compared to the worst period of the financial crisis, most of the respondents reported that there was a 20 per cent increase in export value but a 10 per cent decrease in order value. Although they saw a 20 per cent increase in credit availability, payment default rose 20 per cent. Operating costs also increased 10 per cent. The summary of these changes is shown in Exhibit 22.

Exhibit 22. Change in Firm Performance Comparing to Earlier Periods, July-September 2009

Performance Factors	% of Changes	
	Comparing to the Worst Time of Financial Crisis	Comparing to Normal Times Preceding the Financial Crisis
Export value	20	-10
Order value	-10	-10
Credit availability	20	-10
Payment default	20	30
Operating costs	10	10

Source: Federation of Hong Kong Industries.

The survey respondents identified their major difficulties as labour shortages, an increase in labour cost, a heavy tax burden, and weak overseas markets. Other difficulties they identified included a fluctuation in export tax rebate rates, a lack of managerial and technical talents, an inability to secure credit lines, a lack of supporting industries, and the appreciation in the RMB. Firms reported several means for coping with these difficulties, including restructuring and streamlining production lines, developing new products or upgrading production technology, and reducing the number of workers, among others (see Exhibit 23).

Exhibit 23. Measures Taken to Cope with the post-Financial Crisis Situation

Measures	% of Responding Firms
Restructure company organisation and streamline production lines	76
Develop new products or upgrade production technology	59
Reduce the number of workers	51
Develop domestic sales	27
Outsource production	27
Engage in brand development and product upgrade	22
Transform from being in the processing trade to being a foreign-invested company	13

Source: Federation of Hong Kong Industries.

About 60 per cent of respondents indicated that the worst economic period was not over with only 16 per cent holding the view that the worst of the economic crisis was behind them. However, respondents were quite optimistic regarding the short-to-medium-term prospects for the PRD manufacturing industry with 57 per cent of enterprises predicting that the operational situation at large would stabilise before the end of 2009 and 22 per cent holding the view that it would gradually improve before the end of 2009. Less than 10 per cent thought that the situation would worsen during the next 12 months (see Exhibit 24).

Exhibit 24. Expectations of the Situation for Manufacturing in the PRD

Expectations	% of Responding Firms	
	By the End of 2009	January to September of 2010
Stabilised	57	21
Gradually improved	22	59
Worsened	10	9
No comments	11	14

Source: Federation of Hong Kong Industries.

HONG KONG SHIPPERS' COUNCIL (NOVEMBER 2009)⁹⁰

Through the SME Development Fund, Hong Kong's Trade and Industry Department funded a study on logistics demand and on the cost of relocating Hong Kong manufacturing SMEs from Guangdong to other provinces. The project was organised by the Hong Kong Shippers' Council and the China Business Centre of Hong Kong Polytechnic University, and results were published in December 2009.

The report found that prior to the financial crisis Hong Kong manufacturing SMEs were not actively relocating and that most of them had adopted a "wait and see" approach. The study group interviewed SMEs and found various obstacles to relocation. Interviewees expressed concerns that if they moved their operations they would not be able to find a sufficient number of workers; that the costs they might incur for land, water, electricity supply, and logistics were not clear; that the supply chain on which they depended could not be relocated along with their own operations; that they lacked the internal capabilities to establish new branch factories elsewhere; and that external factors did not support relocation because the SMEs could not get extra orders for the expanded production capabilities in the new branch factories outside of Guangdong. In any event, the financial crisis of late 2008 largely put a stop to industry relocation because now there was no need for enterprises to expand their manufacturing capability. For Hong Kong manufacturing SMEs the immediate challenge to survive meant that they had little time to think about relocating.

The study found that the most likely trend is for Hong Kong manufacturing SMEs to remain in the PRD and in Guangdong Province, with a view to later following and assisting MNCs and large Hong Kong enterprises as they move to new locations and transform and upgrade those places in ways that make the locations potentially more desirable to SMEs.

⁹⁰ Hong Kong Shipper's Council, "A Study on Logistics Demand and the Cost of Hong Kong Manufacturing SMEs Relocation from Guangdong to other Provinces," November 2009.

HONG KONG TRADE DEVELOPMENT COUNCIL (JANUARY 2010)⁹¹

In January 2010, the Hong Kong Trade Development Council conducted a survey to gather the latest opinions of Hong Kong companies regarding their views on business prospects, the current order situation, as well as likely changes in the trading practices of overseas buyers. The results of the survey revealed that Hong Kong exporters were cautiously optimistic as to the business outlook for 2010. A total of 35 per cent of the surveyed companies believed that their export performance would be better in 2010 than in 2009, while 52 per cent thought that their businesses would perform at about the same level. 50 per cent of the surveyed companies thought that their sales to Mainland China would fare better in 2010, with 37 per cent thinking that sales to Latin America would improve, and 32 per cent believing that sales to Central and Eastern Europe would get better in 2010 (see Exhibit 25).

Exhibit 25. Business Outlook for 2010 by Export Market (January 2010)

	Neutral	Optimistic
Overall	52	35
Chinese Mainland	42	50
Latin America	52	37
Central and Eastern Europe	56	32
Western Europe	55	31
Japan	52	32
United States	48	35

Source: Hong Kong Trade Development Council.

By industry sector, 51 per cent of respondents thought that the market for consumer electronics would improve in major markets in 2010, with 42 per cent holding that view for watches and clocks, 35 per cent for footwear, 35 per cent for precious jewellery, 34 per cent for toys and games, and 32 per cent for clothing (see Exhibit 26).

Exhibit 26. Business Outlook for 2010 by Product

Product	Neutral	Optimistic
Footwear	58	35
Consumer electronics	40	51
Watches and clocks	47	42
Clothing	54	32
Household products	57	29
Imitation jewellery	57	28
Toys and games	48	34
Precious jewellery	47	35

Source: Hong Kong Trade Development Council.

The respondents were asked to indicate the likely changes in trading practices of their clients in 2010 as compared to 2009. Most respondents agreed that there would be an increase in the number of orders placed, that buyers would increase their inventory levels, and that the average quantity of orders would increase. However, most respondents disagreed that buyers would place orders earlier, shorten credit periods, or allow for longer delivery lead times. Thus the trading environment facing Hong Kong manufacturers seemed to remain challenging throughout 2010 (see Exhibit 27).

Exhibit 27. Trading Practices of Overseas Buyers in 2010 vs. 2009

Practice	Mean Response
Buyers will order a wider variety of products	3.23
Export products will fetch higher prices	3.16
Buyers will place more orders	3.14
Buyers' inventory levels will be higher	3.11
Average quantity per order will be higher	3.01
Buyers will place orders earlier	2.81
Buyers will agree to shorter credit period	2.65
Buyers will allow longer delivery lead time	2.58

Note: On a scale of one to five, with one suggesting "strongly disagree" and five suggesting "strongly agree."

Source: Hong Kong Trade Development Council.

91 Hong Kong Trade Development Council, "On the Road Recovery: Assessment of 2009 Christmas Sales in Major Markets," 29 January 2010.

THE CHINESE MANUFACTURERS' ASSOCIATION OF HONG KONG (APRIL 2010)⁹²

In March and April of 2010, The Chinese Manufacturers' Association of Hong Kong (CMA) conducted a survey to understand the business environment in the PRD, members' perspective on the business outlook, and strategies to cope with challenges and to grasp opportunities. The 2010 survey indicated that prospects were improving since similar surveys carried out in 2008⁹³ and 2009.⁹⁴ The most important factors affecting business reported in the 2010 survey were labour costs, raw material prices, additional costs and risk arising from labour law and regulations, and risk of appreciation of the RMB (see Exhibit 28). With the economy

recovering, increasing operating costs once again have become the prime concern of the Hong Kong firms. The CMA found that the strategies that firms adopted are similar across the three years, but the 2010 results showed a strengthening in efforts in industrial upgrading, transformation, and relocation (see Exhibit 29). A further breakdown of some of the strategies may be found in Exhibit 30.

- 92 The Chinese Manufacturers' Association of Hong Kong, "Survey on Members' Views on the Business Environment in the Pearl River Delta," April 2010.
- 93 The Chinese Manufacturers' Association of Hong Kong, "Survey on Members' Views on the Business Environment in the Pearl River Delta," April 2008.
- 94 The Chinese Manufacturers' Association of Hong Kong, "Survey on Members' Views on the Business Environment in the Pearl River Delta," April 2009.

Exhibit 28. Factors Affecting the Operation of Hong Kong Manufacturers in the PRD

Main Factors Affecting Business Operation	2008	2009	2010
Raising / expensive labour costs	3.52	3.04	3.61
Raising / high raw material prices	3.52	2.73	3.45
Additional costs and risk arising from labour laws and regulations	3.46	3.22	3.44
Risk arises from change of RMB exchange rate	3.49	2.89	3.20
Customers pressing prices	na	2.98	3.13
Labour shortage	3.05	na	3.09
Insufficient orders	na	3.08	2.39
Short supply of water and electricity	3.27	na	na

Note: 4= "very severe impact," 3= "severe impact," 2= "some impact," 1= "no impact," na = not available.

Source: The Chinese Manufacturers' Association of Hong Kong.

Exhibit 29. Strategies Adopted by Hong Kong Manufacturers, April 2010

Rank	Strategies	Proportion of Companies Adopting the Strategy (%)
1	Expand markets	73.8
2	Improve the quality level / value-added of products	66.3
3	Develop more new products	59.4
4	Upgrade technology	56.3
5	Improve technical or operating process	53.8
6	Adopt advanced machines / equipment	46.9
7	Outsource certain production procedures	41.3
8	Relocate the factories	33.1
8	Merger or reorganisation	33.1
10	Branding	26.9
11	Give up manufacturing and switch to trading business	14.4
12	Close down the business	5.6

Note: Each responding company can choose more than one strategy.

Source: The Chinese Manufacturers' Association of Hong Kong.

While an increasing number of Hong Kong manufacturers planned to sell into the China market, the survey noted several difficulties in doing so. Over 70 per cent of respondents indicated that taxes and fees for domestic sales, approval and regulatory procedures, and restrictions on the domestic sales of processing trade goods have “very severe” or “severe” impact on their sales in China. Nearly 60 per cent of the responding companies indicated that piracy, lack of information on customers’ credit status, price disadvantages, lack

of human resources familiar with sales in China, and lack of suitable distributing channels pose great difficulties for their domestic sales business.

The responses indicated that despite much discussion of operating modes over the last several years, Hong Kong companies had evolved their business models very little since a similar survey was carried out in 2001, with OEM operations still dominating over ODM or OBM (see Exhibit 31).

Exhibit 30. Detailed Tactics Adopted by Hong Kong Manufacturers, April 2010

Strategies	% of Companies Adopting the Strategy
Expand markets	
• Strengthen relations with existing customers	54.4
• Speed up expansion into the Mainland domestic market	39.4
• Attend more exhibitions/trade fairs	34.4
• Increase advertisement in the press or increase promotion activities	19.4
• Expand into e-marketing or e-trading	15.6
• Expand into other emerging markets	11.3
Upgrade technology	
• Strengthen own-R&D	43.8
• Cooperate with universities, research institutions in the Chinese Mainland	16.3
• Purchase new scientific technologies from the markets	15.6
• Cooperate with universities and research centres in Hong Kong	11.9
Relocate the manufacturing business to other areas	
• To more backward areas in Guangdong province	15.0
• To mid and western areas of the Chinese Mainland	10.6
• To other countries	5.6
• To other areas of the Chinese Mainland	5.0
• To the environment-protection industrial parks in the PRD	3.8
• Back to Hong Kong	3.8

Source: The Chinese Manufacturers’ Association of Hong Kong.

Exhibit 31. Changes in the Operation Modes of Hong Kong Firms in the PRD

Operation Mode	Proportion in Responding Companies (%)		Proportion in Total Sales (% , weighted average)	
	2001	2010	2001	2010
OEM	73.2	83	50.9	56.0
ODM	53.0	49.7	24.1	20.1
OBM	35.0	37.7	21.6	22.6
Others	4.8	1.3	3.4	1.3
Total	100	100	100	100

Source: The Chinese Manufacturers’ Association of Hong Kong.

Industry Situation Reports

While it is useful to get the aggregate picture of the challenges facing Hong Kong's manufacturing SMEs and some of the strategies employed to meet these challenges, it is also useful to identify the particular competitive challenges at the industry level and the strategies that some individual firms have used to survive and succeed in the marketplace. Here we will focus on the watch and clock, consumer electronics, garments, mould and die, and toy industries. These were selected due to their importance, but also because they highlight issues that arise in different competitive environments.

THE WATCH AND CLOCK INDUSTRY

Watches can be categorised as mechanical, radio controlled, or digital. Markets exist for commercial watches, leisure and fashion watches, and sports watches. The watch and clock industry manufacturing chain comprises mould making, injection moulding, electroplating, movement manufacturing, case making, strap making, product assembly, and quality testing.

Most of the important players in the global watch industry are in Switzerland, Japan, Hong Kong, and Mainland China. Presently, Swiss manufacturers are viewed as being unbeatable in terms of producing high-end branded watches. Most of the famous brands and high value brands are Swiss. It is almost universally accepted that Swiss made watches are of better quality than watches made elsewhere. Many retail customers will pay a premium for a Swiss made watch, even if it is otherwise branded the same and looks the same.

Chinese firms tend to occupy the low-end of the OEM market, but an increasing number of Chinese firms have or are trying to develop their own brands. In 2007, China exported 1.38 billion watches and clock products.⁹⁵ Electronic products with mechanical indicators account for over 70 per cent of China's export volume.⁹⁶ OEM customers tend to use Chinese companies if they are focused on getting the lowest possible price.

Hong Kong firms operate mostly in the mid to low-end range of the sector. They have a dominant position in the mid-range watch segment. Most Hong Kong firms focus on OEM production, but a few have branched out into ODM and OBM. Most Hong Kong firms are experienced marketers with established distribution channels. This makes it difficult for firms from the Chinese Mainland to compete with them. Lower costs in Mainland China, and pressure from customers to compete with Chinese manufacturers, have led nearly all Hong Kong watch companies to relocate most of their production to the Chinese Mainland. In addition, it is increasingly hard to get workers in Hong Kong to work in the manufacturing sector. OEM customers tend to buy from Hong Kong manufacturers if they are after watches that are of reasonable quality and price, and if they value some of the value-added services such as design and after-sales service that Hong Kong firms can offer.

Industry participants do not expect new locations to emerge to rival Switzerland, Hong Kong, and Mainland China in watch production for at least the next decade. Watch manufacturers need to be close to factories producing cases, bracelets, hands, straps, and other components. If a watch company tried to move to a location without an established supply chain, the likely outcome would be production delays that OEM customers would find intolerable. This makes it difficult for other low-cost locations to become established and contributed to the decline of the Japanese industry, which now is dominated by Seiko, Citizen, and Casio, the OEM business having been lost due to high costs and the loss of the supply chain.

⁹⁵ www.ceu.com.cn

⁹⁶ Watch Industry, Alibaba.com Industry Report.

Basic Facts about the Industry

Gross Industrial Output (GIO) for Hong Kong was HK\$1.7 billion in 2008 for the watch and clock sector. Employment for the sector in Hong Kong is relatively low with 871 persons employed with an estimated average annual wage of HK\$297,359. Wages were approximately 17 per cent of total costs.⁹⁷ Average wages for the sector in Hong Kong are 10 times those for the sector in China as a whole. This is likely explained by general wage disparities between Hong Kong and China, the employment of more senior staff in Hong Kong, and the fact that higher value end products are produced in the sector in Hong Kong with correspondingly more costly labour inputs.

Exhibit 32. Average Monthly Wages for the Sector in RMB

Region	Average Monthly Wages
Hong Kong	21,806
YRD	2,140
PRD	2,163
China	2,265

Sources: Foshan, Dongguan, Shenzhen, Huizhou, Taizhou (JS), Nantong, Shaoxing, and Jiaxing City Statistical Yearbooks, 2009, China Statistical Yearbook, 2009.

97 Hong Kong Census and Statistics Department data on "Professional & scientific, measuring & controlling equipment, n.e.c., & photographic & optical goods," 2009.

98 www.86mdo.com

99 Watch Industry, Alibaba.com Industry Report.

100 Yearbook of Shenzhen, www.sz.gov.cn.

The watch industry is one of Hong Kong's four major export industries. Hong Kong is the world's second largest watch exporter by value after Switzerland, and Hong Kong is the world's second largest exporter by quantity after China. In 2009, Hong Kong exported HK\$43.7 billion watches and clocks, a decrease of 20.8 per cent over the previous year. The top three markets for the export of Hong Kong watches and clocks are the United States, China, and Switzerland, accounting for 42 per cent of the total value of watches and clocks exported (Exhibit 33). Total re-exports from Hong Kong of watches and clocks in 2009 were HK\$43.4 billion or 1.8 per cent of total re-exports. Mainland based processing trade companies re-exporting through Hong Kong accounted for HK\$16.9 billion of this total (Exhibit 34), while Mainland based non-processing trade companies accounted for a further HK\$6.3 billion.

In 2009, Hong Kong imported HK\$39.2 billion watches and clocks, 18.3 per cent lower than the previous year. The top three suppliers of watches to Hong Kong by value were Switzerland (41.6 per cent), China (34.5 per cent), and Japan (11.9 per cent) (See Exhibit 35).

China accounts for 70 per cent of global production of watches and clocks by volume but only 30 per cent by Gross Industrial Output.⁹⁸ The watch industry in China has formed a cluster development structure with small and medium-sized enterprises at its core. Private enterprises and foreign-funded enterprises are expanding rapidly and they presently account for over 70 per cent of all the enterprises in the sector in China.⁹⁹ In 2008, the gross output of the watch and clock industry in Shenzhen was RMB 15 billion. Shenzhen accounted for more than 50 per cent of China's gross output and export volume for watches and clocks. Branded watches made in Shenzhen captured 63 per cent of the Mainland China market for branded watches in 2008.¹⁰⁰ At the end of 2008, there were about 1,000 watch manufacturing enterprises in Shenzhen. Approximately 200 of these enterprises were either large or medium-sized. These firms employed

Exhibit 33. Exports of Watches & Clocks from Hong Kong, HK\$ millions

Destination	2007		2008		2009	
	Value	Y-on-Y Change	Value	Y-on-Y Change	Value	Y-on-Y Change
World	49,958	6.3%	55,204	10.5%	43,730	-20.8%
United States	9,059	-3.9%	9,490	4.8%	7,096	-25.2%
Mainland China	7,033	11.5%	7,937	12.9%	6,088	-23.3%
Switzerland	5,374	23.9%	6,233	16%	5,228	-16.1%

Source: Hong Kong Trade Statistics, Census and Statistics Department.

Exhibit 34. Chinese Mainland Process Industry Watches and Clocks Re-exported from Hong Kong, HK\$ millions

Watches and Clocks Re-export of Processing Products Manufactured in the Chinese Mainland	2006	2007	2008	2009
Value	21,240	21,693	21,765	16,940

Source: Hong Kong Census and Statistics Department.

Exhibit 35. Imports of Watches and Clocks to Hong Kong, HK\$ millions

Source	2007		2008		2009	
	Value	Y-on-Y Change	Value	Y-on-Y Change	Value	Y-on-Y Change
World	41,204	21.4%	47,994	16.5%	39,220	-18.3%
Switzerland	15,904	45.7%	20,126	26.5%	16,321	-18.9%
Mainland China	14,909	6.8%	17,382	16.6%	13,528	-22.2%
Japan	5,431	4.8%	5,671	4.4%	4,670	-17.7%

Source: Hong Kong Trade Statistics, Census and Statistics Department.

200,000 people and produced 800 million watches and clocks.

By the end of 2008, there were 2,000 Hong Kong-funded watch and clock and related accessories enterprises in the PRD.

Issues for Hong Kong Watch Manufacturers

Hong Kong's watch and clock sector is facing several issues. These include the global economic downturn, powerful buyers, tough competition, RMB appreciation, labour availability, wage increases, and increases in utility and material costs. Additionally, legal and regulatory changes regarding processing trade, labour law, the environment, and safety have also been implemented and must be managed.

The downturn in the global economy that began in force in September 2008 led to banks tightening their credit terms for manufacturers, decreased orders for watches, and increased business carrying costs for the watch and clock sector as a whole.¹⁰¹ Trade credit and other lending for the industry largely dried up for a period of time, making it very difficult to operate, particularly for firms that had not set aside sufficient cash reserves.

¹⁰¹ Hong Kong Watch Manufacturers Association.

An early sign of the slump was that there were 20 per cent fewer exhibitors from Asia at the April 2009 BASELWORLD Watch and Jewellery Show than in 2008. Exhibitors stayed away in the belief that order numbers and volumes would fall. Indeed, exports from Hong Kong and China fell by around 20 per cent from 2008 and some firms experienced even steeper declines in orders. By the fourth quarter of 2009, the situation had improved somewhat. Sales of the Hong Kong manufacturers during the Christmas period in 2009 were 15 per cent lower than in 2008, a better situation than had been envisioned just a few months earlier.¹⁰² A survey released by HKTDC in January 2010¹⁰³ shows that 47 per cent of exporters held a neutral view and 42 per cent of exporters were positive on the global watch and clock sales for the 2010 Christmas period.

The industry has estimated that demand is unlikely to return to pre-crisis levels and that the sector would not recover in a sustained manner until mid 2010. The domestic market in Mainland China seems to have been the market that was least affected by the crisis, and it is likely to recover first.¹⁰⁴ It is thought that the European and American markets will bounce back before markets in South-East Asia. The Eastern European markets are expected to take the longest time to recover.¹⁰⁵

The global downturn also affected the customers of Hong Kong manufacturing SMEs, particularly those in the OEM segment. These customers put even more pressure on watch and clock manufacturers to reduce prices while at the same time improving the quality and design of their products. OEM customers know the costs of all the producers and use this knowledge to effectively push for lower and lower prices.

The OEM customers are able to bargain aggressively due to tough competition among watch manufacturers. Industry participants indicate that competition has grown more intense in the industry in recent years, particularly in the OEM segment. With relatively low entry costs, particularly in China, more and more players are entering the industry. New entrants mainly enter the OEM segment because it is much more costly to set up a branded watch company than it is to do high volume contract manufacturing. Some companies enter the industry by subcontracting space in a factory owned by other parties and don't incur any capital costs preferring instead to focus their efforts and their capital on establishing customer relationships. Hong Kong SMEs operating in the Chinese Mainland generally face cost disadvantages versus Chinese competitors due to higher salaries for managers, higher compliance costs, and higher design costs (many Chinese firms do no design themselves).

Hong Kong watch and clock manufacturers with factories in the Chinese Mainland have also been affected by policies in Guangdong and China in general. Current export processing policies in the Chinese Mainland do not affect watch assembly or the sourcing of component inputs such as movements (electronic and mechanical), watch and clock cases (metal, plastic and wood), finished watch glasses, and straps. However, the import of raw materials that would go into the domestic manufacture of these inputs may come under the policies. While watch assembly is not considered polluting, the electroplating process necessary for most watch components is. Thus the watch supply chain is coming under pressure from environmental regulations.

The Labour Contract Law applies across all industries and firms. Watch companies operating in China report that the Law has raised administrative and worker benefit costs significantly and has made it more difficult to deal with seasonal fluctuations in demand through overtime and seasonal work. While in theory the Law should affect all firms equally, and since industry participants believe

¹⁰² news.cetra.org.tw.

¹⁰³ See Hong Kong Trade Development Council, "On the Road to Recovery: Assessment of 2009 Christmas Sales in Major Markets," 29 January 2010.

¹⁰⁴ news.cetra.org.tw.

¹⁰⁵ news.cetra.org.tw.

that it is unlikely production would leave China, eventually such costs should result in higher prices. However, individual firms (particularly SMEs) find it difficult to pass on cost increases in the face of powerful buyers, as SMEs find it more difficult to take on the added administrative burden than larger firms, and some Hong Kong companies believe that Mainland Chinese firms are able (or willing) to skirt the Law. As a result, the Hong Kong SMEs are disproportionately disadvantaged by its implementation. Since the impact should be greatest for the most labour intensive industries, the impact of the Law on Hong Kong's watch and clock companies is likely to be middling compared to other industries, with more labour-intensive industries like garment and toy more affected, and less labour-intensive industries like mould and die less affected.

The watch and clock industry has been subject to pressure to move out of the Pearl River Delta or out of Guangdong completely under the Ministry of Commerce's "Opinion on Supporting the Middle and Western Regions' Reception of Processing Trade Relocation" (November 2007)¹⁰⁶ and Guangdong's "Decision on Promoting the Relocations of Industries and Labour Force."¹⁰⁷ Such relocation is problematic because watch production depends on a dense supply network. Hong Kong watch firms are attracted to the PRD due to the presence of a complete network of suppliers of parts, components, and services such as electroplating. In an effort to encourage relocation, Heping County (Heyuan, Guangdong) and Shenzhen jointly established a watch industry relocation park in 2006 with an investment of RMB 8 billion. The park, which aims to attract 200 firms and to provide 100,000 jobs, has planned a centralised testing centre and a centralised electroplating facility (most watch components need to be electroplated) to minimise pollution. As of mid-2009, 41 watch firms were located in the Park, but relocations had slowed due to the financial crisis. It is yet to be seen whether the park will result in large scale movement of the industry from Shenzhen, or whether it will result in consolidation of the industry, but it is clear

that the overall policy direction is to move watch production out of the core areas of the PRD.

Response Strategies of Hong Kong SMEs

Hong Kong watch and clock manufacturers have undertaken a variety of strategies to deal with recent pressures. In general, Hong Kong watch and clock manufacturers are attempting to maintain their presence in traditional OEM manufacturing while at the same time trying to add value to existing products, develop new high value adding products, develop their own brands, find new markets for their products, and work out their sales plans so as to achieve sustainable development. We note the following:

- The downturn in traditional markets has led many Hong Kong firms to seek markets elsewhere, including Mainland China and the Middle East. For example, a 2008 survey by the HKTDC¹⁰⁸ showed that 89 per cent of respondents were optimistic about the sales of watches to Mainland China. Developing new markets takes time, however, and the scale of potential new markets even if deeply penetrated does not currently compare to that of the existing European and American markets.
- Penetrating the China market will be difficult for many Hong Kong SMEs, because export processing and OEM business is very different from distributing and selling within China. Hong Kong SMEs tend to be good at controlling costs, but are less knowledgeable about consumers, marketing, and distribution. Thus they may encounter difficulties in building a business around domestic sales in China unless they reconfigure their business model.

¹⁰⁶ www.gov.cn

¹⁰⁷ www.gdsme.com.cn

¹⁰⁸ Hong Kong Trade Development Council, "Offshore Trade and Production: Development and Implications" 5 February 2008.

- Contract manufacturing is a commodity business and companies that only do OEM are likely to have a limited life or limited profits and limited growth unless they can provide superior or additional services to their customers. Companies in the OEM segment must either face difficult price competition or look to develop by adding value through other means as well.
- One area in which Hong Kong firms have traditionally distinguished themselves from Mainland Chinese firms is in design and ODM business. Many Hong Kong SMEs are investing in design capabilities in an effort to build sustainable relations with key customers. This may be difficult and costly to do, but is one way to try to stay away from competition based totally on cost.
- Entering the branded watch business (OBM) is also viewed as a potential strategy, but this involves a large investment and long lead times, with uncertain chance of success. Building a branded business is hard for export processing firms, especially for SMEs that may lack the financial scale, managerial resources, and geographic reach required to be a successful branded watch company.
- Other options that have been explored include subcontracting production to others, becoming a subcontractor to larger companies, relocating to the Heping County Park, moving into retailing, and -when all else fails- exiting the business.

Case Study – Renley Watch Manufacturing Company Limited

Renley Watch Manufacturing Company Limited (Renley) is a Hong Kong based watch company engaged in OEM, ODM, and OBM watch production as well as watch retailing. Renley produces 80,000 to 100,000 watches per month in facilities in Hong Kong and Switzerland for OEM customers (and an unspecified number for its own branded production), has a watch components factory in Dongguan, and has watch retail outlets in Hong Kong (4) and the Chinese Mainland (8).

Renley was established by Mr Stanley Lau in 1983 after he had spent 10 years working for other firms in the industry. Renley was started with an investment of HK\$200,000, 1,800 square feet of space in Tsuen Wan, 10 employees, and two customers (one from the US and one from Japan). Renley got into watch design when a company that held the licence for Asian markets for a well-known French watch brand asked Renley to create a watch collection that was stylish yet reasonably priced. Renley manufactured the watches and the company holding the licence handled the sales and marketing of the watches. When this business faced a downturn, Renley decided to reduce its dependence on a single customer and participated in trade fairs and exhibitions in various countries to make new contacts, find new customers, and develop the company's reputation.

In the early 1990s, when most Hong Kong watch manufacturers shifted production to the Chinese Mainland, Renley decided to retain production in Hong Kong, acquired three Swiss watch brands, and opened a factory in Switzerland to manufacture premium quality Swiss-made watches. In 1999, Renley established a retail business, Global Timepieces, to sell its own brands as well as other brands such as Tissot, Cartier and Omega direct to end consumers. The retail outlets in China are named "IN-Style" and sell style watches such as Gucci, Burberry, Armani, as well as Renley's own brands, though the merchandise mix in the Chinese Mainland shops is focused on brands lower-priced than the Hong Kong shops due to differences in local demand.

Today, Renley's activities include design, production, sales, and after-sales service of watches. Renley produces a range of watch styles including classic, sporty, dressy, jewellery, character, and fashion. Most of the watches that Renley manufactures are priced in the range of HK\$1,000 to HK\$50,000 with some watches priced much higher, particularly the watches produced in the Swiss factory. Renley has 25,000 square feet of manufacturing space in Hong Kong, including a 20,000 square foot

factory in Cheung Sha Wan. The company opened a components factory in Dongguan in 2003, but does all of its watch assembly in Hong Kong and Switzerland. The company has 150 employees in Hong Kong, 400 employees in Mainland China, and 25 employees in Switzerland. Roughly 40 per cent of revenues come from the OEM business, 20 per cent from the OBM business, and 40 per cent from retailing. The OEM business is 30 per cent from the US, 30 per cent from Europe, and 40 per cent from the rest of the world. In the period 1983 to 2010, Renley's revenues increased more than twentyfold.

Issues and Challenges

Renley has faced a number of significant challenges in the course of its history. One has been a series of economic downturns. The global economic downturn associated with the dot com collapse and the 9/11 attacks affected markets worldwide. During the SARS period in 2003, suddenly there were no customers and no business, but the costs for rent and staff still needed to be covered. Similar issues arose during the global economic downturn of 2008-2009, with business down sharply and uncertain prospects. Fortunately business rebounded in 2010 to more normal levels.

Another major issue has been competitive pressures. In the branded watch business, Swiss and Japanese companies are the main competitors, but in general Hong Kong companies can do reasonably well in moderately-priced branded watches. In the OEM business, however, strong competitive pressure comes from companies that are manufacturing in the Chinese Mainland. Customers use quotations for contract manufacturing in China to try to obtain lower prices. While producing in Hong Kong means that Renley has not had to face rapidly rising wages in the Pearl River Delta to a great extent, its Hong Kong workforce receives wages on the order of three times that received in the PRD, which has heightened the competitive pressures in the OEM business.

In addition to wages, even finding the right workers in Hong Kong has been a challenge at times in spite of the fact that Renley pays comparatively high wages for the industry. This is due to a general shortage of workers in the industry in Hong Kong. Not having sufficient workers has made it difficult to expand as quickly as Renley might like and may eventually make it difficult to continue to produce watches in Hong Kong if a sufficient number of workers cannot be found.

Managing cash flow was an early issue for the company. As a small factory, Renley struggled to collect cash quickly from its customers in order to be able to pay suppliers and staff in a timely manner. In its first months of operation, Renley focused on developing the documentation and banking relations in order to ensure that its trade finance, payments, and receipt system was in place so that the company could meet its cash commitments.

Another challenge in Renley's early history was when a customer that accounted for 60 per cent of Renley's business ran into difficulty. Renley suddenly had to fill the gap that was left as their largest source of revenue retreated.

Expanding into branded watches and retailing also presented challenges. The branded watch business was unfamiliar to Renley's management. Renley's team knew how to make watches, but not how to manage a brand. Similar difficulties were encountered when Renley moved into retailing. Some of the retail outlets that were set up in the early days were in poor locations and the company ended up having to close them. The sharp increase in rent in some locations was also unexpected and created difficulties. Renley estimates it took three to five years to work out issues associated with its initial forays into branded goods and retailing.

Renley has faced no major regulatory issues and the company's experience in Hong Kong and Switzerland has been similar with both locations being transparent in terms of what is required of companies. In China, the regulatory environment is more challenging. Government officials take a more active interest in the business and it is likely that companies will be visited by the Labour Bureau, the Tax office, and Customs officials, who are likely to tour the company's factories. Cooperating with these officials takes time and costs money. In general terms, doing business in Switzerland and Hong Kong is far simpler than doing business in China.

Company Strategy

While Mr Lau doesn't view Renley as being all that successful and comments that the company is "still learning," the reality is that Renley has survived and grown through some difficult periods. Mr Lau attributes this record in part to foresight. He believes that whatever the industry, a company's management should forecast for the next 10 years. In the case of Renley he points out that "nowadays everybody is talking about branding, but we were doing research and development in Switzerland and started a branded watch business long before it was a very popular strategy. Friends took the view that our OEM business was good and that we should just focus on that, but I could see that just doing OEM had limited potential. Some of the companies that we used to compete with in doing OEM are now out of business."

As other Hong Kong watch manufacturers were moving production to the Chinese Mainland in the early 1990s, Renley decided to differentiate itself from the competition by staying in Hong Kong and obtaining facilities in Switzerland to make higher-value watches. At around the same time, Renley acquired three Swiss watch brands, including brands, technology, stores, and in one case a factory. Renley's manufacturing and branded businesses in Switzerland keep it in close contact with the Swiss market, resulting in good contacts with other industry players, bankers and other professionals that work with watchmakers. In recent years, Renley

has been more active in selling its branded products into the Chinese Mainland. Renley finds that some Chinese customers prefer a Hong Kong made watch because they are generally better quality than watches made in Mainland China.

Although Renley produces some of its own components, it is principally an assembler with key components purchased from Switzerland, Japan, Taiwan, Thailand, Korea, and China. The company has decided not to relocate its main manufacturing to the Chinese Mainland. It sees merit in continuing to do most of its manufacturing in Switzerland and Hong Kong. This is due in significant part to the fact that Swiss-made watches and to a less extent Hong Kong-made watches can command a price premium versus other watches. An advantage of manufacturing in Hong Kong is the flexibility to source components from different supply locations such as Japan and the PRD, which allows Renley to focus more on design.

Renley's strategy is not to chase other companies in trying to make cheaper and cheaper watches, it is to make better quality watches in Switzerland and Hong Kong that will sell at a higher price. The strategy is to carve out a niche in making watches that are innovative and well designed, and to follow-up with good service. This approach is supported by a research and development staff of 10 and the ability to make watch samples in a controlled environment that minimises the risk that designs will be appropriated by others.

Renley's retailing activities began in 1999. A subsidiary, "Global Timepieces," was set up as a separate company that would sell a range of watch brands such as Cartier, Omega, Piaget, and others, not just Renley-owned brands. In Mr Lau's view, this made Global Timepieces more competitive as a watch retailer. The opening of the watch retailing business resulted in Renley being diversified across the watch sector as an OEM, ODM, and OBM company, giving the company greater depth and strength.

Renley focuses a good deal of attention on staff training. Its Hong Kong production staff is trained by its Swiss technicians in traditional Swiss assembly methods for producing high quality watches. This gives the company a standard of quality assurance that many other companies cannot emulate. In 1994, Renley was the first watch manufacturer in Hong Kong to obtain ISO9001 certification and all its operating procedures are based on the ISO9001 standard for quality assurance. Renley has received quality awards from the Hong Kong Productivity Council, the Hong Kong Industry Department, and from others.

On other operational issues, in terms of cash management Renley has established a good relationship with its bank and has set aside a cash reserve to act as a buffer against short-to-medium-term issues such as SARS and economic downturns. To overcome overdependence on one customer, Renley decided to expand its marketing activities and participate in more trade fairs and exhibitions. The company also focused on diversifying to include ODM and OBM to move beyond price-competitive OEM operations.

In terms of management, Mr Lau manages the company very closely. He thinks that the way to deal with challenges and issues that often are unforeseen is to be informed and “hands on.” To this end, Mr Lau gets daily reports from his top-line managers, and speaks to them either in person or via telephone during most working days. During discussions with his management team, Mr Lau remains open-minded and receptive to their ideas. Once Mr Lau has considered the thoughts of his managers, conclusions are drawn and decisions are made and implemented together as a team. Mr Lau has found that this approach motivates staff and results in a happier and more productive workplace.

Renley has overcome most of its challenges by focusing on niche market opportunities, by doing things differently, and not blindly following the pack of other companies in the watch industry, and by focusing on value adding activities such as research and development, innovation, design, and branding.

Future Plans

Renley’s goal over the next decade is to become a leader in watch manufacturing and in operating a branded watch business in Hong Kong. In addition, Renley plans to grow its retail network, mainly in China but also in Hong Kong, as well as focusing on the development of its watch brands. Expanding the OEM business will be a lower priority given the commodity nature of that business.

Renley will keep manufacturing in Switzerland because the company still has a lot of customers who want Swiss-made watches. Renley will also continue manufacturing in Hong Kong because it is easy for Mr Lau to manage and because many members of Renley’s Hong Kong staff have been with the company for up to 25 years and are very experienced in making watches. However, Mr Lau feels that the Hong Kong factory may get smaller as some of his Hong Kong based staff retire, noting that it is quite difficult to find new staff in Hong Kong who have the skills that Renley needs. For the time being, Renley is still reluctant to do large scale manufacturing in China because of uncertainty in labour markets and regulation.

Lessons from the Renley Case

There are a number of lessons that can be learned from the Renley case.

- While the challenges facing entrepreneurs in Hong Kong's manufacturing SMEs are greater than before, in some ways the opportunities are also greater as new markets and sources of supply become available.
- Risks are always present in business. The key is to identify and manage these risks to the extent possible.
- To be successful, SME managers must be motivated and focused on the needs of the business.
- Even SMEs need to forecast what their industry will look like in five to 10 years and to identify potential market opportunities that will develop.
- SMEs should focus on businesses the owner-manager knows. Renley was founded after Mr Lau had worked in the watch industry for ten years.
- Aggressive cash management and developing good relations with banks can be critical, particularly in the early years for SMEs.
- Thinking ahead to where the business should be in five to 10 years is important if a firm is going to stay ahead of the curve.
- While the vast majority of Hong Kong watch manufacturers have moved watch production into the Chinese Mainland, it is possible to succeed while retaining production in Hong Kong, and even in producing in a more expensive location (Switzerland).
- It is important to match production location with different segments of the market and customers' willingness to pay for production in different locations.
- It is possible for Hong Kong manufacturers to move beyond OEM production to ODM and OBM production, and even into retailing. In order to move beyond OEM production, firms must invest in design capabilities, must take the time to learn to manage brands, and / or learn to serve customers directly. While these things may be difficult to do, it is certainly possible.
- It is also possible for Hong Kong manufacturers to simultaneously engage in OEM, ODM, OBM, and retail activities.
- Providing high-quality service can lead to positive long-term relationships with key customers.
- Acquisition of foreign brands can be an effective means of entering OBM businesses. Even so, it can take five years to learn how to manage brands effectively.
- The Chinese Mainland offers an unprecedented opportunity for Hong Kong SMEs to develop and sell their own brands and to get into retailing.
- Worker training is key to producing high quality products and Hong Kong Productivity Council programmes can help companies develop their quality systems.
- Quality certification helps ensure quality standards within the company and also signal quality to buyers.
- Overreliance on a single buyer can result in difficulties for the firm. Thus it is important to diversify the customer base as early as possible. Trade fairs can be useful vehicles for expanding the customer base.
- For many SMEs, senior management needs to be involved in the business on a daily basis to ensure the company keeps moving in the right direction.
- Managers should listen to their employees and talk to them in an open and honest way. Senior managers should share their vision with their team and discuss openly with them what the company needs to do to succeed. This approach can motivate staff and result in a more pleasant and productive workplace.

THE CONSUMER ELECTRONICS INDUSTRY

Consumer electronics refers to any device containing an electronic circuit board that is intended for regular use by individuals. This includes televisions, cameras, digital cameras, PDAs, calculators, VCRs, DVDs, audio devices, headphones, camcorders, and many other home and office products.

Consumer electronics companies engage either in OEM, OBM, or ODM, or a combination of the three. The global consumer electronics industry is mainly dominated by branded companies from Japan, South Korea, Europe, and the US. These companies typically concentrate research and development in their home country and place their manufacturing activities throughout the world, with assembly often in the Chinese Mainland.

China is one of the world's largest consumer electronics manufacturing bases. The 2009 China Statistical Yearbook reports that the "communication, computer, and other electronic equipment manufacturing enterprises above designated size"¹⁰⁹ in China employed 6.8 million workers, contributed a Gross Industrial Output (GIO) of RMB 4,390 billion and value added tax (VAT) payable of RMB 61.9 billion in 2008.¹¹⁰ Electronics production in China is concentrated in the Pearl River Delta and the Yangtze River Delta. Guangdong reported that communication, computer, and other electronic equipment manufacturing enterprises in the province employed 2.9 million workers, contributed a GIO of RMB 1,537 billion and VAT payable of RMB 26 billion in 2008.¹¹¹

Japanese and South Korean firms have developed globally recognised brand names on the back of technological superiority. Taiwan firms are also very active, mostly on an OEM basis. Hong Kong companies have leveraged knowledge of markets, customers, technologies, and production locations in the Chinese Mainland to carve out a position in the industry. Firms from the Chinese Mainland are considered to be in the early stages in terms of technology and brand development, but are

developing stronger positions and some have introduced their own brands into global markets.¹¹²

China has been increasing its strength as a production location for consumer electronics. In addition, the Chinese market is among the fastest growing in the world. Industry analysts note that to a certain extent Hong Kong companies are caught between the Japanese and Korean firms who develop their own brands and products on the one hand, and firms from the Chinese Mainland, who have lower costs. In contract manufacturing, Hong Kong firms often face direct competition from much larger Taiwanese companies. However, the electronics market is a large market with many niches and Hong Kong companies have become skilled at supplying such niches. Thus, there appears to be room for creative Hong Kong companies that can find the right niches in the marketplace.

Basic Facts about the Industry

The global consumer electronics industry generated revenue of around US\$694 billion in 2008 and is expected to grow at a Compound Annual Growth Rate (CAGR) of around five per cent over the period 2010 to 2013.¹¹³ The category that best represents this sector in Hong Kong statistics is "Radio, television and communication equipment and apparatus." The GIO for this sector in Hong Kong was HK\$1.1 billion in 2008, employment was 1,266, and the estimated average annual wage was HK\$134,281. Wages for the sector in Hong Kong are four times those for the sector in China as a whole. This is likely explained by general wage disparities between Hong Kong and China as well as the employment of more senior staff in Hong Kong. Wages were approximately 16 per cent of total sector costs in Hong Kong.¹¹⁴

109 Enterprise above designated size refers to the enterprise with annual revenue of RMB 5 million or above.

110 2009 China Statistical Yearbook.

111 2009 Guangdong Statistical Yearbook.

112 ESA interviews.

113 www.reportlinker.com.

114 Hong Kong Census and Statistics Department data on "Radio, television and communication equipment and apparatus," 2009.

Exhibit 36. Average Monthly Wages for the Sector in RMB

Region	Average Monthly Wages
Hong Kong	9,847
YRD	1,856
PRD	2,568
China	2,493

Source: Foshan, Dongguan, Shenzhen, Huizhou, Taizhou (JS), Nantong, Shaoxing, and Jiaxing City Statistical Yearbooks, 2009, China Statistical Yearbook, 2009.

115 Hong Kong Census and Statistics Department

Total consumer electronics exports from Hong Kong in 2009 were HK\$492.7 billion, or 20 per cent of Hong Kong's total exports. Total domestic exports were HK\$8.3 billion, a 10 per cent decrease from the previous year. Total imports into Hong Kong were HK\$454.3 billion, or 16.9 per cent of total imports. Total re-exports from Hong Kong were HK\$484.7 billion or 20 per cent of Hong Kong's total re-exports. Data for re-exports sourced in the Chinese Mainland for the full sector is not available for sound recording and reproducers, and television image and sound recorders and reproducers, Chinese Mainland-based processing trade re-exports through Hong Kong were HK\$162 billion, Mainland China based non-processing trade re-exports were HK\$64 billion, and total re-exports originating from the Mainland were HK\$226.2 billion or 9.3 per cent of total re-exports.¹¹⁵

Exhibit 37. Consumer Electronics Exports from Hong Kong, HK\$ millions

Destinations	2007		2008		2009	
	Value	Y-o-Y Change	Value	Y-o-Y Change	Value	Y-o-Y Change
World	506,637	13.6%	551,023	8.8%	492,699	-10.6%
Chinese Mainland	185,760	26.6%	197,035	6.1%	176,577	-10.4%
US	58,698	4.3%	57,866	-1.4%	51,363	-11.2%
Japan	26,379	38.4%	28,392	7.6%	27,464	-3.3%

Source: Hong Kong Census and Statistics Department.

Exhibit 38. Consumer Electronics Re-exported from Hong Kong, HK\$ millions

Total	2007		2008		2009	
	Value	Y-o-Y Growth	Value	Y-o-Y Growth	Value	Y-o-Y Growth
World	497,964	16.5%	541,779	8.8%	484,666	-10.5%

Source: Hong Kong Census and Statistics Department.

Exhibit 39. Consumer Electronics Imports to Hong Kong, HK\$ millions

Origin	2007		2008		2009	
	Value	Y-o-Y Change	Value	Y-o-Y Change	Value	Y-o-Y Change
World	459,782	11.4%	499,043	8.5%	454,272	-9.0%
Chinese Mainland	259,860	17.1%	275,162	5.9%	246,478	-10.4%
Japan	35,006	14.3%	37,903	8.3%	31,291	-17.4%
Taiwan	17,128	17.2%	14,822	-13.5%	11,599	-21.7%

Source: Hong Kong Census and Statistics Department.

Issues for Hong Kong Consumer Electronics Manufacturers

Hong Kong consumer electronics manufacturing firms operating in the PRD are facing major issues including rising operating costs, a shortage of skilled workers, appreciation of the RMB against the US dollar, pricing pressure from customers amid the downturn of the global economy during the year, and an inability to compete with Mainland Chinese firms purely on the basis of production costs. Competing in China's domestic market is difficult due to the fragmented nature of the market, the relatively low purchasing power of most of the population in Mainland China, shifting regulations, policies that have historically seemed to favour domestic Mainland China firms in the sector rather than Hong Kong companies or joint venture companies, and the evolving nature of the market.

The electronics industry was one of the hardest hit sectors during the 2008 financial crisis but the reviving global economy has stimulated the market demand for consumer electronics, and electronic product exports in Hong Kong in the first quarter of 2010 reported an 18.4 per cent increase year-on-year. In December 2009, a survey by the HKTDC reported that the consumer electronics sector is expected to see a stronger rebound than most other sectors. An assessment released by HKTDC on 29 January 2010¹¹⁶ shows a majority of exporters holding a neutral view (40 per cent) and an optimistic view (51 per cent) on prospects for the global consumer electronics industry. In spite of the difficulties that they faced, most Hong Kong firms in the electronics industry survived the crisis, although many of them experienced a decline in profit or a move into loss-making territory.¹¹⁷ In the first two months in 2009, the overall profit of the electronics industry in China decreased 96.3 per cent year-on-year.¹¹⁸

National and local industrial policies show a determination by the central and local governments in China to upgrade the sector. Electronic information and technology is one of the eight innovative and high technology areas that the Chinese Government in Mainland China supports.¹¹⁹ Firms in the eight technology areas will be given favourable tax treatment. These policies favour Mainland Chinese firms and will make it harder for Hong Kong owned manufacturers to compete.

In April 2009, the Chinese Government published a "Plan on Adjusting and Revitalising the Electronics and Information Industry" (2009-2011) to stimulate the development of the electronics and information industry, to speed up its restructuring, and to upgrade the sector. The main measures of the plan include expanding the coverage of telecommunication, broadcast, and television infrastructure in China's rural area to support the development of photovoltaic power generation, and to promote LED lighting products. Hong Kong manufacturing SMEs will be forced to make corresponding changes to keep pace with this national strategy.

116 See Hong Kong Trade Development Council, "On the Road to Recovery: Assessment of 2009 Christmas Sales in Major Markets," 29 January 2010.

117 ESA interviews.

118 www.pcbcity.com.cn.

119 The Catalogue of the Innovative and High Technology Areas with the Government's Primary Support, Appendix of Measures for Administration of Recognition of Innovative and High-Tech Enterprises, (Guokefahuo [2008] no. 172).

The Guangdong Government also published its own “Plan on Adjusting and Revitalising the Electronics and Information Industry” in November 2009.¹²⁰ The Plan focuses on industrial restructuring and upgrading, and governmental support is focused on pillar sectors, leading enterprises, and the development of self-owned technology and brands. Further, the timeframe for the “home appliance and motor vehicles to the countryside” and the “motor vehicle and home appliance replacement” policies have been further extended.¹²¹ These policies categorise certain consumer electronic products such as televisions and telephones as home appliances and eligible for support. These policies will stimulate the demand in China for consumer electronics and Hong Kong firms will want to be positioned to take advantage.

Labour issues are compounded by the fact that consumer electronics manufacturing requires a large number of skilled technicians and the number of migrant workers looking for work in the PRD, especially skilled technicians, has fallen since 2008. The Labour Contract Law will increase manufacturing costs because of the requirement that firms provide additional worker benefits. This will have the greatest impact on labour intensive industries, meaning that the effect on the consumer electronics sector is likely to be less pronounced than on many others,¹²² but firms will still need to cover any additional cost and they will need to be in a position to source skilled workers on an ongoing basis.

The consumer electronics sector does not have any export processing restrictions directly imposed on it but the supply chain for non ferrous metals is affected by restrictions on copper, aluminium, nickel, tin, and zinc products.¹²³ The export rebate for the sector did not change in 2007 or since. The upstream electroplating of components and the manufacture of circuit boards used in the sector are polluting activities that are under close scrutiny and control, and are being restricted. In 2008, the Guangdong Environmental Protection Bureau issued a plan¹²⁴ to consolidate all electroplating factories to purpose-built parks with their own centralised water purifying centres so that all discharges can be controlled. Factories that fail to move will be closed down. These activities have the potential to disrupt the sector by disrupting the supply chain.

Response Strategies of Hong Kong SMEs

Hong Kong electronics firms understand that competition in the industry is cost-based to an extent and that cost increases must be managed through improved operating efficiencies, but the precision that is required in doing the manufacturing means that it is a combination of price, quality, and performance that actually determines which firms get orders and which firms do not. Most successful Hong Kong firms are committed to doing well across all of these attributes in order to cope with competition from both Chinese firms at the low-end and Japanese, Korean, and Taiwan firms at the higher-end.¹²⁵

Many Hong Kong electronics firms do their manufacturing in Guangdong which is cheaper than doing it in Hong Kong, but more expensive than manufacturing in some other parts of China. However, as these firms point out, making products in Guangdong means that the end product is still relatively high in quality, so some firms in the sector have for the time being strategically accepted a presence in Guangdong as being a necessary trade-off noting that controlling cost is only one issue that needs to be managed. In response to the economic downturn, many firms in the electronics industry tried to cut costs by reducing production or by laying off workers.

¹²⁰ www.uschina.org.

¹²¹ The initial “Home appliance replacement” policy expired on 31 May 2010 and has been extended until 31 December 2011.

¹²² China Statistical Yearbook 2009, calculated ratio of GIO to Employment.

¹²³ Ministry of Commerce, 2007

¹²⁴ The opinions on general planning and management for the highly polluting industries such as electroplating, printing, and dyeing”, Guangdong Environmental Protection Department, 2008

¹²⁵ Interview with the Hong Kong Electronics Industry Council, 14 April 2010.

Some Hong Kong owned firms have addressed the labour issue by providing benefits that are attractive to workers in the PRD and which are above those being provided by competing firms. Firms that view this as not feasible or as being a temporary solution to the problem have relocated or will consider relocating their operations to an area where labour is less costly and more abundant, such as the Northern part of the PRD, the YRD, or China's interior. Relocation within Mainland China is becoming an option for some firms in the sector, and it will become a more attractive option if the trend of larger companies moving to parts of Mainland China other than the core of the PRD continues.

Although some other countries including Vietnam and Indonesia offer low-cost manufacturing environments, most firms in the sector currently feel that it is would be premature for them to move there because those locations currently lack the infrastructure that is needed to support the business that an SME in the consumer electronics sector would need to run. For instance, if a Hong Kong owned SME set up an electronics factory in a location that does not have a critical mass in all the segments in the value chain, then the company would need to buy all the materials in Hong Kong, package and ship them to the other location, produce the products, and ship the products back to Hong Kong. The only real advantage in setting up in a low-cost location would be to access low-cost labour and most firms agree that chasing low-cost labour is not a sustainable long-term strategy.

Some Hong Kong firms have attempted to differentiate themselves by innovating through better design, better technology, or through branding, so as to expand to do ODM or OBM. Some are developing new niches, such as green manufacturing opportunities in LED lighting and electric vehicles.

Some Hong Kong SMEs have turned their attention to the Chinese Mainland market, though many that are finding it difficult to compete in China's domestic market have opted not to do so for now, continuing to focus instead on supplying to markets outside of the Chinese Mainland where the firm can compete more effectively.

Case Study – Suga Holdings Limited

Suga International Holdings Limited (Suga) was founded in 1991 and is headquartered in Hong Kong. Suga is an Electronics Manufacturing Services (EMS) provider offering Original Equipment Manufacturing (OEM) and Original Design Manufacturing (ODM) solutions.

In 1992, Suga commenced manufacturing operations in Huizhou in Guangdong Province. The business grew rapidly and in 1994 another manufacturing base was set up in Shenzhen, which was further expanded in 1999 and in 2005. In 2002, Suga set up a third manufacturing base, once more in Shenzhen. Suga was listed on the main board of the Hong Kong Stock Exchange in 2002.

Suga has made its name as a manufacturer of niche products that have gone on to become very successful. This includes a series of interactive education products (since 2003) and specialised professional audio products (since 2006).

Beginning with just seven staff including the founder Mr Ng, Suga has approximately 2000 employees. The firm started with a relatively small investment of HK\$2 million. Suga has experienced substantial growth since then and has won wide recognition from both clients and third party agencies for its consistent quality and excellent management.

Except for some high-end corporate management activities including a portion of its research and development, all of Suga's main activities are located in China.

Suga's sales in the 2010 fiscal year were HK\$959 million, with electronic products accounting for 95.6 per cent of sales, and moulds and plastic products accounting for 4.4 per cent. Total sales increased by 18.1 per cent from 2009 to 2010. Suga's revenue is derived fairly evenly from the US, the Asia Pacific region (including China), and Europe. China is currently a relatively small market and it is hoped that during the next few years the China market will grow at a fast rate.

Issues and Challenges

Being a listed company puts Suga into the spotlight. This adds to the competitive pressure that Suga has to deal with and means that Suga pays close attention to its competitive environment. However, Suga doesn't have too many competitors because it specialises in selling niche products in most markets. The exception is in Japan where the company has several competitors.

Suga has had to work hard to establish trust between the company and its customers in order to secure business and develop it. Mr Ng notes that "even though Suga's price is higher than many of its competitors, Suga is competitive once the price/performance ratio is taken into account. It is that ratio that is most important for the customer because if you offer them low price but you have low quality it is not an efficient trade-off for them."

Mr Ng relates that the major challenge that Suga has faced over the long-term is the need to continually innovate. He makes the point that innovation is hard, but that to remain successful as a producer of niche products it is an essential element. Suga has to constantly find innovative people who come up with innovative ideas. It also needs to frequently revisit the firm's business model to match it up with changes in the business environment.

Constantly striving to innovate means that there will be failures as well as successes. Mr Ng cites Suga's foray into OBM in the digital audio business as one failed initiative. This was in part due to inexperience in managing a brand and in doing retailing, in part due to the cost involved in trying to build a brand, and in part it was because of differences in branding at an industry level. On this latter point, Mr Ng suggests that for many products, such as garments, branding is pivotal to success for a greater proportion of companies in the industry. He thinks that this is because fundamentally there is actually not too much of a difference between many of the products. With reference to garments, for instance, one shirt is very much like another and technology does not play a big part in manufacturing the shirt or in differentiating it from other shirts. This makes branding important to success for many companies in that industry and it means that it is worthwhile spending the money that is required to build a brand. This is not the case for most firms in the consumer electronics sector, however.

The challenge for Suga has been to focus on the right technologies and to leverage off its technological capability to capture an attractive profit margin. This technology-led edge creates the challenge of dealing with complexity. Suga's products require technology and engineering support at a fairly high level. Also, Suga has automated operations where possible and this adds to the cost and complexity of running the business.

Figuring out when to make a big push into the domestic market in China is another issue for Suga. Many firms are looking to compete in China's fast-growing domestic market, but Mr Ng makes the point that benchmarking the whole of consumer consumption for Mainland China against that in the US or in Europe reveals China to be a small market at present. Thus he feels that any move to try and replace existing markets in the US, Europe, and Japan, with the market in Mainland China would be premature.

Suga has occasionally been challenged by the shortage of labour in Mainland China and the company is affected when the cost of employment increases. The relatively low level of labour intensity in the industry makes this a lower order issue than some others, however.

The recent financial crisis was an issue for Suga, but less so than for many other firms in the consumer electronics sector, largely due to the nature of its products. Mr Ng admits that Suga's gross profit margin was down a bit from 13.1 per cent in fiscal year 2008 to 11.9 per cent in fiscal year 2009. Overall, however, in terms of production, orders, and share price, the firm's performance was pretty good and the firm was growing. Revenues from Japanese customers were down the most because they focus more on the consumer products. But the economic downturn did not hit the education products, it only slightly hit the pet products, and demand for the professional audio products even grew during the economic downturn.

Suga's factories are located in relatively expensive areas. Cost increases need to be covered by the business and when they frequently occur there is a need to pass the costs along to the customer, which is sometimes difficult.

Suga has had to deal with a major and unexpected loss of business on several occasions. Early in Suga's development the company's first customer ran into difficulty and significantly cut the orders that they placed with Suga at a time when Suga was trying to grow and diversify its revenue streams, but before it had managed to do so. On another occasion, one of Suga's customers started to do so well with Suga's help that they were acquired by a large company that then decided to take the business that had previously been given to Suga in-house. Mr Ng notes that "even excellence in a specialised field or niche area may not make the company successful, or even if we are doing well the result may not be that satisfactory." The opposite situation sometimes occurs with Suga finding that a rush of orders stretches its existing capacity.

Hong Kong's regulatory system is simple, transparent, and the regulations are applied fairly. Things are quite different in China where there are more regulations, the regulations change often, they are less clear and therefore pose a greater administrative burden, and there is less certainty as to the purpose and direction of the regulations. The regulatory environment in China requires that Suga place some senior executive staff in China who know how to deal with the system and with the government officials there.

Company Strategy

Suga leveraged a small amount of start-up capital very well to create a relatively large scale capacity to do manufacturing. Suga did this through "Chengbao", meaning that Suga effectively leased a portion of another factory's production capacity, using the money that it otherwise would have spent in trying to establish a small production facility of its own. This arrangement lasted for a few years until Suga attained a size and scale that enabled the company to set up its own factory in 1994. If not for the Chengbao arrangement, this probably would have taken much longer, if it happened at all. Good financial management, including the maintenance of strategic cash buffers at the bank along with considerable banking facilities, has served Suga well, giving it great flexibility in pursuing business expansion if it so desires.

Suga does not aim to be a low cost manufacturer but Mr Ng thinks that maintaining Suga's manufacturing base in Mainland China will keep the company competitive, as will the continued automation of firm processes that are labour intensive.

What really differentiates Suga is its focus on specialised products. These products are not as vulnerable to market fluctuation as general products, and they tend to have a higher profit margin than general products. By being the leading manufacturer of a niche product, Suga becomes more important to the customers that have developed the markets for those products. This fact, and the investment that is made in developing the specialised technology, creates barriers to entry in Suga's markets which means that other companies would find it harder to compete with Suga. It also means that Suga grows alongside its customers, scaling up in a way that is more measured and lower in risk than if Suga had to add capacity and punt on where demand might come from. In 2009, specialised products represented 60 per cent of Suga's output.

Suga's success is reflected in its Chinese company name which means the "best integrity." Adherence to this characteristic played a pivotal role in Suga's early success. In 1992, Mr Ng made a business pitch to a large Japanese customer when Suga was small. At that time, the large Japanese customer had a new product, the LCD TV, and they were looking for manufacturers. When Mr Ng met with the large Japanese customer, the senior executives asked him about his relevant experience and he commented that he had none in making LCD televisions, but that the company had other relevant experience, was willing to learn, and would welcome the opportunity to work with the large Japanese customer and to receive early support from them including instruction as to how they would like the product to be assembled. Somewhat unexpectedly, the large Japanese customer gave Suga the contract even though Suga was the smallest bidder. The large Japanese customer executives informed Mr Ng that the approach taken by all the other companies that they met with was to say "oh we can do it, no problem, it's easy" and the decision was taken to give the work to Suga because Suga was honest and upfront when others were not. Today the large Japanese customer is still Suga's customer

and on the back of the commitment made to Suga by the large Japanese customer, as well as Suga's performance for the large Japanese customer, the firm managed to take on a total of three big Japanese customers in a relatively short period of time. This spearheaded Suga's fast growth in business.

An unintended positive consequence of managing to secure a few large Japanese companies as customers is that they have loyally supported Suga during a couple of tough periods by doing things like arranging letters of credit for the company to use to finance its operation during the short-term. With a letter of credit from a major Japanese company, Suga is able to continue to get bank financing so that materials could be purchased when needed, for instance.

Mr Ng also attributes Suga's success to the investments it has made in developing a world-class ERP system and in automating whenever possible. These moves have improved Suga's manufacturing and operating efficiency, as well as the quality and timeliness of its management decision-making. To exploit the competitive advantage that comes from technological superiority, and to put Suga in a position of being able to innovate, Suga maintains a leading-edge capability in specialised technology by ensuring that its research and development team is well-trained and that its skills are regularly updated. This includes having the research and development team participate in product development competitions.

Planning is important to Suga, as is the setting of 3-to-5-year strategies which are reviewed annually. Monthly planning and review meetings are held with the senior management team and during those meetings there is an opportunity for cross-functional collaboration between business units that otherwise might not have a structured environment in which to share ideas. The important discussions that take place between the marketing and engineering teams, for example, sometimes improve new technology to make it more attractive to the market.

In terms of dealing with regulatory issues, Suga takes its regulatory responsibilities very seriously. Compliance is essential to having a strong business, and Suga ensures that its actions are geared to world's best practice in all of the markets in which it operates. By way of example, even when Suga was very small it used one of the big global accounting firms as its auditor.

Suga's response to the loss of a couple of key customers early in the life of the company was to target several large Japanese companies with a reputation for excellence in quality, a track record of doing business over the long-term with contract manufacturing companies, and existing customer markets of significant size, thus creating more stable demand for Suga's products. Following success in developing relationships with target Japanese clients, Suga then worked to geographically diversify its customer base to protect the company against a shock emanating from any one country. This strategy paid off when Suga felt the effects of the economic downturn far less than many of its competitors. Diversification at the product level has also proven a good strategy; as the revenue from the general consumer electronic products which are more sensitive to the global economic downturn has declined, Suga has reallocated resources to support niche products with higher margins.

To control for unexpected spikes in demand Suga also maintains good relationships with other firms in the industry and has manufacturing partners that Suga can work with in the event that a flurry of orders arrives. This gives the firm greater flexibility.

Finally, Mr Ng explains the importance of teamwork in solving the company's problems and in helping it to overcome the many challenges that confront it. Mr Ng's view is that employees should be treated as partners in the business and that the same respect and loyalty should be shown to them that one would show to one's family. Mr Ng believes that "this will lead the workers to do their best for the company" thereby making it better able to compete.

Future Plans

Suga plans to continue focusing on high margin businesses in niche markets including pet training devices, interactive educational products, and electronic ticket processors, among others. Suga is also trying to tap into other markets with great potential, including those for WIFI products and health care products. It is hoped that the company will develop so that each of the subsidiaries becomes a leader in its specialised area.

Mr Ng is considering what form the company must take in order to maximise its growth. He thinks that for the firm to grow it cannot position itself purely as a manufacturing company without strategic intent, it must be able to differentiate in some way and it must be able to transform to fit future business environments. For example, with the recent focus on environmental issues, Suga has decided to explore the opportunity to develop LED lighting for use in the image projection business in a way that would reduce the size of current projection equipment and save energy.

Hong Kong will remain as the location of Suga's headquarters and production will stay in Mainland China. Suga will continue to look for opportunities to forge strategic alliances with overseas marketing experts with the aim of securing more overseas customers through such alliances. Looking ten years ahead, Suga aims to be diversified geographically to the point that it has a quarter of its annual sales in each of the US, Europe, Japan, and China.

Mr Ng plans to remain in his present role for some time yet and he does not currently have a succession plan. He explains that Suga has a team of professional managers who are well qualified to run the company if there were ever the need.

Lessons from the Suga Holdings Case

There are a number of lessons that can be learned from the Suga case.

- SMEs should focus on specialised products. These products are not as vulnerable to market fluctuation as general products, and they tend to have a higher profit margin than general products.
- By being the leading manufacturer of a niche product, the SME becomes more important to the customers that have developed the end markets for those products. This creates barriers to entry which mean that other companies would find it harder to compete with the firm.
- SMEs that specialise in selling niche products are likely to have fewer competitors.
- The price/performance ratio is most important for the customer because low price but low quality is not an efficient trade-off.
- SMEs need to continually innovate. Innovation is difficult but to remain successful it is essential. This means finding innovative people and developing innovative ideas is important.
- Striving to innovate means that there will be failures as well as successes.
- SMEs should ensure that their business model matches the business environment.
- To avoid problems from an overreliance on one large customer, SMEs should develop a customer base with a diverse geographical and product mix.
- SMEs in this sector need to carefully consider whether it is worth spending the money that is required to build a brand.
- SMEs can leverage off their technological capability to capture an attractive profit margin.
- SMEs in the sector operate in a complex environment that requires technology and engineering support at a fairly high level.
- Firms will need to automate operations where possible. This adds to the cost and complexity of running the business.
- China's domestic market is fast-growing but comparatively small and not yet very attractive. Thus any move to try and replace existing markets in the US, Europe, and Japan, with the market in Mainland China being premature.
- Cost increases need to be covered by the business and when they frequently occur there is a need to pass the costs along to the customer, which is sometimes difficult.
- Customers and competitors won't wait for a firm to put its strategy in place. Firms need to constantly revisit their strategies and think through the various scenarios that might affect their business and plan on how to respond to them.
- Excellence in a specialised field or niche area may not be enough to make the firm successful.
- Spikes and troughs in demand occur and plans should be in place to deal with them.
- Hong Kong's regulatory system is simpler and more transparent than China's. Firms may need senior staff in China who know how to deal with the system there.
- SMEs must take their regulatory responsibilities very seriously. It is unlikely that being small in size will be accepted as a reason for regulatory non-compliance.
- SMEs should benchmark their activities against world's best practice.
- SMEs can and should think and act like big firms. They should consider using globally recognised professional services firms. They will benefit from putting world-class management performance systems in place.
- SMEs don't need a lot of start-up capital. They can scale capacity by leasing a portion of another factory's production capacity. The money saved by not immediately buying a factory can be spent in marketing and developing the business.
- Good financial management is important to SMEs. This includes the maintenance of strategic cash buffers, and the establishment of banking facilities.

- Having a manufacturing base in Mainland China may make the SME more competitive, as will the continued automation of firm processes that are labour intensive.
- Creating loyal customers will pay back during tough times. Loyal companies may do things like arrange letters of credit for the firm to use to finance its operation during the short-term.
- SMEs must work to understand the needs of their partners as well as their customers.
- SMEs can develop and maintain a technological advantage by ensuring that their research and development team is well-trained and that its skills are regularly updated. Research and development staff need to be motivated and incentivised just like other staff. Motivation can come in many forms including through participation in competitions.
- SMEs need to plan. They should set strategies and review them regularly.
- Meetings with the senior management team present an opportunity for cross-functional collaboration between different business units. Such collaborations have the potential to bring about material improvements in the business.
- Teamwork is important. To create a strong team, the firm should treat employees as partners in the business and that the same respect and loyalty should be shown to them that one would show to one's family.
- Failure can be a lesson on how the firm can improve. Although a short-term problem may affect short-term profit, a lesson well learned may have a greater positive impact on long-term profit.
- Focusing on the short-term is often the wrong thing to do. Many of the problems that firms face are due to attempts to maximise profit on a short-term basis. This can lead to disharmony with staff, customers, and other important stakeholders that the business depends on for its long-term success.
- Integrity and reputation are all-important to success in the industry. Both qualities are hard won and, if lost, are even harder to regain.

THE GARMENT INDUSTRY

The garment industry consists of fashion design, apparel manufacturing, clothes wholesale, and retailing. The global garment industry's total revenue in 2006 was US\$1,253 billion. This is estimated to reach a value of US\$1,782 billion by the end of 2010.¹²⁶

China is the largest producer and consumer of garments, producing over 50 per cent of the world's total in 2008. Guangdong Province is the largest garment producer in China, accounting for 18.3 per cent of total reported Gross Industrial Output (GIO) in garments in China in 2008 (ahead of Zhejiang, Jiangsu, Shandong, and Fujian). It is reported that there are over 30,000 garment enterprises in Guangdong in 2009 and about 80 per cent of these enterprises are mainly export-oriented.¹²⁷ The 2009 Guangdong Statistical Yearbook reports that the garment sector in Guangdong accounted for 1.1 million workers, GIO of RMB 172.5 billion, exports of US\$23.9 billion, imports of US\$823.5 million, and VAT of RMB 5.6 billion in 2008. Garment manufacturing is concentrated in the PRD, especially in Dongguan, Zhongshan, and Foshan.

Hong Kong firms are a leading global force in the industry. Several of the world's leading garment firms are headquartered in Hong Kong and it has been estimated that Hong Kong firms control on the order of a quarter or more of world garment trade. Hong Kong companies generally look after strategy, coordination, marketing, and finance from Hong Kong, while producing in the Pearl River Delta and elsewhere. Hong Kong companies started moving production into the PRD in the 1980s and little production remains in Hong Kong. The vast majority of Hong Kong garment companies, large as well as small, are engaged in OEM production for well-known brands and retailers such as Armani,

¹²⁶ www.fashionproducts.com.

¹²⁷ gcontent.nddaily.com.

Hugo Boss, and Banana Republic. Hong Kong companies have benefited from Hong Kong's openness, managerial skills, financial sector, international linkages, transportation system, and communications infrastructure, while offsetting disadvantages in labour and other costs by shifting production into the Chinese Mainland.

The end of the global garment quota system in January 2005 led to a tremendous spike in Hong Kong's garment re-exports from China in the first six months of 2005. Since then, the global garment trade has steadied, with China's share significantly higher than before. Hong Kong and other international garment exporters have invested heavily in capacity in the Chinese Mainland.

Some developing countries such as Bangladesh, India, Vietnam, Cambodia, and Thailand are growing their low-end garment industry. These countries have lower operating costs than China. Some garment companies in the PRD have considered moving their manufacturing factories to one or more of these countries, though few have done so to date. While industry participants expect that South Asia in particular will become a larger player in the low end segments of the industry, and that even Africa may become a more significant producer, China will remain the dominant production location in the garment industry for the foreseeable future. Thus it is key for Hong Kong firms to be able to continue to leverage Chinese production locations, and to compete against competitors from the Mainland if they are to succeed. While companies that are not able to distinguish themselves in terms of technology, design, flexibility, reliability, and quality will face a tough time, there are enough Hong Kong firms that do distinguish themselves on one or more of these dimensions to indicate that Hong Kong will retain a strong position in the industry.

Basic Facts about the Industry

GIO and employment in the garment sector in Hong Kong decreased from HK\$23 billion and 24,000 people in 2004 to HK\$8 billion and 13,000 people in 2008.¹²⁸ Average wages for the garment sector in Hong Kong are six times those for wages in the sector for China as a whole. This is likely explained by general wage disparities between Hong Kong and China, the employment of more senior staff in Hong Kong, and the fact that higher value end products are produced in the sector in Hong Kong with corresponding higher quality and more costly labour inputs. Wages were approximately 23 per cent of total costs for the sector.

Exhibit 40. Average Monthly Wages for the Sector in RMB

Region	Average Monthly Wages
Hong Kong	9,034
YRD	1,605
PRD	1,710
China	1,559

Source: Foshan, Dongguan, Shenzhen, Huizhou, Taizhou (JS), Nantong, Shaoxing, and Jiaxing City Statistical Yearbooks, 2009, China Statistical Yearbook, 2009. —

The total exports from Hong Kong for the textile and clothing sector in 2009 were HK\$254.5 billion or 10.4 per cent of total exports. Total domestic garment exports for Hong Kong were HK\$4.4 billion, a decrease of 80 per cent from the previous year. Re-exports from Hong Kong for the textile and clothing sector were HK\$247.8 billion or 10.3 per cent of total re-exports. Mainland based processing trade re-exports through Hong Kong accounted for HK\$118.4 billion of this total, while Mainland based non-processing trade accounted for a further HK\$45.6 billion. Total re-exports originating from the Chinese Mainland were HK\$164 billion or 6.8 per cent of Hong Kong's total re-exports, and 66 per cent of garment re-exports.¹²⁹

128 Hong Kong Census and Statistics Department.

129 Hong Kong Census and Statistics Department.

Exhibit 41. Textiles and Clothing Exports from Hong Kong, HK\$ millions

Destinations	2007		2008		2009	
	Value	Y-o-Y Growth	Value	Y-o-Y Growth	Value	Y-o-Y Growth
World	329,269	0.1%	313,024	-4.9%	254,532	-18.7%
US	83,925	1.3%	77,383	-7.8%	63,083	-18.5%
Germany	16,674	5.7%	18,148	8.8%	15,384	-15.2%
UK	24,092	5.7%	23,811	-1.2%	18,722	-21.4%

Source: Hong Kong Census and Statistics Department.

Exhibit 42. Textiles and Clothing Re-exported from Hong Kong, HK\$ millions

Destinations	2007		2008		2009	
	Value	Y-o-Y Change	Value	Y-o-Y Change	Value	Y-o-Y Change
World	286,772	5.2%	287,611	0.3%	247,881	-13.8%
US	68,562	10.7%	66,037	-3.7%	61,517	-6.8%
UK	19,749	13.3%	22,578	14.3%	18,400	-18.5%
Germany	14,376	20.6%	17,366	20.8%	15,281	-12.0%

Source: Hong Kong Census and Statistics Department.

Exhibit 43. Chinese Mainland Process Industry Garments Re-exported from Hong Kong, HK\$ millions

Hong Kong's Garments Re-exports of the Export Processing Products Manufactured in the Chinese Mainland	2006	2007	2008	2009
Value	125,952	141,669	135,230	118,446

Source: Hong Kong Census and Statistics Department.

Exhibit 44. Textiles and Clothing Imports to Hong Kong, HK\$ millions

Origins	2007		2008		2009	
	Value	Y-o-Y Change	Value	Y-o-Y Change	Value	Y-o-Y Change
World	255,439	0.0%	240,646	-5.8%	197,740	-17.8%
Mainland China	135,343	1.0%	128,247	-5.2%	106,932	-16.6%
Italy	18,863	1.2%	17,762	-6.2%	15,027	-18.2%

Source: Hong Kong Census and Statistics Department.

In 2009, Hong Kong imported textile and clothing sector traded goods of HK\$197.7 billion or 7.3 per cent of total imports. This was down 17.8 per cent from 2008.

Issues for Hong Kong Garment Manufacturers

The major issues facing Hong Kong garment firms operating in the PRD are rising operating costs, a shortage of skilled workers, a decrease in orders from overseas buyers, competition from other developing countries, increased order frequency, reduced individual order volume, changing styles, a demand for speedier delivery, higher quality demands from end customers, and the appreciation in the RMB. Competition in the garment industry within China and between China and other locations is intensified by low entry barriers.

The impact of the global economic slowdown can be seen in that Chinese Customs reported that the garment exports from China fell by 9.8 per cent from US\$185.3 billion in 2008 to US\$167.1 billion in 2009. Hong Kong's garment business was greatly affected by the downturn, with total exports, total imports, and re-exports of textiles and clothing seeing double digit declines in 2009. China's garment exports started to grow again during the latter part of 2009. However, retailers' confidence remained fragile, and they have been reducing their working capital by placing smaller order volumes and demanding quicker delivery times at cheaper prices.¹³⁰

The garment industry is labour-intensive. This means that it is hit disproportionately by increases in labour costs in China and is more subject to competition from low wage nations than other sectors. China has had a labour cost advantage that helped it compete in the industry. Increasingly, however, lower labour costs can be found in other developing nations, though China still benefits from massive scale, a huge home market, and established garment and textile production chains.

In addition, there is a shortage of skilled workers in the sector in the PRD. The manpower shortage across the economy in areas such as Guangzhou, Shenzhen, and Zhuhai was estimated at more than two million in early 2010,¹³¹ forcing garment factories to reduce production. The Guangdong Labour and Social Security Bureau increased the minimum wage effective from 1 May 2010. Most of the Hong Kong factory owners we interviewed thought the new measure would be of little help in attracting more migrant workers as many manufacturers still face labour shortages even after paying their employees more than the amount that the government requires.¹³² Further, increases in labour costs have a significant impact on profitability and even the viability of the business, and on the competitiveness of the PRD in the industry.

The garment industry was one of the industries singled out for greater restrictions on export processing and reduced VAT rebates in China in 2006 and 2007 on the grounds that the garment industry was too labour and resource intensive. The dyeing sector, a key component of the garment sector, has been singled out as a polluting industry that also requires restrictions. This has the potential to disrupt a key step in the supply chain.

130 "HK exporters in Pearl River Delta win more orders," South China Morning Post, 27 May 2009.

131 english.tianhechem.com.

132 Interview with the leadership of Federation of Hong Kong Industries, 31 March 2010.

China's Labour Contract Law is not differentially applicable at an industry level, but it is clear that the new law will increase manufacturing costs because of the requirement that firms provide additional worker benefits. This will have the greatest impact on labour intensive industries, meaning that the effect on the garment sector is likely to be more pronounced than on many others.¹³³

At the end of 2008 the State Council introduced a "Plan on Adjusting and Revitalising the Textiles and Garment Industry" to help the Chinese garment industry to overcome the global economic downturn.¹³⁴ This Plan has helped the industry in Mainland China raise finances and improve their technological capabilities. Raising the tax rebate rate for textile exports, providing subsidies, and postponing social insurance payments has improved the textile companies' cash flows.

The NDRC Plan for the PRD and related policies have put pressure on garment firms, particularly those that do contract manufacturing, to move elsewhere in Guangdong, move out of Guangdong altogether, and/ or move into ODM and OBM as a means of adding greater value. The Guangdong Government introduced a "double-transfer initiative" in 2008¹³⁵ to encourage companies in the Pearl River Delta region to relocate their labour-intensive production facilities to less developed regions in the East, West, and North of the Province where there is readily available local labour.

The relocation of a garment factory is less difficult than other industries due to the simple nature of the machinery and production processes involved. Their requirement for local services is also lower than other industries and their simpler supply chain means that may not also be necessary to move their upstream suppliers as well. Nevertheless, the garment industry has a long processing and supply chain where the PRD still has advantages. The PRD can provide fast and reliable delivery for garments products as it has established a very good supply chain and flexible services system. The logistics costs will increase

if the garment factories move outside of the garment manufacturing cluster.

While Hong Kong firms' ability to manage production in South China is still an advantage, competition with other areas of China will heat up. There will be challenges associated with moving production into new areas of China. Moving deeper into China's interior dilutes executive control from Hong Kong. It also may bring executives into more direct competition with strong local manufacturers, and require them to deal with local governments less aligned with their export oriented activities. In addition, international sourcing operations traditionally focused on Hong Kong and the Pearl River Delta will diversify their supply locations in China.

Response Strategies of Hong Kong SMEs

The sharp decline in Hong Kong domestic garment exports suggests that the industry in Hong Kong suffered greater losses than in many other locations as a result of the global economic crisis and it may also point to an acceleration of moves by remaining firms to relocate garment manufacturing to the Chinese Mainland. For firms already in the PRD, moving to less developed parts of Guangdong may reduce labour costs and allow them to find semi-skilled workers, but may impose difficulties in finding and retaining skilled technicians and management, as well as increase supply costs and the cost of shipping finished products.

133 China Statistical Yearbook 2009, calculated ratio of GIO to Employment

134 www.lawinfochina.com.

135 www.newsgd.com.

The end of the international garment quota system has changed the industry's competitive landscape. One major impact was competition on price rather than on quota. Several Hong Kong firms that had set up production in multiple locations (or at least in locations other than Hong Kong or the Chinese Mainland) to get around quota restrictions focused their production more and more in the PRD and YRD. With recent cost and regulatory changes in China, however, some have started opening new facilities in interior provinces. Others have opened or considered facilities in Vietnam, Bangladesh, India, and other countries. Still others have supplemented or even replaced their own production activities with outsourced production. In more extreme cases, companies have shifted from manufacturing to sourcing and trading.

Another impact of the end of the quota regime that has been accelerated by the global economic downturn has been the search for new markets. Under the quota restrictions, many companies specialised in producing for only one or a few markets. The end of the regime opened new markets, at least among developed countries. In addition, many Hong Kong companies have shifted their attention to the Chinese Mainland market. We note that it will be difficult for Hong Kong companies to compete in the Mainland market against Mainland competitors in price sensitive segments of the market. Instead, the Hong Kong firms will probably have to compete in higher quality segments if they are to succeed in China. While some firms have focused on China as a new market, others have shifted some of their attention to markets in Southeast Asia, South Asia, Latin America, Eastern Europe, and even Africa.

Another impact of the end of the quota regime and increased cost and competitive pressure has been on the range of products and services offered by some garment companies. Under the quota regime, companies often focused on one or two products for which they had quota. The lifting of restrictions has allowed some companies to produce and sell a variety of garment products, since the production and support activities across products in the garment industry are similar. A wider product range, in turn, can help increase scale efficiency in some activities while allowing the firm to supply a larger portion of a buyer's needs. A wider product range and greater scale, in turn, has allowed some companies to invest more in design and has allowed them to provide additional support services to customers that would not have been efficient for a company supplying only a single product.

As regulatory and policy pressure mounts for garment production to relocate from the PRD, companies that are identified as developing new products, new designs, and their own brands may be able to receive more favourable treatment than other companies. While there are no guarantees, a company being able to show it is moving up the value-added ladder may receive more flexible treatment going forward.

Finally, rising costs of operation in the PRD during the 2004 to 2007 had already driven some factories to close down or to relocate outside the PRD even before the economic downturn of 2008-2009. More closed during the downturn. We expect that tough competition in the industry will lead to more closures and consolidations going forward.

Case Study – Lever Style Incorporated

Lever Style Inc. was founded in Hong Kong in 1956 as Lever Shirt G.W.B & D. Factory Ltd. In 2007 Lever Shirt merged with Trinity's outerwear manufacturing division to form Lever Style Inc. (Lever Style). The company is led by a third generation family member, Mr Stanley Szeto. In 1981 Lever Shirt was one of the first garment manufacturers to open production facilities in China and the company now has a significant presence in Guangdong, while retaining corporate headquarters in Hong Kong.

Lever Style's traditional line of business was Original Equipment Manufacturing (OEM) for established western brand companies but the company has since extended into Original Design Manufacturing (ODM). The company's focus is on high-end branded products for clients such as Armani Collezioni, Armani Exchange, Banana Republic, Calvin Klein, Country Road, Hugo Boss, Paul Smith, Ralph Lauren, and Reiss.¹³⁶ They also produce mid-range products for the Japanese mass fashion retail company UNIQLO.¹³⁷ Lever Style tends to deal with a relatively small number of customers that have size and scale globally (Hugo Boss) or within a significant market (Country Road). The US is the largest market accounting for 40 per cent of revenue, the European Union, Japan, Australia, and other locations account for a further 40 per cent of revenue, with Mainland China making up the final 20 per cent.¹³⁸

The company currently has approximately 7,000 staff with the majority of them based in Mainland China. Product design, customer service, merchandising, and sales are coordinated out of the Hong Kong and New York offices, while production is located in Guangdong. Lever Style manufactures more than 10 million garments a year for men and women across a wide range of garment types and finishes.

Lever Style is highly regarded by relevant players in the garment industry for its creativity, innovation, and clever management.

Issues and Challenges

Presently, cost pressure is the major issue for the company. Given its emphasis on designs and sales to high-end brands, Lever Style is a relatively high-cost producer. The company manufactures in Guangdong, which the company claims is the second highest cost location (to Italy) among major garment producing locations. Competition can also be tough in the sector. Barriers to entry are low in the garment sector. In addition, there are suspicions that some competitors do not fully comply with laws and regulations. This makes the competitive pressures more difficult.

The most difficult aspect of operating in Mainland China for Lever is having to explain to customers that certain issues are hard to address due to regulatory uncertainty and bureaucratic obstacles, while its main regulatory concern is protectionism in the West.

Mr Szeto notes that "there are always new entrants who try to do things cheaper." The regulatory issue that most troubles Mr Szeto, however, is protectionism in the West. He comments that the quota system was protectionist in nature and that with its abolition, and with China's accession to the WTO, the world seems generally to be heading towards freer trade.

¹³⁶ www.leverstyle.com.

¹³⁷ www.hktdc.com.

¹³⁸ www.hktdc.com.

Company Strategy

Mr Szeto admits that he “doesn’t have a crystal ball”. This means that the uncertainty brought on by the various business challenges confronting Lever Style must be dealt with proactively by having strategies in place to fit the business environment.

Lever Style has responded to cost pressure by reengineering its processes to be leaner, more flexible, and more efficient. Lever Style’s move into China in the early 1980s, long before many other Hong Kong firms, meant that when branded garment retailers and brand owners from outside markets came to Mainland China looking for manufacturers, Lever Style already had a track-record in China most Hong Kong garment manufacturers did not. More recently, Lever Style has tried to avoid fiercely competitive segments such as low-value mass produced unbranded garments. According to Mr Szeto, “We don’t compete based on price. We compete based on our servicing, on our product development capability, on our reliability and on our reputation. We use those things to differentiate ourselves from the guys who grab a hundred workers and start in the business in the hope of making it. Those people are always going to exist, but the customers that we work with may not have confidence on somebody like that.”

Central to Lever Style’s approach is differentiation through a combination of offering value-added services, providing superior service across all activities that the company performs, being responsive to customer needs, and by maintaining an excellent company reputation. Mr Szeto cites the relationship with Country Road, a company that used to simply tell Lever Style to buy a particular fabric from an Italian mill, buy other garment components from a Japanese supplier, and then “just stitch the garment for us.” These days, Lever Style proposes both designs and fabrics to Country Road and sources the fabrics that Lever Style thinks will suit their customer. Lever Style is involved in ODM rather than just OEM and there is deep cooperation between the two companies.

The company is selective in choosing customers, targeting high volume business and seeking to grow as its customers grow. This often means turning away potential business that is small in scale and piecemeal. This is something that many firms are reluctant to do, particularly when they have spare capacity, but as Mr Szeto notes, spare capacity is an asset that once given away is harder to fill with other high-value adding orders. Low-value, patchy, and unpredictable orders are a distraction that Lever Style attempts to avoid. Lever Style has made some strategic acquisitions and it now runs a multi-product operation that allows it to cross-sell its products. For example, the company used to sell only shirts to Banana Republic, but it now also sells them suits. Mr Szeto notes that Lever Style’s “multi-product capability” has helped it to generate more sales with its existing customers.

Not all initiatives have succeeded. In the 1990s the company set up a branded retail division and licensed several low-end American brands. At the time, it was thought that higher margins could be made through retailing company-owned brands. Initially, the strategy worked and the company made decent profits, but in the late 90s, the division started to suffer significant losses. It was clear that retailing in Hong Kong and in China was going to become even more competitive and that the company did not have the skills or the knowledge to compete in that part of the industry. Lever Style got out of the business and is not looking to take on a similar challenge in the foreseeable future as it sees no natural synergy at an operating level between manufacturing and branding and retail.

Ensuring that the company has a diversified customer base was key in managing during the recent economic downturn. With this in place, Lever Style decided not to aggressively pursue new markets during the downturn but rather to focus on existing markets that were stable and to seek out developing them further for the time being. Lever Style is already well-known in its market. The company does not participate in trade fairs. The space that the company occupies is relatively small

and potential customers know of Lever Style and its capabilities. Mr Szeto believes that as long as the company continues to act and think progressively and operate efficiently then new customers are likely to be attracted over time and deeper working relationships with existing customers will also result.

The fragmented nature of the garment industry and Lever's focused strategy means that the company does not actively monitor its competitors. Instead, it looks to learn from other companies. Mr Szeto states that Lever Style "tracks other companies not because they are competitors, but so we might see where they are doing well and learn from them." Lever has adopted Toyota production methods with its focus on designing out overburden, reducing inconsistency, eliminating waste, inventory management, and Just-in-Time (JIT) delivery.

Lever tries to remain environmentally and socially conscious. In addition to being careful to follow all appropriate laws and rules, in 2006 Lever Style became one of the first apparel manufacturers in China to be certified for SA8000, one of world's strictest social responsibility standards. The company has also obtained ISO 9001:2000 certification, as well as being certified by third party compliance audit firms such as CSCC and ITS. In an environment in which pollution and sustainability issues are increasingly in the spotlight, having a reputation for environmental sustainability may lead companies to do business with Lever Style. Mr Szeto notes that "being sustainable doesn't necessarily cost money in order to save money. It is not like that you have to spend millions of dollars to be sustainable, and being environmentally conscious gives a reputational bump. We would rather be known as a company that is environmentally conscious than as a polluter." External recognition of Lever Style's commitment to the environment came when the firm's factory in Shenzhen was chosen as one of three pilot factories in the Pearl River Delta that was selected to run a WWF low carbon manufacturing programme.

Over the years, Mr Szeto has restructured the family owned business into more of a "modern competitive company." This involved professionalising its leadership and management teams, and by encouraging a flatter management style to permit more direct and efficient communication, and more autonomous decision making. Mr Szeto believes that knowing his strengths and leaving it to others to do the things that he is not particularly good at has played an important role in Lever Style's success. Mr Szeto has strong strategic skills, but others have excellent production skills and day-to-day management skills and he leaves these activities to them as much as possible. This frees up his time to add value where his time is best spent.

The company's growth is evidence of its success in dealing with competitive pressures. Five years ago Lever Style was approximately half its current size. Mr Szeto benchmarks against the best, however, and notes that the company is not yet growing as quickly as Li and Fung which has doubled in size every three years in the past two decades.

Future Plans

Mr Szeto is bullish on opportunities in the industry saying that "people will always need to buy clothes. There are sunset companies but this is not a sunset industry." With this mindset, Lever Style plans to try and double in size every few years and achieve at least double-digit growth annually. If all goes to plan, Mr Szeto hopes that Lever Style will be big enough to consider becoming a publicly listed company in a few years. Achieving this would put the company in a stronger position to continue its growth by using its equity to make strategic acquisitions.

In the long-run Lever Style plans to develop production capability outside of Mainland China, but it may do so by working with partner companies rather than “going it alone.” The idea would be to continue doing the high value-adding work in design, sourcing, and other services, and to subcontract the labour intensive work to companies in Bangladesh or Vietnam, for example. For now, there are plans to open a modern manufacturing facility in Huizhou, Guangdong Province in late 2010, with the prospect of producing 10 million garments annually and employing 8,000 workers,¹³⁹ with a further overseas customer service office to be set up in London.

Mr Szeto is keen for the company to be recognised for doing things a little differently, for doing things in a better and more creative way. He cites role model companies as being Li and Fung in the garment industry and Dell in terms of changing a business model in a “revolutionary way.”

Lessons from the Lever Style Case

There are a number of lessons that can be learned from the Lever Style case.

- It is important for firms to play to their strengths and for owner-managers to do the same. With professional management in the firm, owner-operators can do the tasks that play to their strengths and leave other tasks to others.
- SMEs can successfully undergo generational change as long as succession issues are addressed at the right time.
- To understand where the firm is comparatively weak, the firm should benchmark against the best firms in the industry and to look at what the outside world is doing.
- SMEs can benchmark aspects of their business against leading firms from other industries and can incorporate processes and systems that work in other industries where possible.
- Firms should accept that uncertainty will always exist and they should not be constrained by it. Growth can and does occur in uncertain environments. What is important is that there are strategies to deal with uncertainty by engaging in scenario planning and in forward thinking.
- Companies need to continually adapt to their environment and not keep unthinkingly doing the things that worked for them in the past. Wishing that things would be different won't change the environment. Adapting is the only way to prosper long-term.
- Costs should be reduced to the extent that this is possible, but most SMEs will not have the scale or the financial firepower to compete with larger firms on a cost leadership basis. Thus they also need to consider differentiation strategies.
- SMEs can avoid fierce competition by choosing to do business in segments that have less direct competition. Firms need to identify and focus on value drivers that will insulate them from purely price competition. For most Hong Kong SMEs, this will mean focusing on creativity, innovation, continuous improvement, flexibility, and reduction in lead-times. Being smaller and more nimble, SMEs can often carve out advantages in these areas.
- SMEs in the sector should look to add value to their customers by extending their operations to include ODM and OBM if they have the capability to do so. Firms that are able to offer their customers a wider range of services including design, material sourcing, manufacturing, delivery, customer service, and after-sales service are likely to be more attractive.
- Doing ODM is likely to be simpler than doing OBM. Building a brand takes a lot of time and is expensive.
- If the firm is able to integrate some of its activities or processes with its customers, then the customers are unlikely to give their business to another firm. Such integration requires regular communication to understand the needs of the customer and to coordinate activities.
- It is important to choose the right customers and to not just accept any order that is offered to the firm. Companies should target customers that

are likely to yield them profits and look to grow alongside their customers.

- Building a customer base that is diversified but that places large and regular orders to create scale effects, and which will enable the possible cross-selling of other products, will create significant upside while reducing risk.
- Following the abolition of quotas, diversification through the manufacture of multiple products is a more viable option for firms in the sector. Firms that pursue such a strategy will likely already possess many of the capabilities they need to succeed.
- A reputation for reliability and having a good reputation in general are vital to SMEs. Doing business with firms with poor or uncertain reputations is just too risky a strategy for many global customers, who are judged not just on profits, but also on the labour and environmental practices of their suppliers. Further, the firm will need to communicate its positive reputation in convincing ways, because customers may not take the time to do sufficient due diligence themselves when they have other known low-risk options.
- Firms in the garment sector should invest in staff recruitment and retention policies as much of the value in the industry is added through having the right people (or destroyed by not having the right people).
- Success in the industry is dependent on identifying and understanding trends in fashion and producing to cater to that demand more so than it is on an ability to blindly mass produce. Managers who are in touch with the trends and who have foresight regarding the industry are a significant asset.
- When in markets that require flexibility, firms should be careful not to overinvest in inflexible automation that is geared toward mass production of goods that may not find a timely market.

THE MOULD AND DIE INDUSTRY

Moulds and dies are used to turn metal, plastics, glass, rubber, and other source materials into standardised components. Moulds and dies are therefore important to a very wide range of industries including plastics, hardware, electric equipment, toys, home appliances, watches and clocks, auto parts, communication equipment, office instruments, optical instruments, consumer electronics, and other products.¹⁴⁰ The mould and die sector is dominated mostly by firms from developed countries including Japan, Germany, the US, and Italy. China is the only developing country that has a strong presence in the sector. The developed countries lead the sector in technology.

Hong Kong's mould and die industry started with a world-level production system borrowed from the US.¹⁴¹ Hong Kong firms have been gaining competitive strength since the 1980s when they started to move their production facilities to Guangdong. Today they have the capacity to produce world quality moulds and dies at a moderate price. The mould and die industry in Guangdong developed mainly as a result of investment by Hong Kong firms. An estimate for 2003 shows that there were over 10,000 Hong Kong invested firms in the PRD producing moulds and dies employing about 81,000 Hong Kong staff.¹⁴² Hong Kong firms currently lead their Mainland competitors in expertise and technology, but the gap has been closing. Chinese firms often target experienced engineers and technicians from foreign-invested firms to improve their knowledge and competitiveness.

140 Hong Kong Mould & Die Council and Hong Kong Productivity Council, Survey Report on Technician Demand in the Mould and Die Sector, 2005.

141 Interview with Hong Kong Mould & Die Council, 9 April 2010.

142 Hong Kong Mould & Die Council and Hong Kong Productivity Council, Survey Report on Technician Demand in the Mould and Die Sector, 2005.

Industry players are confident that the Chinese Mainland market will keep growing and they see strong opportunities in the automobile, machinery, and electronic industries.¹⁴³ For instance, to produce one model of car requires 1,500 mould and die sets.¹⁴⁴ With China selling 13.64 million motor vehicles in 2009 alone,¹⁴⁵ this is a large and growing market. This should provide ample opportunity for Hong Kong companies that can find the right niches going forward. However, Hong Kong's position in this industry is one that could come under significant competitive threat even as market opportunities expand.

143 Interview with Hong Kong Mould & Die Council, 9 April 2010.

144 Advertising page, Hong Kong Mould & Die Council Annual Report 2009.

145 Report on the Work of the Government 2010, Wen Jiabao, delivered at the Third Session of the Eleventh National People's Congress on 5 March 2010.

146 Hong Kong Census and Statistics Department data on "Machinery, equipment, apparatus, parts and components, n.e.c", 2009.

147 Hong Kong Census and Statistics Department, Hong Kong Merchandise Trade Statistics 2009, Domestic Exports and Re-exports, Trade category UN SITC rev.3 code 7491 – Moulding boxes for metal foundry; mould bases; moulding patterns; moulds for metal (other than ingot moulds), metal carbides, glass, mineral materials, rubber or plastics.

Basic Facts about the Industry

The Gross Industrial Output (GIO) for Hong Kong was HK\$5.4 billion in 2008 for the "Machinery, equipment, apparatus parts and components" sector which includes moulds and dies. There were 5,591 employees in the sector in Hong Kong with an estimated average annual wage of HK\$156,680. Wages were approximately 20 per cent of total costs for the sector.¹⁴⁶ Wages for the sector in Hong Kong are five times those for the sector in China as a whole. This is likely explained by general wage disparities between Hong Kong and China, the employment of more senior staff in Hong Kong, and the fact that higher value end products are produced in Hong Kong with corresponding higher quality and more costly labour inputs.

Hong Kong's total domestic exports for moulds and dies in 2009 were HK\$188 million, a 13 per cent decrease from the previous year. Re-exports from Hong Kong were HK\$2.9 billion or 0.12 per cent of total re-exports. No data is available for Mainland China based processing and non-processing trade companies.¹⁴⁷ Japan was the world's largest mould and die exporter from 1991 to 2008, while China has been among the top three since 2007. The largest importers of moulds and dies are the US, China, and Mexico.

Exhibit 45. Average Monthly Wages for the Sector in RMB

Region	Average Monthly Wages
Hong Kong	11,489
YRD	1,881
PRD	2,439
China	2,200

Source: Foshan, Dongguan, Shenzhen, Huizhou, Taizhou (JS), Nantong, Shaoxing, and Jiaxing City Statistical Yearbooks, 2009, China Statistical Yearbook, 2009.

Exhibit 46. Top Mould and Die Exporters in the World and Hong Kong, US\$ millions

2007		2008		2009	
Exporter	Value	Exporter	Value	Exporter	Value
Japan	1,821	Japan	1,969	Japan	-
Italy	1,389	China	1,850	China	1,769
China	1,344	Germany	1,404	Germany	1,132
Germany	1,253	Italy	1,274	Italy	1,094
Korea	951	Korea	1,053	US	940
Hong Kong	452	Hong Kong	467	Hong Kong	411

Source: UN Commodity Trade Statistics Database 2007-2009, Trade category UN SITC rev.3 code 7491 – Moulding boxes for metal foundry; mould bases; moulding patterns; moulds for metal (other than ingot moulds), metal carbides, glass, mineral materials, rubber or plastics.

Exhibit 47. Top Mould and Die Importers in the World and Hong Kong, US\$ millions

2007		2008		2009	
Importer	Value	Importer	Value	Importer	Value
US	1,593	US	1,533	Mainland China	1,210
Mainland China	1,288	Mainland China	1,442	Mexico	1,143
Mexico	1,061	Mexico	1,212	US	1,141
Germany	694	Germany	841	Germany	735
Japan	670	Japan	724	Japan	-
Hong Kong	406	Hong Kong	454	Hong Kong	414

Sources: UN Commodity Trade Statistics Database 2009, Trade category UN SITC rev.3 code 7491.

Exhibit 48. Mould and Die Exports from Hong Kong, HK\$ millions

Region	2007		2008		2009	
	Value	Y-o-Y Change (%)	Value	Y-o-Y Change (%)	Value	Y-o-Y Change (%)
World	3,523	1.3	3,635	3.0	3,187	-12.3
Mainland China	1,486	-10.0	1,376	-7.4	1,294	-6.0
US	420	-5.1	460	9.6	351	-23.8
Vietnam	194	135.0	154	-20.8	219	42.6
Germany	144	42.05	199	38.2	172	-13.8

Notes: The major trade partners are based on the ranking in 2009.

Source: UN Commodity Trade Statistics Database 2006-2009, Trade category UN SITC rev.3 code 7491.

Exhibit 49. Mould and Die Imports to Hong Kong, HK\$ millions

Region	2007		2008		2009	
	Value	Y-o-Y Change (%)	Value	Y-o-Y Change (%)	Value	Y-o-Y Change (%)
World	3,164	-0.9	3,534	11.7	3,213	-9.1
Mainland China	2,116	9.9	2,516	18.9	2,385	-5.2
Japan	442	-27.8	488	10.4	384	-21.3
US	64	-28.6	70	10.1	110	57.5
Korea	190	84.5	158	-16.6	71	-55.5

Source: UN Commodity Trade Statistics Database 2006-2009, Trade category UN SITC rev.3 code 7491.

Exhibit 50. The Mould and Die Sector of Top Three Provinces (January-November 2008)

	Establishments		Employment		GIO	
	Value	Percentage (%)	Value	Percentage (%)	Value (RMB billion)	Percentage (%)
China	1,932	100.0	348,065	100.0	90.87	100.0
Guangdong	456	23.6	126,025	36.2	26.23	28.9
Jiangsu	302	15.6	43,112	12.4	20.64	22.7
Zhejiang	379	19.6	81,624	23.5	10.41	11.5

Notes: Figures are of state-owned enterprises and non-state-owned enterprises with annual sales of RMB 5 million. Figures are preliminary.

Sources: National Bureau of Statistics of China; China Mechanical Electrical Data Online.

In recent years, China has grown into a major producer in the sector. In 2009, in the absence of Japan's statistics, China reported higher imports and exports for moulds and dies than any other country, with exports of US\$1.7 billion and imports of US\$1.2 billion.¹⁴⁸ The Pearl River Delta and Yangtze River Delta regions accounted for two thirds of China's total mould and die output in 2007.¹⁴⁹ The largest producer, exporter, and importer of mould and die products in China is Guangdong. In 2009, Guangdong exported US\$756 million of moulds and dies, 42 per cent of China's total, and imported US\$368 million moulds and dies, 19 per cent of China's total.¹⁵⁰

Domestic and export sales of mould and die products for Mainland China grew at an annual rate of 20 per cent from 2000 to 2007,¹⁵¹ but growth slowed in 2008 to 2009 as a result of the global financial crisis. Sales in 2009 totalled RMB 100 billion,¹⁵² but sales in the first four months of 2010 reached just under RMB 100 billion.¹⁵³ The domestic market is approximately seven times the size of the export market.

Issues for Hong Kong Mould and Die Manufacturers

Hong Kong owned mould and die firms that manufacture in the Chinese Mainland have advantages in marketing, in implementing international business practices, and in maintaining good customer relationships over the long term versus Mainland competitors. They also tend to be more flexible, make decisions faster, be quicker to adopt new and suitable technologies, and respond to market changes rapidly. However, Hong Kong owned firms that manufacture in the Mainland have relatively high costs, are less aggressive than Mainland Chinese firms, and find it harder to obtain financing in the Mainland than their Chinese peers.

Buyers in the mould and die industry are highly price sensitive and competition from Mainland China owned mould and die companies has intensified. The global financial crisis affected Hong Kong mould and die firms supplying traditional export sectors like toys, home appliances, electronics, and computer peripherals.¹⁵⁴ With lower exports in these markets, mould and die firms were put

148 UN Commodity Trade Statistics Database, category 7491 (SITC.3). comtrade.un.org.

149 www.cdmia.com.cn.

150 Trade statistics the mould and die sector for individual provinces of China may not all fall exactly into the UN SITC category of 7491 due to anomalies in the compiling of China's statistics.

151 "Current status and development trend for China Mould and Die industry", Speech delivered by Cao Yan'an, Executive Vice President of China's Mould and Die Council, on International Mould Exhibition in Frankfurt, 2007. www.cdmia.com.cn.

152 www.mymould.net.cn.

153 News from the thirteenth China International Mould Technology and Equipment Exhibition, 2010. www.mjcy.ibicn.com.

154 Introduction of Hong Kong Mould & Die Council, www.industryhk.org.

under pressure to reduce prices. During the worst period in 2009, demand fell by 40 to 45 per cent from its peak. By 2010, prices were around 20 per cent lower than the peak and profit margins for larger companies down from 12 per cent to five per cent. Firms that were small, could not offer special technological advantages, or offer a niche product, were more vulnerable to the downturn and many closed down.

Growth in the sector is becoming more difficult for Hong Kong SMEs because they are less likely to receive the sort of capital allocations that are being given to Mainland China companies. Often large investments of up to RMB 100 million are made into Mainland China companies. Several of the large Chinese mould and die companies have acquired advanced equipment and technologies from Germany, Japan, and the US, that has given them the capability to develop high quality moulds. These companies are encroaching on the market share held by Hong Kong owned mould and die companies.

Since the mould and die industry is less labour-intensive than many other industries in the Pearl River Delta, it is less vulnerable to labour cost increases and costs associated with administering the Labour Contract Law than in many other industries.¹⁵⁵ However, the industry uses specialised labour in the form of highly trained technicians and this category of labour is often in short supply. Hong Kong firms find that their Mainland Chinese personnel sometimes leave to start their own companies once they have received sufficient training. This creates additional competitive pressure.¹⁵⁶

Local protectionism in Mainland China is an important issue affecting Hong Kong mould and die companies. The mould and die industry is the basis of the machinery sector, providing essential products to its downstream industries. In order to develop their own industries, many Chinese provinces treat the mould and die industry as a strategic industry and offer favourable policies to support and develop indigenous companies. YRD

governments have been particularly aggressive in their attempts to compete with the PRD and this is having a significant impact on Hong Kong owned companies. The Guangdong Government also offers favourable policies to local mould and die companies, but applies stricter criteria when assessing the eligibility of firms that are not fully owned by Mainland interests, so companies from Hong Kong lose out both ways.

The Central Government has implemented a two-year plan (2009-2011) for restructuring and revitalising 10 key industries. This may result in an increase in demand for mould and die products, which would improve the long-term potential of the sector. The Guangdong Government has tabled its own restructuring and revitalisation plans for 11 key industries. The plan for the equipment manufacturing industry¹⁵⁷ will have the greatest direct impact on the mould and die sector and is designed to encourage its development so as to support other industries that have been identified as value-adding.

It is further expected that the time extension of the "Home appliance and motor vehicles to the countryside" and the "Motor vehicle and home appliance replacement" policies will boost the sales growth of motor vehicles and home appliances in 2010.¹⁵⁸ In 2009 alone, the Central Government provided RMB 45 billion in subsidies for vehicle and appliance trade-ins and for rural residents to purchase home appliances and motor vehicles, including motorbikes.¹⁵⁹

155 China Statistical Yearbook 2009, calculated ratio of GIO to Employment.

156 Interview with Hong Kong Mould & Die Council, 9 April 2010.

157 "Opinion on Implementing the Plan for Restructuring and Invigorating Guangdong's Equipment Manufacturing Industry," Yuefuban [2009] no 121, 10 November 2009.

158 The "Vehicles to the Countryside" policy has been extended until 31 December 2010 and the "Motorcycles to the Countryside" policy until 31 January 2013. The current "Home appliance replacement" policy has been extended until 31 December 2011.

159 Report on the Work of the Government 2010, Wen Jiabao, delivered at the Third Session of the Eleventh National People's Congress on 5 March 2010.

The mould and die sector is not limited by any export processing restrictions, it is also not likely that suppliers to the sector are limited because the restricted categories cover processed metals and not the raw unprocessed metals that are used in mould and die production. In July 2010, export rebates on 406 products including key steel products, and semi-finished nonferrous metals were eliminated. Steel is a key input for mould and die sector. In June 2010, the State Council announced a restructuring of the industry by closing smaller less efficient plants, consolidating towards larger plants, and upgrading the production and energy efficiency of the plants. These moves may have a short-term impact on supply for the mould and die sector.

Policy support for the industry as well as increased overall need for mould and die operations has led some large customer companies to set up their own mould and die shops. The nature of the industry is that many customers are large, have sufficient internal demand, are financially secure, and can obtain the capital needed to take mould and die manufacturing in-house. Consequently, a number of firms in the sector have seen orders from longstanding customers go to nil in a relatively short period of time.

Response Strategies of Hong Kong SMEs

Larger companies that survived the global financial crisis scaled back new product launches and focused more on maintaining and improving the quality of their existing product range.¹⁶⁰

One response to lower operating margins has been to improve efficiency through the use of innovative technology or automation that will bring about long-term efficiencies and cost reductions

Another approach has been to identify attributes that customers value enough to justify a price premium such as new product features, creative designs, or faster response times. In this way, the Hong Kong firms are playing to their advantages of modern equipment, advanced technology, good design, tightly controlled production, and strict quality control.

Some Hong Kong firms are differentiating on the basis of technology, which requires significant investment that might be challenging for Hong Kong's SMEs given their small size. However, it appears that in this sector companies which focus on research and development, technology adoption, and innovation to the extent that they are able may face the best prospects of doing well in the future. Some firms are investing a proportion of their revenues into ongoing research and development, while others have formed joint-venture partnerships or entered into other business arrangements with technology providers that keep them at the front of advances in manufacturing technology.

To combat the problem of obtaining sufficient capital, Hong Kong SMEs in the sector have made efforts to communicate their advantages to investors from the region or from overseas. For global investors, these advantages go beyond those already mentioned to include an ability to better communicate in English, as well as better social and physical infrastructure that attract potential foreign-firm investors during their visits to the PRD via Hong Kong. Firms in the sector have also taken to partnering with firms in the Chinese Mainland to tap into the funds that those firms can access.

Hong Kong firms have been limiting the number of employees they have outside low-cost environments to try to maintain cost parity with Mainland firms. Moving to the YRD is also a strategy that Hong Kong firms in the sector are considering in order to obtain workers they need and to compete against other lower cost manufacturers who operate in the YRD.

¹⁶⁰ Interview with Hong Kong Mould and Die Council, 9 April 2010.

Some Hong Kong firms are finding ways to partner with customers to ensure their customers do not establish in-house mould and die activities. There are several ways in which this type of deep collaboration could take place with the main points for agreement being which firm takes on the capital risk by investing in the equipment, and what guarantees are put in place to ensure that outsourcing remains more beneficial to the customer than bringing the mould and die activities under its own control. Deeper collaboration that does not involve in-house manufacturing is also being achieved by locating next to the factories of major customers.

Hong Kong firms are responding to protectionism in China by lobbying, but this is being done with an understanding that little is likely to be achieved. Some Hong Kong mould and die manufacturers hope to overcome possible policy bias by demonstrating that due to their experience, managerial capabilities, and capacity to innovate, they have more value to add to the industry than indigenous firms, and to underscore the belief that they are important to the downstream activities that remain attractive to provincial governments in China.

Case Study – Datamatic CNC Engineering Company Limited

Established in 1983, Datamatic CNC Engineering Company Limited (Datamatic) is a mould and die manufacturing company headquartered in Hong Kong. After a few of years of sub-contracting CNC jobs, Datamatic acquired the International Mould Factory Company Limited in 1985 to provide complete sets of injection moulds. Datamatic commenced business with five employees and the company now has approximately 190 employees with all except six being located in the Chinese Mainland.

In 1995, Datamatic shifted its production from Hong Kong to the PRD where it set up a Sino-Hong Kong joint venture named Datamatic Guangzhou Injection Mould Company Limited (Datamatic Guangzhou). The joint venture built a workshop of 3,000 square metres in Guangzhou to provide turnkey mould making and pilot moulding solutions. In 2005, Datamatic Guangzhou expanded its workshop and installed an advanced moulding machine. At first, Datamatic relocated all of its manufacturing but kept its engineering activities in Hong Kong. After about two to three years, Datamatic moved its engineering activities to Guangzhou as well. These days, Hong Kong acts as a liaison office and takes care of the coordination and planning of activities such as marketing and shipping.

When Datamatic first moved to China business was slow. To try and develop new business, Datamatic engaged in marketing and promotion activities in major potential customer markets. This involved doing exhibitions, sending company catalogues out, ensuring that the website was up-to-date, and a range of similar activities. At one of the exhibitions a German company making automotive lighting (Hella) placed a trial order with Datamatic. The firm took the trial order very seriously, the order went very well, and Datamatic got a foothold in the automotive lighting industry, an industry that has become its main market.

Datamatic sells its products all over the world with major markets in China, the US, France, Germany, Spain, Mexico, and Brazil. Its major direct clients are car component manufacturers such as Hella, Valeo, AL, Decoma, CML, ARTEB, Stanley, and Koito. Approximately 50 per cent of Datamatic's production stays in the Chinese Mainland and the other 50 per cent is shipped to other places.

Issues and Challenges

Dealing with cost-driven competition from Mainland China owned mould and die companies is one of Datamatic's major challenges. Steadily decreasing prices for mould and die manufacturing is a further challenge for Datamatic. Although the turnover in the mould and die industry in Mainland China is increasing, average product prices are dropping.

The industry is relatively capital intensive and the technology used in the industry is fast evolving, meaning that regular investments in technology must be made. Smaller firms like Datamatic face relatively large costs if they try to pioneer new technology.

There is a shortage of skilled technicians for the sector in the PRD. The entry and growth of firms from the Chinese Mainland has increased demand for trained engineers and technicians. Many Datamatic employees have been offered attractive packages by Chinese firms and a number have left to start companies of their own.

China's regulatory environment is viewed as more onerous than Hong Kong's. Performing routine tasks in China takes far longer than it takes in more developed and less heavily regulated markets. However, the actions taken by the Chinese Government occasionally work in Datamatic's favour. For instance, when Datamatic moved to Guangzhou in the 1990s the company was given a tax holiday on company tax for three years at half-tax and for two years entirely free of tax.

Early on, Datamatic met with a significant challenge when its partner in the Mainland did not buy nearly as much from Datamatic as was initially projected. Datamatic had already invested in additional staff and facilities with the expectation that significant internal demand from within the group of companies controlled by the Mainland Chinese partner would be forthcoming. When this did not occur, Datamatic had to reassess its business aspirations and accept several loss-making years.

Company Strategy

Datamatic's key response to its various challenges has been to focus on developing a niche market in automobile lens moulds. This niche feeds into the automobile market in the Chinese Mainland, a market that is projected to grow rapidly. Presently the niche strategy is paying off and approximately 95 per cent Datamatic's sales are related to automotive lighting. Being a smaller and more nimble operator allows Datamatic to be more flexible, to make decisions faster, to more quickly adopt new and suitable technologies, and to rapidly respond to market changes. This enables Datamatic to create advantages that are hard for the large Mainland owned mould and die manufacturers to match.

Datamatic's focus is to continuously improve its operations and its business step-by-step. Being a smaller operator the company does not have the money to spend to make quantum leaps in the development of technology, but it makes targeted investments in research and development to keep the company at the leading edge of technology and to improve the precision and efficiency of its operations. It also applies new affordable technology developed by others. For example, Datamatic was the first company in Hong Kong that provided Computer Number Control (CNC), Electrical Discharge Machining (EDM), Wire-EDM, and CNC services. Datamatic was one of the first to start to fully computerise its equipment in 1988. Datamatic regularly teams up with professional organisations such as the Hong Kong Productivity Council) and strategic partners to explore more business and technology advancement. Datamatic also takes part in activities that are organised by the Hong Kong Mould & Die Council to get the latest industry information which it then uses to make continuous improvements to its business.

Datamatic has worked hard to develop a good reputation and a good client network. Through these assets, Datamatic has advantages over Mainland China owned competitors in obtaining business, in implementing international business practices, and in maintaining good customer relationships over the long-term.

Datamatic moved into China to follow major clients who began setting up significant manufacturing operations in the PRD. The company identified a possible partner in Guangzhou and formed a joint venture in 1995. This helped reduce land and labour costs and improved access to labour. Datamatic has found that workers from Guangzhou are less likely leave the company and set up as competitors than workers who come from other parts of China. Knowing them to be more stable, Datamatic targets workers from Guangzhou. Increasingly however, Datamatic is finding that it is difficult to attract workers from Guangzhou. In recent times, this means that Datamatic has had to look to recruit staff from the Northern part of China.

The company knows that its staff make the decisions and take the actions that will help it remain competitive. This means that the staff have to be well trained so that they are capable of making decisions and taking action as required. To this end, Datamatic has in collaboration with several universities implemented a number of training and educational programmes aimed at developing its staff.

Quality accreditation is important to Datamatic as a signal to its customers that the company is committed to quality, and as a means of driving internal improvements. Datamatic has ISO 9001:2000 accreditation and has adopted elements of ISO 16949 in its manufacturing system. The company has also instituted a Quality Improvement Committee to help review and improve product standards. Datamatic has received an "Operation Excellence Award" as well as awards for "mould design" several times from the Hong Kong Mould & Die Council.

Datamatic does no direct marketing these days, because it operates in a niche market in which all the key players in the industry know one another. The number of major clients is "less than ten" and the number of firms that Datamatic counts as serious competitors globally in its niche is between 10 and 15 companies. Datamatic has a smaller capital base than all the companies it considers competitors. If competition was based purely on financial strength rather than on other factors like quality, innovation, and reliability, then Datamatic would have to fight hard to survive.

The General Manager of Datamatic, Mr Leton Lee, thinks that the most important element of success is being aware of changes in market, changes in technology, changes in business environment, fundamental changes to the industry, and change in general. Companies have to learn how to manage change and how to respond quickly to shifts in the factors that affect the business. Datamatic has adapted to the need to deal with change by finding an "optimum size" and sticking to it. Datamatic's business is set up to afford maximum flexibility. The production line, in particular, is designed to be as compact as possible to enable Datamatic to be more flexible and responsive to client needs.

Future Plans

Datamatic plans to maintain stable and steady growth into the future and does not intend doing anything "too aggressive." This translates into expectations of revenue growth of around five per cent each year for the coming five years, greater than five per cent increases in profit, and double digit salary increases for staff.

The company will invest in research and development, concentrating particularly on the development of new manufacturing methodology and on improved machine facilities. Datamatic plans to install more new facilities and more high-end milling machines. The investment pattern during the last few years has been to reinvest a percentage of company sales revenue into research and development and the establishment of new facilities. This practice will continue into the future since the old machines depreciate fast and the technology changes fast.

Datamatic is considering setting up a subsidiary in the YRD to support its clients in that part of China. The company does not envision moving manufacturing wholesale to the YRD, but it can see the merit in considering expanding into the YRD so as to have a presence there alongside major clients. Datamatic does not plan to manufacture outside of China. The company is optimistic about the Chinese automobile market and about the opportunities for growth in its niche. Datamatic enlarged the size of its plant in 2005 and purchased more equipment. These changes allow for further product diversification which will make Datamatic more competitive. The Company plans stay at the forefront of advances in technology and it will continue to focus on manufacturing high-end products for automobile lighting components.

Datamatic aims to be a sustainable manufacturer and to maintain a harmonious relationship with the communities in which it operates. The company is committed to environmental protection so as to provide for a better future for all people and to this end it has invested in a waste recycling system to reduce pollution and to be able to claim status as an environmentally friendly firm.

Lessons from the Datamatic Case

There are a number of lessons that can be learned from the Datamatic case.

- Firms in the sector need to learn to expect and anticipate changes in market, technology, and business environment, and be ready to adapt quickly in the ways that are needed to survive.
- Hong Kong firms must demonstrate their value to customers that are considering taking their mould and die work in-house by emphasising the advantages that accompany sourcing externally, the expertise that a specialist company can provide, a willingness to better understand and anticipate customer needs, and opportunities to engage in forms of business collaboration.
- Firms should diversify customer risk by developing relationships with more multiple customers in multiple geographic markets and in multiple industries.
- Hong Kong firms operating in the PRD face higher materials costs than many of their Mainland competitors as well as potential material shortages because non-local companies are required to import some of the critical materials that are used in production.
- Since SMEs in the mould and die industry use specialised labour that can be attracted away by competitors or can leave to set up firms of their own, the SMEs need to have means of attracting and retaining key personnel.
- Firms can combat labour shortages by paying higher wages and offering better conditions and benefits to workers than competing firms.
- SMEs may consider moving their manufacturing operations to other locations, such as the YRD, where competition for skilled workers is less intense at present and where costs are lower in general.
- SMEs should identify and take advantage of incentives and policy measures that are put in place by authorities in Mainland China. These will be different across different locations and will have time-limits. SMEs will need to do their homework to figure out which incentives best suit them.

- Companies that try to compete based purely on financial strength rather than on other factors like quality, innovation, flexibility, and reliability, will have to fight hard to survive
- SMEs should focus on developing a niche market. Being a niche operator allows an SME to be more flexible, to make decisions faster, to more quickly adopt new and suitable technologies, and to rapidly respond to market changes. This creates advantages that are hard for the large Mainland mould and die manufacturers to compete against,
- The mould and die industry is capital intensive and the technology is fast evolving. To remain competitive, firms should consider how they will fund ongoing investments in research and development and facilities.
- Increased environmental and pollution concerns mean that a firm that can claim status as being environmentally friendly is likely to improve its chances of securing business and developing new business relationships.
- SMEs won't have the money to spend to make quantum leaps in the development of technology, but they can be alert to advances in technology and apply new technology when others develop it.
- Quality accreditation is an important signal to customers that the company is committed to quality and is a means of driving internal improvements.

THE TOY INDUSTRY

Hong Kong companies play an extremely important role in the world toy industry. Together, Hong Kong and the Chinese Mainland account for around 75 per cent of global toy manufacturing. Over 70 per cent of the toy manufacturers in China are based in Guangdong Province, mostly in Dongguan, and many of them are Hong Kong companies.¹⁶¹ Hong Kong's toy industry produces a wide variety of products. Hong Kong toy manufacturers have developed deep market, customer, logistics, and production knowledge and have broad networks. Although increasingly challenged by indigenous Chinese enterprises, Hong Kong toy manufacturers distinguish themselves from competitors through their quick responses, efficiency, reliability, and through their compliance with common standards, regulations, intellectual property rights, and codes of practices; the latter features all being critical to securing OEM orders from overseas industry giants who require ethical sourcing practices.

Most Hong Kong toy manufacturers engage in OEM production, mainly in the form of export processing in Guangdong Province. There is, however, a growing trend for Hong Kong toy manufacturers to pursue higher value-added activities like product design, prototype manufacturing, and branding. Several famous brands have been developed by Hong Kong toy manufacturers including Playmates, May Cheong, Silverlit, Toy2R, and Hot Toys.

Industry participants do not expect intense competition from outside of the Chinese Mainland or Hong Kong in the foreseeable future. They reason that India has too much red tape, not enough infrastructure, and a different mindset than the one that is needed to succeed in the toy industry; Vietnam is a late entrant that has not yet accumulated the technical skills to make a wide range of toys; Taiwan and Korea have already moved to higher tech/higher value industries; Thailand and the Philippines lack political and economic stability or supply networks; and Indonesia, Bangladesh, and Sri Lanka would have to start almost from scratch to build a presence in the toy sector. Other locations that were once competitors have been beaten by lower production costs in the Chinese Mainland and by logistics systems, often based in Hong Kong, that link production in China to global markets. Thus the expectation is that Hong Kong and Hong Kong companies will continue to have a strong competitive position, though margins may come increasingly under threat.

Basic Facts about the Industry

The Gross Industrial Output (GIO) for Hong Kong was HK\$151 million in 2008 for the “electrical appliances and houseware and electronic toys” sector which is the only industry line within the toys industry for which recent data is publicly available. Hong Kong employment for electrical appliances and houseware and electronic toys is low with 414 persons employed at an estimated average annual wage of HK\$99,729. Wages were approximately 32 per cent of total costs.¹⁶² Wages for electrical appliances and houseware and electronic toys in Hong Kong are five times those for the sector in

China as a whole. This is likely explained by general wage disparities between Hong Kong and China and the employment of more senior staff in Hong Kong.

Exhibit 51. Average Monthly Wages for the Sector in RMB

Region	Average Monthly Wages
Hong Kong	7,328
YRD	1,567
PRD	1,543
China	1,585

Sources: Foshan, Dongguan, Shenzhen, Huizhou, Taizhou (JS), Nantong, Shaoxing, and Jiaxing City Statistical Yearbooks, 2009, China Statistical Yearbook, 2009.

Total exports of toys, baby carriages, games, and sporting goods from Hong Kong in 2009 were HK\$104.9 billion, or 4.2 per cent of Hong Kong’s total exports. The US and the EU were the two biggest markets for Hong Kong’s toy exports, accounting for 56 per cent of the total. Demand fell in both these markets with the economic downturn that began in late 2008. Hong Kong’s exports into the US fell by 28 per cent in 2009, and those to the European Union fell 10 per cent (Exhibit 52). Re-exports of toys, baby carriages, games, and sporting goods from Hong Kong were HK\$104.7 billion or 4.3 per cent of total re-exports (Exhibit 53). Export processing facilities in the Chinese Mainland accounted for HK\$50.1 billion of this total (Exhibit 54), while Chinese Mainland-based non-processing trade companies accounted for a further HK\$29.4 billion¹⁶³, the balance of the re-exports being for toys from places other than Mainland China. Total domestic exports for this sector in 2009 were HK\$137 million, a 21 per cent decrease from the previous year.

In 2009, imports of toys, baby carriages, games, and sporting goods to Hong Kong were HK\$91.9 billion, or 3.4 per cent of total imports. The Chinese Mainland accounted for 83 per cent of the imports, followed by Japan, the United States, and Taiwan (Exhibit 55).

¹⁶² Hong Kong Census and Statistics Department data on “Electrical appliances and houseware and electronic toys,” 2009.

¹⁶³ Hong Kong Census and Statistics Department.

Exhibit 52. Exports of Toys, Baby Carriages, Games, and Sporting Goods from Hong Kong, HK\$ millions

Destination	2007		2008		2009	
	Value	Y-o-Y Change	Value	Y-o-Y Change	Value	Y-o-Y Change
World	109,924	20.8%	120,078	9.2%	104,914	-12.6%
US	33,545	4.1%	34,402	2.6%	24,783	-28.0%
EU	30,094	20.9%	37,402	24.3%	33,561	-10.3%
Japan	9,257	-8.9%	8,254	-10.8%	9,063	9.8%

Note: Trade category UN SITC rev.4 code 894 - baby carriages, toys, games, and sporting goods.

Source: Hong Kong Census and Statistics Department.

Exhibit 53. Toys, Baby Carriages, Games, and Sporting Goods Re-exported from Hong Kong, HK\$ millions

Total	2007		2008		2009	
	Value	Y-o-Y Growth	Value	Y-o-Y Growth	Value	Y-o-Y Growth
World	109,711	20.9%	119,875	9.3%	104,756	-12.6%

Source: Hong Kong Census and Statistics Department.

Exhibit 54. Chinese Mainland Process Industry Toys, Baby Carriages, Games, and Sporting Goods Re-exported from Hong Kong, HK\$ millions

Toys, Baby Carriages, Games, and Sporting Goods Re-export of Processing Products Manufactured in the Chinese Mainland	2006	2007	2008	2009
Value	62,046	70,682	66,595	50,184

Source: Hong Kong Census and Statistics Department.

Exhibit 55. Imports of Toys, Baby Carriages, Games, and Sporting Goods to Hong Kong, HK\$ millions

Origin	2007		2008		2009	
	Value	Y-o-Y Change	Value	Y-o-Y Change	Value	Y-o-Y Change
World	95,651	21.2%	109,477	14.5%	91,980	-16.0%
Chinese Mainland	74,940	27.7%	91,150	21.6%	76,334	-16.3%
Japan	14,568	-6.4%	11,817	-18.9%	9,754	-17.5%
US	1,822	49.8%	2,043	12.1%	1,675	-18.0%
Taiwan	931	-7.8%	746	-19.9%	586	-21.4%

Source: Hong Kong Census and Statistics Department.

Issues for Hong Kong Toy Manufacturers

Similar to other Hong Kong manufacturers in the PRD, Hong Kong toy companies also face challenges from changes in markets, powerful buyers and license holders, increasing competition, and increased costs associated with rising wage rates and input costs, the appreciation of the RMB, the implementation of the Labour Contract Law, and shifts in policies on export processing. In addition, as a relatively labour-intensive and low value-added industry, the toy sector is feeling the effects of the industrial upgrading movement that is being pushed by both the Central and Guangdong Provincial Governments. As an industry heavily reliant on both plastics and packaging, it also attracts its share of attention from Mainland and overseas environmentalists concerned about production of large amounts of yet more potential waste, despite industry efforts to use recycled plastic materials.

The toy sector was under pressure before the onset of the global economic downturn in 2008. Wage increases in the toy sector had been rising at double digit per centages each year. In addition, it is estimated that the implementation of Labour Contract Law alone added 30 per cent to the labour costs for toy manufacturers in the PRD.¹⁶⁴ The price of raw materials used in toy manufacturing, such as plastic and metal fittings, had also increased.¹⁶⁵ The toy sector was also negatively impacted by changes made by Mainland Government authorities in June 2007 that lowered the export VAT rebate for toys

from 13 per cent to 11 per cent. In 2007, 1,454 of the 1,725 toy factories inspected in Guangdong were found to have safety flaws. A total of 764 of these factories lost their export licences or had them suspended. In August 2007, the Certification and Accreditation Administration of China issued new regulations for toy exporters that makes it more difficult to obtain and retain an export licence. According to Guangdong Customs, from January to July in 2008 there were 1,404 toy companies in Guangdong doing export business, which was 3,618 fewer than one year earlier¹⁶⁶. This means that 72 per cent of the toy companies either exited the export market altogether or put their exporting activities on hold.¹⁶⁷

In the first quarter of 2009, the EU announced 143 toy recalls, 134 of which concerned toys that originated from the Chinese Mainland. During the same period, the US and Canada announced 13 toy recalls, all of which were for Chinese products. This led to another round of new safety and environmental laws in the US and EU. The combination of new Chinese and overseas regulations have increased input, compliance, quality management, and licence costs.

Demand for toys from the US and the EU decreased dramatically with the onset of the global economic downturn. In 2009 and Hong Kong's exports to these two markets were down 19 per cent from 2008. In response, the Chinese Government raised the export tax rebate for toy exports from 11 per cent to 14 per cent in November 2008, and further raised the export tax rebate to 15 per cent in June 2009, in an attempt to stimulate toy exports. In the first ten months of 2009, toy exports in China decreased 11.2 per cent, and toy exports in Guangdong Province decreased 10.9 per cent.¹⁶⁸ Industrial players estimated that Hong Kong's toy exports would grow between zero and 10 per cent in 2010.¹⁶⁹ In the first four months of 2010, Guangdong's toy exports increased 21.4 per cent year-on-year. However, Guangdong Customs indicated that most of the orders were short-term orders, and the outlook of the industry was still uncertain.¹⁷⁰ A survey published by HKTDC in December 2009¹⁷¹ indicated that the demand for basic toys will continue

¹⁶⁴ www.fisme.hk

¹⁶⁵ Wei Jin, "Winter of Toy Industry in China", Consumer Guide – Academic version, April 2010.

¹⁶⁶ Note that the Hong Kong Toys Council estimates that in 2007 there were 8,500 toy factories and exporters in Guangdong and that this had decreased to about 3,000 toy factories and exporters by 2010.

¹⁶⁷ Wei Jin, "Winter of Toy Industry in China," Consumer Guide – Academic version, April 2010.

¹⁶⁸ www.easttoys.com.

¹⁶⁹ www.glokids.cn.

¹⁷⁰ www.past5000.com.

¹⁷¹ See Hong Kong Trade Development Council, "Hong Kong's Export Outlook for 2010: Challenges amid a Slow Global Recovery," 16 December 2009.

into the medium-term. A further survey released by the HKTDC in January 2010 found that just 34 per cent of Hong Kong manufacturing sector respondents were optimistic as to the business outlook for the toy industry in 2010, and another 48 per cent of respondents were neutral in their outlook.¹⁷²

Despite the increased costs, toy manufacturers, particularly SMEs, have not been able to raise prices sufficiently to offset the cost increases because of widespread consumer resistance to paying more for most toys and because they lack negotiating power with trade buyers. Consolidation of toy retailing in major markets at the retail level has given more power to fewer toy brands and retailers, leaving the “big four” retailers including Wal-Mart and Toys “R” Us, and brand holders like Hasbro and Mattel in a position to exert their buying power so as to compress manufacturer profit margins. The profit margin of toy companies in Shenzhen has been reported to be three per cent to five per cent on average, and even lower for SMEs.¹⁷³ Financial pressure has led to the closure of many toy factories, especially as sub-sub-contracting has become higher risk in terms of compliance management.

Competition is also becoming fiercer as the toy market in Mainland China expands and toy production spreads across China. Two major factors – cheaper prices and copycatting in the Shantou area – are hurting smaller Hong Kong-owned PRD factories. Many toy factories in Mainland China are targeting the domestic and developing world markets where controls over intellectual property violations and safety are less rigorous. This is hitting mid-size own-brand Hong Kong toy manufacturers that target the same markets.

Toys were one of the first Hong Kong industries to enter the PRD, which makes the “empty the cage” policy of the Guangdong Government that seeks to push out companies in traditional industries in favour of companies in “higher technology” industries particularly hard for them to accept. Presently, there are few viable options for Hong

Kong toy manufacturers to go beyond Guangdong as the further from the Greater PRD they go, the less of a competitive edge they have relative to the Mainland toy manufacturers. It may not be practicable, for example, to replicate outside Guangdong the current model of employing migrant workers recruited from cheaper labour markets elsewhere in the Mainland and housed in large factory compounds. Moreover, most toys are not high value items and the scope to increase their value is limited. Similarly, the scope to overhaul or upgrade long-established production technology is limited.

Response Strategies of Hong Kong SMEs

Hong Kong toy manufacturers have engaged in a range of strategies to deal with recent issues. In general, Hong Kong toy manufacturers are attempting to maintain a presence in traditional OEM manufacturing while at the same time trying to find ways to add value to existing products and processes, carve out profitable niches in existing product categories, develop new products in niche markets, develop branded products, build business in the Chinese Mainland, and partner with firms in the entertainment industry to create toys that are popularised via a presence in films, television, the internet, and theme parks.

¹⁷² Hong Kong Trade Development Council, “On the Road to Recovery: Assessment of 2009 Christmas Sales in Major Markets,” 29 January 2010.

¹⁷³ www.glokids.cn.

We note the following:

- Hong Kong toy makers are looking to enter the Chinese market in order to tap into demand associated with the estimated 252 million children aged fourteen and under. Many Hong Kong firms have entered in a small way to learn more about consumer requirements in China and how they differ from those in traditional markets. However, selling into China is not easy. According to interviewees, obstacles to Hong Kong toy manufacturers entering the China market include an immature market structure, poorly established or inaccessible distribution channels, unclear regulations, under-the-table practices, and difficulty collecting on invoices.¹⁷⁴
- Most toy manufacturing is relatively labour intensive and apart from moulding and injection work, many of the manufacturing activities are hard to automate. This means that labour costs need to be kept low in order to remain competitive. It also means that firms need to have access to a steady stream of workers. To achieve this, some firms have already moved out of traditional manufacturing areas in the PRD to locations such as Shaoguan, and to other mountainous areas of Guangdong from which semi-rural labour can be more easily sourced at cheaper rates. However, the new locations are further from Hong Kong and ports, making logistics less convenient and more costly. Logistics costs and proximity considerations need to be carefully weighed against cost of labour and access to workers.
- Contract manufacturing of toys is considered a commodity business and companies that only do OEM are likely to have limited life, limited profits, or limited growth unless they have additional or superior services to offer to their customers. Such companies face fierce price competition unless they find ways to add value by superior performance or through bundled services.
- Developing branded toys is a strategy to add value that is being followed by an increasing number of Hong Kong firms. Some are self-branding in the Hong Kong and Mainland markets while co-branding with leading firms in other markets such as the US. Co-branding allows the Hong Kong firm to gain quick access to large markets alongside known and respected brands, knowledge that may help the firm build its own brands in other markets, and the opportunity to perform other activities and services (such as OEM manufacturing) for its co-branding partners.
- Improving product design and applying upgraded technology are other ways for Hong Kong firms to add value. In the PRD, the technology in the toy industry is already quite advanced, but Hong Kong firms have dealt more extensively and over a longer period of time than most competitors with international firms that require manufacturing to be done to global standards and in compliance with stringent requirements. Some Hong Kong firms have engaged in technology reengineering projects to maintain their competitive edge, others have focused on combining engineering excellence and design capabilities to build new features into toys.
- Some firms are extending their scope by using engineering skills developed in the toy sector to enter crossover markets such as electronic learning products or the smart phone sector.

¹⁷⁴ ESA interviews with industrial players.

- As the entertainment and toy sectors become increasingly interconnected, some Hong Kong firms are working with entertainment companies to develop toys that can be marketed through media and entertainment channels. Some entertainment firms are developing content that is inspired by a toy. This “fusing of interests” is becoming a popular strategy to create new markets for existing products and to create new products that can be sold into existing markets. Hong Kong toy manufacturers that have teamed up with US entertainment firms, have had mixed results, but Hong Kong firms have gained valuable experience and there is an ongoing appetite to continue the strategy of crossover marketing.
- Hong Kong firms are increasingly focusing on specialised niches to make themselves “indispensable” for specialised components or products. Some firms, such as Jetta, have long made engineering excellence their niche, others have more recently either created niches, such as V-Tech, or have moved into niche markets and ended up dominating them by being better at branding or design or both, such as May Cheong.
- Hong Kong firms are also more focused on doing deals with the big toy retail firms that involve innovative, original, and high quality products which are certified as being non-counterfeit. Hong Kong firms have battled to protect their intellectual property, and a lesson learned is that it is more effective to take action against the importers, distributors, and retailers of counterfeit products who sell outside of China than it is to take action against manufacturers that infringe on intellectual property rights in China.

Case Study – Silverlit Toys Manufactory Limited

Silverlit is a Hong Kong-based family-owned and managed company engaged in OEM, ODM, and OBM toy production. Established in 1977 with five staff and a few old machines located in 2,000 square feet in Chai Wan, Silverlit now does most of its manufacturing in a 750,000 square foot factory in Dongguan and has several thousand workers. The company does no manufacturing in Hong Kong. Silverlit has branches in the US, United Kingdom, Germany, France, Netherlands, and Spain. In China it has offices in Beijing, Shanghai, Guangzhou, Chengdu, and Wuhan. By 2010, Europe and the US each represented around 40 per cent of Silverlit’s global sales, China less than 10 per cent of sales, and the rest of the world the balance. Initially focused entirely on OEM, the firm now derives about 10 per cent of its revenue from OEM with most of the firm’s business being concentrated on the development and manufacture of its own brands of toys.

The company’s first big breakthrough was with a press-and-go mechanism for a car toy that its engineers developed internally in 1984. The mechanism was different from the pull-back and wind-up mechanisms widely used in toys at that time. Silverlit patented the innovation and the company has since sold 100 million pieces for use in a wide variety of products. In 1996 Silverlit came out with the “TurboZ,” a remote control car that contained a microprocessor that made it programmable. The TurboZ appealed to a wide-ranging age group and sold one million pieces in the first year. Similar higher-value products followed, including an interactive robotic dog called “i-Cybie” which was launched in 2001 and became another big seller. The i-Cybie demonstrated Silverlit’s technological capability being the first mass produced toy that used advanced voice recognition technology.

In 2006 the company launched “PicooZ,” a micro-sized remote control toy helicopter for indoor operation. The first shipment of 2.5 million units sold out as soon as they hit stores. The PicooZ has been hailed as “changing the world of play by creating a new segment of high-tech toy that appealed to customers from office girls in Japan to grandparents in Europe.”¹⁷⁵ Silverlit teamed up with Canada’s Spin Master Limited, which sells the PicooZ under Spin Master’s Air Hogs brand in North America, while Silverlit sells it in the rest of the world. Silverlit deepened the relationship with Spin Master by agreeing to produce 60 per cent of Air Hogs toys thereby becoming Spin Master’s main OEM partner.

Seeing the potential for crossover between the toy and entertainment industries, Silverlit entered into a partnership in 2007 with a Mainland China media company to produce a cartoon series entitled “Golden Hero.” Golden Hero is broadcast by many local television stations in China and the firm has found that sales of the toys that are featured in the series increase by between 10 and 20 per cent in markets in which the series is shown each time that the series is aired. In 2009, Silverlit bought the French pre-school brand Ouaps, whose emphasis on innovative technology and quality fitted well with Silverlit.

Issues and Challenges

Silverlit has faced a number of significant challenges during the past 30 years. The global economic downturn particularly affected some of Silverlit’s major markets, such as the US, the UK, and Spain and recovery has been slower than Silverlit would like. There has been a noticeable decrease in orders and buyers are placing smaller and more frequent orders which makes production planning more difficult for Silverlit.

Keeping production costs down in the face of increases in minimum wages (for both Silverlit and suppliers), appreciation of the RMB, and increases in other input costs is an ongoing challenge. Finding sufficient numbers of workers is a problem as it is for all manufacturers in Dongguan. This is particularly true for managerial talent because the city lacks higher education institutions. Although wages in toy factories around the PRD are similar, other factors such as the working and living conditions are becoming more important as workers can easily get information on conditions via mobile phones or the internet.

Another challenge has been an inability to raise prices to offset cost increases. Silverlit doesn’t see this situation changing in the near term as parents buy cheaper toys for their children, and the big retailers squeeze manufacturer margins to preserve their own. Still another challenge has been to stay ahead of Chinese toy companies as they begin to invest more in innovation. Silverlit expects that Mainland firms will soon compete for orders from large retailers in big markets through design and value added features.

Silverlit has found intellectual property infringement to be a big issue. Several years ago the firm started losing orders for the PicooZ in Europe and elsewhere to counterfeit products. Although the firm has noticed a genuine commitment on the part of China’s Central Government to improve intellectual property protection, it finds enforcement at the local level lacking.

Selling in the China market requires 3C quality certification. This certification is difficult, time consuming, and costly for firms like Silverlit to obtain. However, in many cities in China, many low quality products have obtained 3C certification, suggesting that their quality is on par with Silverlit’s, and making it difficult to differentiate in these locations. While certification standards are strict in Shanghai and Beijing, and reasonably strict in cities like Nanjing and Hangzhou, the process is clearly less stringent in most other cities in China.

¹⁷⁵ ESA Project Interview with Sarah Monks, 2010-05-18, quoting Silverlit managing director Kevin Choi Kei-fung.

Company Strategy

Silverlit constantly evaluates its position and adjusts its business model and product development efforts according to market forces. When the market was simpler, the firm made simple and small toys. When that market became saturated, the firm began making more complicated electronic toys. When the market for electronic toys became saturated, the firm shifted to remote control toys such as cars and helicopters. When the market for remote control cars started to become saturated, the firm turned its focus to licensing toys connected to the entertainment industry, and when that market began to get competitive the firm developed its own brand of toys that could be marketed through entertainment and media channels that it either owns, has a stake in, or has significant control over.

In response to cost pressures, Silverlit is relentlessly focused on improving production efficiency, on improving and simplifying product design, and on simplifying management processes. As a firm that relies heavily on labour, Silverlit also pays close attention to the needs of its workers. This has helped the firm to understand that workers have come to expect better working conditions, leisure, and development opportunities. In response, Silverlit has opened a library for them, provided additional entertainment facilities, and put in place systems to understand and respond to issues that are important to workers.

In an increasingly competitive business dominated by a few large retailers with significant buyer power, Silverlit has found that the only way to prosper is to offer products with features others do not have, and which justify a price premium. Silverlit differentiates its products from those of its competitors by trying to be more creative than the competition. In 1988, Silverlit established an internal design team so that innovations, creative thinking, and advances in technology could be applied across different products from remote-controlled model cars, to model railways, boats, helicopters, and other electronic toys. This enabled the firm to capitalise on its research and development efforts

and facilitated the development of its own branded products.

Silverlit's "innovation mindset" applies to everything that the firm does and it has found that often the most successful innovations are neither very high-tech nor sophisticated, but result from simple and creative thinking that is constantly applied. Silverlit created a new segment by producing toys with better quality and features than those in the low-end mass market, but more affordable than those purchased by serious hobbyists and toy enthusiasts. This strategy created a market with large volumes and good margins. Silverlit is innovative even when it comes to the packaging of its products. The aim is to make toys that are as different from the competition, and better in every aspect, rather than to follow competitors or market trends.

Silverlit tightly controls the quality of its products. In the early 1990s, Silverlit became the first toy manufacturer in Asia to qualify for ISO 9001 certification. This demonstrated the firm's commitment to quality and enabled it to obtain price premiums from the market. In addition, most of the customers that Silverlit targets won't purchase low quality substitutes even if they are significantly cheaper. This has helped Silverlit defend its position against Mainland Chinese competitors that have lower costs than Silverlit, but offer toys that are poorer in quality and unable to meet the quality and safety standards of the large retailers.

To protect its intellectual property, Silverlit initially took legal action against the firms that were making counterfeit products in China. This proved to be costly, time consuming, and impractical due to lack of local enforcement. Eventually Silverlit found threatening legal action against the buyers of the counterfeit products more effective because the buyers tended to be located in markets where the laws were clearer and more easily enforced. The issue has not been fully dealt with, however, and there are many firms that still make copycat products that steal potential sales from Silverlit.

Silverlit is determined to operate mostly as an OBM company. In addition to its pioneering new technologies and segments, Silverlit has also linked its toys to entertainment products. In 2007, Silverlit entered into a partnership with Shanghai Character License Administrative Company Limited (SCLA), an established Mainland publisher of titles that include popular comics, and the owner of a television production house to produce a 52-part series called "Golden Hero." Billed as the first original Chinese hero-themed children's television show, it was screened on some 45 Mainland television stations from 2008 to 2009, with a second series in production in 2010. It has also been broadcast in Taiwan. SCLA comes up with the storylines while Silverlit develops related toy concepts. The ultimate goal is to launch a toy brand that is developed and tested in China into the US and European markets.

Silverlit is increasingly manufacturing self-branded toys, but also produces under licence and co-brands some of its products. The idea for "Golden Hero" came from the relationship that Silverlit has with Marvel to produce toys under license in support of the Spiderman, Ironman, and Cars movie franchises. By signing with Marvel and producing licensed products, Silverlit hopes to improve the firm's image and thus lead to increased orders for products that carry the Silverlit brand. In North America Silverlit co-brands its planes with Spin Master because in that market Spin Master is a more recognised brand and offers very professional after-sales service. Silverlit therefore puts two brands, its and Spin Master's, on the products. Silverlit uses its own brand in other countries where there isn't a dominant brand already.

In response to the changing order patterns from customers due to the global economic crisis of 2008/09, Silverlit is attempting to build closer contact with its customers through its offices in the US and in Europe. Staff in those offices make frequent personal contact with customers to get orders confirmed, to try and increase orders, and

to find out what customers are thinking and how their needs are changing. Most competing firms do not have offices in the US or Europe and do not have such tight contact with their customers. Silverlit has found a face to face strategy to be more effective in securing orders even as customer budgets tighten, the firm still manages to secure customer orders.

Silverlit's China strategy draws on more than 10 years of retail experience in that market. The firm struggled to make significant sales in the Chinese Mainland when there was little intellectual property protection, incomes were low even in the major cities, and the regulatory environment favoured Mainland China-owned manufacturers. Now that the Chinese Government is addressing these issues, Silverlit is finding greater opportunity in China and is opening more sales channels. Presently, the firm has approximately 400 sales stands in China, mostly in large department stores in Beijing, Shanghai, Guangzhou, Chengdu, and Wuhan. Silverlit does not expect to expand Chinese sales very quickly, but it does expect sales to grow steadily and believes that China represents an important future market. Silverlit plans to enter second-tier and third-tier cities as intellectual property protection and economic conditions improve in those cities.

Future Plans

Having conquered the skies, Silverlit is now set on building a global brand originating in China. The pioneering branding strategy that Silverlit entered into with SCLA could help transform Silverlit into a media-focused and content-driven global toy brand, like Bandai in Japan. Although the focus with SCLA is currently on the market in the Chinese Mainland, there is a plan ultimately to expand the strategy into other markets such as the US and Europe.

The Chinese market, which now accounts for less than 10 per cent of Silverlit's business, is a major focus for the future. The firm sees enormous opportunity as the market matures, as income levels rise, and as intellectual property rights are better enforced.

Silverlit plans to continue manufacturing in Dongguan even though labour costs might be higher than elsewhere because the firm's products are quite sophisticated and they depend heavily on upstream manufacturers that are also located in Dongguan or nearby.

In the past, children aged 10 and above tended to be interested in electronic toys and games. Today, children between the ages of 4 and 10 are interested in these products. To cater to this shift, Silverlit plans to invest more into research and development for toys for a younger profile and will likely expand its present team of 200 researchers.

Lessons from the Silverlit Case

There are a number of lessons that can be learned from the Silverlit case.

- Changing customer buying patterns can create problems in trying to plan for the order of raw materials, the hiring of workers, and the scheduling of production.
- To combat cost increases, firms must focus on improving production efficiency, on improving and simplifying product design, and on simplifying management processes.
- Increasing wages alone is no longer sufficient to attract and retain workers in China. Other factors such as the general working and living conditions play an increasingly important role in determining the employment choices of workers.
- Workers in China have greater access to information than before. Firms will need to more closely monitor employee desires in order to find and retain capable workers.
- Increasing product prices in order to maintain profit margins is not easy to do during tough economic times. This may mean that cost increases can't be offset in the short-term by corresponding revenue increases.
- It is hard to make profits when large and powerful buyers are able to push down margins. Big retailers that hold significant bargaining power will squeeze manufacturer profit margins so as to not reduce their own profit margins.
- In markets with significant buyer power, sellers that have clear quality, technological, design, and service advantages will perform better and have a greater capacity to "hold the line" on prices and margins than those that do not.
- Customers that value quality won't purchase low quality products even if they are significantly cheaper. This represents opportunity for quality-minded producers.
- Competing firms that presently follow a strategy of imitation may quickly evolve to follow a strategy of innovation once they gain greater experience.
- SMEs can create long-term sustainable competitive advantages through product differentiation and by being more innovative and creative than competitors.
- Having invested a great deal of time and money in doing research and development, SMEs may find that the results of their efforts are appropriated by firms that are prepared to manufacture counterfeit or copycat products.
- Taking legal action against firms that make counterfeit products may prove to be costly, time consuming, and impractical, but taking or threatening legal action against the trade buyers of the counterfeit products may be a more successful strategy.
- The commitment on the part of the Chinese Government to improve intellectual property protection does not necessarily mean that effective action is taken to protect intellectual property rights at a local level.
- Some Hong Kong firms are finding it easier to protect their intellectual property in larger cities such as Shanghai and Beijing in China where intellectual property laws are more carefully monitored and enforced. This makes it relatively easier for firms that rely on intellectual property to compete in these locations.
- SMEs can develop niches by identifying markets in between the low-end mass market and the high-end market and by producing products that are better quality and have more features than those in the mass market but which are more affordable than those purchased by serious enthusiasts.

- Specialised products are not as vulnerable to market fluctuation as general products, and they tend to have a higher profit margin than general products.
- By being the leading manufacturer of a niche product, the SME becomes more important to customers that serve end markets for those products. This makes it difficult for other companies to compete with the firm.
- SMEs that focus on specific niches are likely to have fewer competitors, be more flexible, be able to make decisions faster, more quickly adopt new technologies, and respond quicker to market changes.
- SMEs should constantly evaluate their position and adjust their business model and product development efforts in line with changes in market forces.
- Applying for ISO 9001 certification demonstrates the firm's commitment to quality and may enable it to extract price premiums from the market.
- SMEs should find ways to continuously innovate and improve their products and processes. Investing in ongoing research and development is the cornerstone of innovation, but often it is the case that the most successful innovations are neither very high-tech nor sophisticated, but result from simple and creative thinking.
- Establishing an internal design team may lead to innovations, creative thinking, and advances in technology being applied across different products, which maximises the value of investing in such a team.
- SMEs that focus on OEM will face difficult competition.
- SMEs may be able to stay ahead of the competition by focusing on OBM because brands are harder to imitate and have unique value.
- SMEs should consider partnerships with firms that possess skills, capabilities, or resources that they don't when there is a clear strategic case for doing so. Co-branding is one example of a partnership to leverage such capabilities.
- Manufacturing products under licence may enhance the overall profile of the firm and lead to increased orders for other products that the firm produces.
- Toy brands can be developed by partnering with entertainment companies that create and control content that is distributed via television, the internet, or other mass media.
- SMEs should strive to keep in close contact with its customers through offices in locations in which there are significant sales. Face-to-face contact can be very effective in securing customer orders even when customer budgets are tight.
- Hong Kong SMEs will find it easier to sell in the Chinese Mainland as intellectual property protection improves, disposable incomes rise, and regulatory environments that favour Mainland-owned manufacturers give way to a more level playing field.
- As intellectual property protection and economic conditions improve in China's second-tier and third-tier cities, SMEs will find it easier to sell into those cities.

Strategies to Meet the Challenges Facing Hong Kong Manufacturing SMEs

The challenges that Hong Kong manufacturing SMEs face are daunting. In order to survive and to thrive, the SMEs will have to deal with external challenges as well as internal management challenges. The most successful companies will be those that ask and answer the difficult questions and chart a clear strategy that allows them to deal with both the external and internal challenges. The following are strategies that the SMEs may employ to improve their prospects and the questions they need to ask and answer going forward. The answers to some of the questions may differ from industry to industry and from firm to firm. The key is that the SMEs develop a clear and coherent set of strategies and policies to navigate difficult and uncertain terrain. Leaving matters to chance or to a purely reactive approach is a recipe for disaster, while firms that develop coherent strategies may well be able to profit from changes in the external and internal environments.

One feature of existing surveys is that even though there is much discussion of the difficulties that Hong Kong's manufacturing SMEs face, the majority of responding firms have made only incremental changes to their strategies as of yet. The dominant responses have been improving relationships with existing customers, increasing development capacity, seeking incremental means of cutting costs, and trying to expand sales in the Chinese Mainland. Changing lines of business, relocating away from the PRD, shifting from OEM to OBM production, and other more radical approaches are noticeable largely by their absence. This may mean that the challenges are not as great as have been supposed or that much greater changes will be required in the future for the SMEs to survive and thrive.

The following sets forth strategic options for dealing with the external and internal challenges that Hong Kong manufacturing SMEs face. The options list many types of information and analysis that SMEs should undertake in order to formulate and implement their strategies. Given their limited resources, SMEs will have to prioritise

their investigations. Even so, it is hard to imagine that any company can succeed without a basic understanding of their industry's major products and segments, the major types of customers and their needs, the major types of competitors and their advantages and disadvantages, and the firm's own ability to execute the desired strategy and run a business. These need to be the main priorities. Beyond that, it is important that managers at least understand what the other items on the following lists are so that they do not get blindsided.

The strategic options are also included in the "SME Advisory Kit" which accompanies this report. "The SME Advisory Kit" also provides suggestions as to the "how to" steps appropriate to the different options and investigations. The latter are not included in the base report due to space considerations.

STRATEGIES TO DEAL WITH EXTERNAL CHALLENGES

There are a number of strategies that Hong Kong manufacturing SMEs may employ in order to deal with the challenges they face. They can broadly be defined as:

- Cost reduction strategies
- Differentiation strategies
- Labour market strategies
- Business model strategies
- Geographic market strategies
- Regulatory and policy-related strategies
- Exit or consolidation strategies

These strategies are not mutually exclusive. In fact, companies will have to make choices in all of these areas and they may choose to keep the status quo in some areas while making changes in others. We do note that the managers interviewed for this project were in general agreement that across the board status quo strategies (i.e. changing nothing) was unlikely to lead to success for most of Hong Kong's manufacturing SMEs.

Cost Reduction Strategies

Strategies to deal directly with cost increases can include the following:

- **Improve efficiency within the factories**

Improving efficiency within the factories could involve improving factory layouts, optimising process flows, providing additional training for workers, and improving management practices. Many SMEs could work to install modern cellular and team production processes, reduce the physical footprint of activities, debottleneck process flows, and more sharply define work tasks for greater efficiency.

- **Automate production processes**

Automating production processes is a way to reduce the overall labour content, reducing exposure to labour shortages and increasing wage rates. This can only be done if the processes can effectively be automated and if the capital required is not beyond the means of the SMEs. As labour becomes more expensive and scarce, companies should identify labour saving automation that would not have made sense in China in the past. This could include not only automation of individual manufacturing operations, but of materials handling and packaging as well.

- **Improve efficiency in logistics, distribution and other activities**

Improving efficiency in logistics, distribution, and other activities can often reduce total costs more than improvements in manufacturing. A comprehensive approach to cost reduction provides the best opportunity to offset cost increases. Logistics and distribution costs are often higher than actual production costs. SMEs should undertake an examination of their total cost picture, identify key cost elements (not just in the actual manufacturing), and develop cost control strategies in response.

- **Outsource business processes**

SMEs often face inefficiencies in business processes, such as accounting, payroll, information technology, warehousing, and others due to a lack of scale and specialised resources. Outsourcing such business processes can often lower the costs for SMEs. In some cases, such services can be purchased in bulk by groups of firms coordinated by industry associations.

- **Relocate to other places in China**

As costs rise in the Pearl River Delta, manufacturing SMEs have the option to relocate production to other parts of China in which costs are lower. This can only be done effectively if the relevant supply chains can be extended to the new locations and if the Hong Kong firms can manage farther afield than the PRD. SMEs should investigate where supply chains might support new production locations and should follow the moves of large companies that could bring their suppliers with them if they relocate.

- **Relocate to other places in South or Southeast Asia**

Relocating to other countries, mostly probably in South or Southeast Asia can be another option to combat rising costs in China. However, this will only be feasible if the infrastructure, supply chains, labour force, and regulatory environment are suitable. Again, this also requires the Hong Kong firms to manage in a new environment that might not be as accessible as the PRD.

- **Relocate along with similar firms**

Much of the discussion of potential relocation of Hong Kong companies assumes that they move as individual firms. In some industries, it might prove beneficial for groups of firms to move simultaneously in order to ensure a critical mass exists in the new location to attract suitable suppliers. There are examples of such group relocation in the Italian footwear industry and in mobile handsets, where a group of firms moved from Shenzhen to Huizhou with the support of the Huizhou and

Central Governments, who set up research and testing facilities.

Differentiation Strategies

Another means of dealing with cost increases is to differentiate in order to gain some pricing flexibility. Approaches to differentiation include:

- **Improve product quality**

Customers often are willing to pay higher prices for demonstrably higher quality products. Depending on the industry, quality may be defined by precision craftsmanship, speed, reliability, product life, fashion or design content, attractive appearance, image, incorporation of more advanced technologies, or customisation. The challenge is to provide higher quality that the customer values, can be achieved in a cost effective manner, and is difficult to imitate. SMEs often have a hard time developing the capabilities to produce products with demonstrably higher quality than those of competitors. It is also necessary to find ways of demonstrating superior quality to customers.

- **Improve services to customers**

Improving services to customers can include providing just in time inventory management for customers, providing design services, providing rapid turnaround and delivery, and providing reliable supply. To the extent that the firm can distinguish itself from its competitors, it may be able to obtain some pricing flexibility. The key is that the SME view itself not just as producing a product, but as producing value for the customer that could go well beyond the product itself and could involve special delivery conditions, inventory matching, designing, and other activities as well.

- **Move from OEM to ODM or OBM production**

Moving from OEM to ODM or OBM production can allow manufacturing SMEs to distinguish themselves and obtain better prices. However, ODM requires the firm to invest in design capabilities and OBM production requires the firm to invest in branding, marketing, and

distribution. This in turn requires substantial resources and capabilities that most Hong Kong SMEs that started in OEM production do not possess. To brand successfully, the company must either have or bring on board people with the appropriate marketing skills, must engage in consumer research, and must develop a clear and consistent message that is fully backed up by the quality of the product and the entire purchasing experience of the consumer (including choice of locations, types of outlets, packaging, displays, price points, and promotional material).

- **Tailor strategy to serve particular niches**

By definition, SMEs generally cannot supply all types of customers. As a result, it is often better for SMEs to tailor their strategy to serving particular niches, gaining distinctiveness and the ability to differentiate by understanding and serving the needs of customers in the target niches better than competitors. In order to carry out this strategy, the SME must develop a deep understanding of the niche, their precise needs, and cost effective ways of meeting those needs while distinguishing itself from competitors.

- **Supply high value market segments**

High value niches, with customers that may be less price sensitive than the mass market, provide particular opportunities for pricing flexibility, but requires a firm to develop the capabilities to serve these markets. The idea is that high value segments generally have buyers that do not purchase on price alone. Appealing to customers who want high performance, a specific image, exclusivity, special features, or other non-price features again requires products that meet the relevant criteria and companies that can communicate their appeal clearly.

Labour Market Strategies

Obtaining and retaining labour and managerial talent are major challenges for Hong Kong manufacturing SMEs. Labour market strategies may include the following:

- **Engage in more active recruiting**

In the past, many Hong Kong manufacturing SMEs took a relatively passive approach to recruiting, hiring people who came to apply or working through a government employment agency. Increasingly, firms are finding they must become more proactive in attending job fairs, working through existing employees, and engaging additional sources of information or access to potential employees. Even SMEs can no longer rely on others to attract the personnel that they need.

- **Understand that high turnover is costly**

High turnover often imposes costs in terms of recruiting, training, inexperience, learning time, and disruption of teams. Often SMEs do not understand the full cost of high turnover, and therefore may understate the value of doing what is necessary to retain workers. SMEs should calculate the cost of recruiting, processing, training, bringing up to speed, and dealing with the departure of workers. In many cases, the results will be surprising. This means that SMEs need to be able to judge very quickly whether an employee is a good fit and take steps to ensure that valuable employees stay.

- **Increase wages**

The overwhelming attraction for employees in the manufacturing sector in China is wages. Thus increasing wages is always one mechanism to obtain workers. This of course is difficult for companies that already operate with low margins. However, some companies have found that they have been able to reduce turnover through higher wages and therefore can offset the higher wages at least in part through productivity gains. The wage / job satisfaction trade-off is a difficult one for SMEs to judge. The key is that they try.

- **Provide better working environments**

Although wages may be the most important worker attractor, increasingly the entire working environment, including working conditions, canteen facilities, leisure opportunities, athletic facilities, and other amenities can be decisive in a company's ability to attract and retain workers. Again, while adding cost, improvements in the working environment can be a competitive weapon in the quest to attract and retain employees. This is particularly true as workers in the Chinese Mainland have higher aspirations and more employment alternatives inside and outside the manufacturing sector.

- **Institute effective performance evaluation schemes**

Nothing discourages workers more than an ineffective evaluation scheme and nothing encourages workers more than an effective scheme linked to compensation. Managers should ensure that they have good employee evaluation systems in place to help motivate and monitor workers. While many firms view workers as interchangeable cogs and use simple numerical output counts to evaluate and reward employees, others are starting to get more out of employees by taking a more systematic approach to evaluating attitude, cooperativeness, willingness to work in teams, and for suggesting improvements.

- **Shift production to sources of labour**

As options for young workers improve in China, especially in the interior, some firms will find it easier to attract and retain labour if they move production closer to the sources of workers. This will be aided by improving infrastructure and perhaps by incentives to move into China's interior, but raises the difficulties associated with moving away from established supply chains and managing at a greater distance from Hong Kong. In the future, as Guangdong appears to wish to shift some businesses out of the PRD, it could prove fruitful to locate in places where workers can live at home with their families and still have

manufacturing jobs, which is still not the case in large portions of China's interior.

- **Develop managerial talent from the Chinese Mainland**

Many Hong Kong manufacturing SMEs prefer to hire managers from Hong Kong. However, the supply of trained Hong Kong managers with manufacturing experience is declining. One obvious potential source of managers is the Chinese Mainland. Here the best approach may be bringing in relatively young managers and developing them within the organisation. The challenge is that it may be difficult to retain such people, who may leave to work for competitors or set up competing companies of their own. This may be unavoidable. The key is likely to be how the company tries to instil loyalty and a sense of belonging within the firm.

- **Bring in managerial talent from elsewhere**

In addition to Hong Kong and the Chinese Mainland, Hong Kong SMEs should consider managers from other locations, such as Taiwan, Korea, Singapore, Malaysia, and other places in Southeast Asia. Several of these economies have more of an ongoing manufacturing tradition than Hong Kong and managers from these locations may be less likely to start up competing firms of their own in China. This may require SME owners and managers to travel more and look beyond their traditional sources of managerial talent.

- **Share wealth with management talent**

Providing senior managers with some stake in the business, such as rewards linked to company performance or even an ownership share, can provide motivation and may make it easier to retain key personnel. This may be difficult in SME corporate cultures where often only a single individual has a real stake in the success of the firm. The trouble is that in such structures anyone with sufficient talent will soon go elsewhere or start up on their own.

Business Model Strategies

Changes in business models involve changing the activity mix of the company in order to focus on the activities in which the company can build competitive advantages and leave other activities behind. Examples of such strategies include:

- **Shift from manufacturing to outsourcing production**

If the Hong Kong manufacturing SMEs believe that others, such as firms from the Chinese Mainland, will have an unassailable cost advantage, or that they will not be able to obtain suitable margins through manufacturing, they may shift from manufacturing to outsourcing production to others. In such cases, the Hong Kong SME would use its knowledge of markets and contacts with customers to sell its outsourced production.

- **Become a trader or agent for other companies**

The extreme case of outsourcing would be manufacturing SMEs transforming themselves into traders or agents for other companies. Again, they would use their market knowledge and customer relations to sell the traded goods. Presumably they would be sourcing from other Hong Kong firms or firms from the Chinese Mainland in most cases, though in some sectors, finding sources in South Asia or Southeast Asia would also be desirable.

- **Become a subcontractor**

The opposite approach would be to become a subcontractor for a larger company, letting the larger company deal with powerful buyers, export-related regulations, and other administrative matters. This approach has been used by a number of companies that no longer can or wish to deal with the administrative burden of being an exporter themselves so instead supply other companies that have the administrative capacity, financial strength, and access to customers to continue to export.

- **Engage in forward integration into retailing or sell direct to end customers**

While most Hong Kong manufacturing SMEs sell to OEM customers, and thus have little contact with end consumers, others have forward integrated into retailing. The advantage is that such companies are less beholden to powerful retail chains and can set their own prices. However, retailing requires skills and expertise that is likely to be beyond the capability of most manufacturing SMEs to master, particularly since most SMEs have had little direct contact with end consumers. The most likely places for such retail businesses are Hong Kong and the Chinese Mainland, where Hong Kong products can still obtain a premium in some sectors. SMEs wishing to follow this strategy need to ensure that they have or bring in sufficient expertise to run retail operations, with the associated site selection, retail rentals, licensing, accounting, and promotion activities associated with retailing.

Geographic Market Strategies

Most Hong Kong manufacturing SMEs produce on an OEM basis for eventual sale in one or a small number of OECD markets. The downturn in these markets has meant that some companies have had to seek ways of reaching end consumers in other markets. The choices here are as follows:

- **New OECD markets**

Diversification to new OECD markets is helped by the fact that OECD markets in aggregate are still be far the world's largest markets, accounting for well over half of global consumption. Such diversification is hindered at present by the fact that the global downturn has hit all the major OECD markets. In addition, serving new OECD markets often requires firms to compete against already relatively well-entrenched competitors and supply chains.

- **The Chinese Mainland**

The Chinese Mainland is clearly the world's major growth market at present. However, China only accounts for under 6 per cent of global consumption today. In addition, China's relatively low per capita income means that the Chinese market has a different segment structure and often different consumer requirements than the markets that usually absorb the goods of Hong Kong's manufacturing SMEs. In order to serve the Chinese Mainland market Hong Kong manufacturing SMEs must develop their own distribution networks or find others that can distribute for them. Finally, the Hong Kong firms have to compete with firms from the Mainland without the advantage that the Hong Kong firms often have in international markets, that is knowledge of international tastes and requirements. All of this makes selling in the Chinese Mainland a potentially rewarding, but difficult, undertaking.

- **Other developing country markets**

Other developing markets, including those in South Asia, Southeast Asia, Latin America, the Middle East, and Africa, are expected to grow faster than OECD markets over the next several years. Diversifying markets to include such countries is another potential avenue for sales growth. The challenge here is that these markets tend to have obstacles in logistics, distribution, and sales systems that have to be overcome for them to be viable markets for the Hong Kong SMEs. Presumably the easiest path for sales in these markets is to sell to OEM customers, traders, and agents that already have distribution and sales in these markets.

Regulatory and Policy-related Strategies

Hong Kong SMEs operating in the Chinese Mainland need to have strategies to deal with the regulatory and policy environment in China. These include:

- **Strategies to deal with environmental and product safety regulations**

Hong Kong manufacturing SMEs have little choice but to ensure that they are in full compliance with environmental and product safety standards. This is necessary to operate in Hong Kong and the Chinese Mainland and will be necessary in many cases to satisfy customers as well. Companies that believe that adhering to such standards puts them at an untenable competitive disadvantage will have to consider outsourcing some operations. For many polluting industries, there are cleaner fuels, cleaner technologies, or ways of handling effluent in a more environmentally sensitive way than is done at present. In some cases, joint investments in clean technologies by co-located companies, or relocation to specialised industrial parks with the right infrastructure could provide solutions.

- **Strategies to deal with administrative requirements**

The administrative burden on Hong Kong manufacturing SMEs operating in the Pearl River Delta region is increasing. This is unlikely to change anytime soon. In fact, if anything the administrative burden is likely to increase. Hong Kong companies will have to carefully budget for the administrative costs and may find that outsourcing some record keeping and related functions may be cost effective. Interviewees indicate that more and more government departments are visiting factories in the Chinese Mainland and having senior management on hand to meet with officials from these departments is disruptive to the enterprise. Even SMEs may be forced to hire specific government relations personnel to take on part of the task of dealing with officials. Early planning so that accounting and reporting systems within the firm also gather the information required by government departments could also help reduce the administrative costs.

- **Strategies to deal with policies to restructure or upgrade local economies**

Hong Kong companies often view themselves as potential victims of policies designed to upgrade the economy of the Pearl River Delta. While such policies may cause disruption to many companies, they are unlikely to be reversed. Hong Kong manufacturing SMEs need to determine if there are ways to actually benefit from such policies by entering favoured industries, by engaging in favoured activities (such as branding or research and development), and need to avail themselves of financial, technological, and other support that may be provided as part of the upgrading policies. If none of this is possible, the Hong Kong manufacturing SMEs may have to consider relocating to an area where their industry is supported. It is important that SMEs understand precisely what different levels of government desire in terms of industrial structures and activities and to portray their own operations in this light. Unfortunately, the Chinese Government tends to take a sector by sector approach rather than a technology by technology approach. Thus high technology solutions in traditional industries might not find favour while labour, resource, and energy-intensive process in “high technology” industries might.

- **Strategies to leverage policies in support of SMEs**

Both the Hong Kong and Guangdong Governments have enacted a range of policies to support SMEs. Hong Kong manufacturing SMEs should ensure that they are knowledgeable about such programmes and can use the programmes where appropriate to their benefit. These include programmes that provide financial support; information on markets, technologies, and policies; support for upgrading; training support; and other programmes. Of course, SMEs need to do a cost-benefit analysis to ensure that the administrative costs of participation in such programmes do not outweigh the benefits.

- **Strategies for relationship management**

Many owners and managers of Hong Kong manufacturing SMEs operating in the PRD do not spend sufficient time in the PRD to get to know local officials as well as their Mainland competitors. An active strategy of government relations will help Hong Kong SMEs better understand rules and regulations and how they are likely to be enforced. A number of interviewees commented that too many Hong Kong entrepreneurs expect to be able to do business in the Chinese Mainland, produce in the Mainland, sell in the Mainland, and in other ways leverage the Mainland without spending much time in the Mainland themselves. Such an approach will always leave Hong Kong entrepreneurs a step behind their Mainland counterparts when it comes to anticipating and understanding the nature of changing rules and regulations and precisely how they are going to be administered.

Exit or Consolidation Strategies

Given the severity of the forces influencing Hong Kong manufacturing SMEs, we expect that there will be significant consolidation and / or exit in some sectors. Approaches include:

- **Sell out or shut down**

Hong Kong SMEs that find their position untenable and prospects bleak may choose to exit by selling out (if a buyer can be found) or simply shutting down. While a last resort, such options must be assessed from time to time. The key here would be working with new owners or local governments to ensure an orderly transfer or closure and minimising the losses incurred during the exit process.

- **Change lines of business completely**

For some firms, exit in one sector may be the first step to developing new businesses in other sectors. The key here is to ensure that there is a market for the new product or service, that the company can develop some distinct competitive advantages, and that it has or can obtain the resources to make the entry work. In other words, any SME considering changing lines of business should go through all the steps indicated for selecting businesses to be in and for developing strategies for the new businesses described below.

- **Consolidate the sector by acquiring other firms or investing to beat them in the market place and grow organically**

There is likely to be significant consolidation in industries currently populated by Hong Kong manufacturing SMEs. Some companies may choose to take the initiative to consolidate their sector, at least in part, by acquiring competitors or by investing to grow by beating them in the marketplace. This approach would require the resources to make the acquisitions or investments necessary. Sectors that are in a state of flux may be ripe for such moves for the right company. We should remember that Hong Kong's large companies started as small companies and grew by recognising and acting on business opportunities. In difficult times, strong firms may be able to gain competitive positions that they will retain when times get better.

STRATEGIES TO DEAL WITH INTERNAL MANAGEMENT CHALLENGES

The vast majority of SMEs that are started around the world fail. The main reasons for these failures are not challenges posed by the external environment, but rather shortcomings in internal strategies, management, operations, and financial controls. In many cases, these shortcomings are due to limited resources, stretched management personnel, and incomplete strategies or business plans. Some of the main internal challenges SMEs face:

- Selecting businesses in which to compete
- Formulating compelling strategies or business plans
- Understanding customers
- Understanding competitors
- Developing clear competitive advantages
- Financing operations and financial management
- Administering and Managing the firm
- Keeping up to date on market, technological, and managerial developments
- Marketing and selling to existing and potential customers
- Reducing dependence on individual customers and suppliers
- Additional challenges

Selecting Businesses

SMEs sometimes get into new businesses because of an apparent opportunity without thinking through exactly how they will succeed in the business, or in fact whether it is possible to succeed in the business. The following are steps that can be taken to select businesses in which to compete:

- **Link to the knowledge and skill set of the SME owner and managers**

For SMEs, the advice is to “do what you know.” Since the firm often depends on the knowledge and skill set of a small number of people, it is important to understand what this knowledge and skill set is and in what businesses they may be leveraged. Sometimes the knowledge could be very narrow and appropriate for only a single industry or even a single segment in a single industry. In other cases, the knowledge and skills may be more broadly applied.

- **Understand the ease of entry**

Easy entry in terms of minimal capital costs, licence restrictions, and special qualifications or approvals may mean that it is easy for the SME to enter, but it also means that other SMEs can enter as well. The best situation is an industry that is difficult to enter in general, but in which the SME has particular knowledge, skills, resources, or relationships that make it easier for the particular firm to enter. The key is understanding the potential asymmetries that might give the firm an advantage in the new business.

- **Understand where the firm can be unique**

A good business to enter will be one in which there is something distinctive about the firm that gives it a unique advantage in terms of creating value for customers while beating the competition. By definition, it is impossible to gain an advantage versus competitors by copying their strategies or by having strategies and resources that are easily copied, bypassed, or substituted. Thus firms need to understand or develop unique attributes that are hard to copy, bypass, or substitute for.

- **Focus on industries where the SME has a “good idea”**

Some SMEs are founded around a good business idea that is particularly useful in a particular industry. The SME should determine what its good ideas are and in which industries these ideas can be leveraged. A “good idea” is generally the recognition of a new customer need, a new way of serving an existing customer need, a distinctive bundling of products or services, or a more cost-effective means of delivering a standard product or service. We note that the “good idea” needs to directly relate to how the SME is going to create value for the customer, beat the competition, and make money in the process.

- **Focus on industries where there are unmet market needs**

The best opportunities generally are found where there are unmet market needs that the SME can meet. It is important to identify exactly what these needs are and how the company will meet them. Unmet market needs provide particularly valuable opportunities since meeting them gives the firm the chance to be a first mover and to become established with limited competition, at least at first.

Formulating Compelling Strategies or Business Plans

Many SMEs do not have a clear strategy. Instead, they jump from opportunity to opportunity. While this may lead to success for a short period of time, such success rarely persists. There are several key steps in formulating compelling strategies or business plans:

- **Develop a clear vision**

Without a clear vision, the company has no clear direction or reason for being. The vision should include the purpose of the firm, the scope of its business, how it wants to position itself, and what its core advantages are intended to be.

- **Identify clear target markets and customers**

SMEs by definition cannot serve everyone. SMEs have to carefully choose their target markets and customers. They need to choose who to serve and who not to serve and then tailor their business plans accordingly.

- **Identify what customer needs are to be met**

The firm must create value for its customers if it is going to succeed. Firms must be very specific about the value they wish to create for their customers. This is best done by explicitly identifying what needs are being met and exactly how the firm will meet them in ways that allow it to compete successfully against others.

- **Determine what the firm can be best in**

It is not enough to create value for customers. The firm must develop ways to beat the competition in the process. This requires the firm to determine what it can do better than the competition. As one interviewee put it, “The best noodle shop in town will make lots of money.” Striving to be the best in important aspects of the business gives the company the best chance for success.

- **Set clear goals for the company**

Clear goals provide a focus for action throughout the firm, a motivator for employees and management, a means of determining compensation, and a means of measuring the firm’s achievements. Clear goals streamline management significantly. Without such goals, employees tend to lose track of what the company wishes to achieve and fail to come up with creative ways of operating.

- **Identify the key functional policies necessary to carry out the strategy**

One key to good strategy is internal consistency. All of the functional policies of the firm (production, marketing, financing, administration, etc.) should be consistent with the overall strategy. SME managers should identify how their functional policies support each other and support the vision and goals of the company. If this cannot be determined, then something in the strategy or its implementation will need to be changed.

- **Think through different alternatives to get where the company needs to go**

Too often SME managers seize upon their first solution to a problem without thinking through different alternatives before reaching a conclusion. The firm should think through multiple options before making major strategic decisions. Some options may be incremental, some may require stretch, some may be radical. The important thing is not to limit options too early before potentially beneficial options are properly explored.

- **Identify and arrange the resources necessary to carry out the strategy**

Too often SMEs embark on a strategy without an adequate sense of the human, financial, and other resources that are required to successfully implement the strategy. While detailed resource requirement lists may take time to put together, managers are often surprised how quickly they can come a good estimates of the key resources they require.

- **Implement the strategy**

The best strategy in the world will not be effective unless it is implemented properly. This requires a phased approach with clear milestones along the way. It also requires clear communication and a sense of shared purpose within the company.

- **Understand when to change strategy**

Strategies usually evolve over time. Companies must constantly check to see if their strategy is suitable to the external environment and when change may be necessary. When a strategy is no longer yielding strong performance, and there are no improvements in sight, it is time to reconsider the strategy.

Understanding Customers

Many SMEs are “order fillers” that act in response to specific customer orders without understanding the full requirements of the customer. This makes it difficult for the SMEs to differentiate themselves or to offer specific services that might enhance their value to customers:

- **Use the “order” as starting point**

The firm should think beyond the details of the order to understand the customer’s business and how the order fits into it.

- **Think about new ways to create value for the customer**

An understanding of stated and unstated customer requirements or benefits can provide a basis for a longer term and more even handed relationship than is the norm. New ways of creating value could include performing additional functions such as design, managing logistics and inventories, or other activities

- **Explore ways of expanding business with existing customers**

Existing customers are always the easiest to sell to. Understanding customer requirements is the best way to explore whether there is a potential to expand share in the existing product lines, sell to or support the customers in new product lines, or develop business with similar potential customers.

- **Anticipate developments within customer companies**

Understanding customers and their requirements provides an early warning system for new generations of products, new market initiatives, or new technology introductions by customers. Staying ahead of the curve could allow for expanded business opportunities.

- **Reassess the attractiveness of customers**

Many SMEs hang onto unprofitable customers that drain the SME's resources and distract them from taking advantage of other opportunities. SMEs should periodically reassess the attractiveness of their customers and take steps to focus on the profitable customers.

Understanding competitors

SMEs often do not have the resources to undertake detailed competitor analysis. Even if this is the case, it is essential that SMEs understand their competitors well enough to be able to develop strategies to beat them in the marketplace:

- **Learn about competitors from multiple sources**

SMEs should try to learn what they can about competitors from customers, suppliers, industry experts, and publicly available information sources.

- **Assess the different types of competitors**

Hong Kong manufacturing SMEs face competition from firms from the Chinese Mainland, Taiwan, Japan, Korea, South Asia, and Southeast Asia, and from other Hong Kong firms. These different types of firms all have their own sets of competitive advantages and disadvantages.

- **Reverse engineer competitor strategies**

Firms should try to understand the competitors' strategies in some details, particularly with respect to target markets, advantages and disadvantages, and intended competitive positions.

- **Reverse engineer competitor cost positions**

Many Hong Kong SMEs believe their Mainland competitors have a significant cost advantage, but few have actually estimated the magnitude of this potential advantage and therefore what actual costs competitors may have.

- **Track competitor initiatives and build competitor profiles**

Tracking important initiatives by competitors allows the firm to better understand competitors' strategies, trajectories, strengths, weaknesses, and any creative steps they take. A competitor database can be kept to organise information on competitors.

- **Do not underestimate competitors**

SMEs often underestimate their competitors and tend to believe that competitors have unfair advantages. Competitors are usually smarter than most managers give them credit for and while unfair advantages are often a fact of life that just has to be dealt with, SME managers all over the world tend to overstate the unfair advantages of their competitors.

Developing Clear Competitive Advantages

SMEs often do not have a strategy to develop clear competitive advantages. Beating the competition requires the development of clear competitive advantages. The key is that the firm needs to identify, create, and leverage advantages if it is going to succeed. These advantages can come from several sources:

- **Superior vision**

Superior vision allows the firm to identify and serve opportunities that other competitors may not realise exist, or to do so in new ways.

- **Superior knowledge**

Superior knowledge of customer requirements, technological solutions, production processes, distribution channels, sources of supply, and government regulations and policies can all be sources of advantage.

- **Superior resources**

Superior human resources, financial resources, locations, brands, reputation, and relationships can all be important sources of advantage.

- **Superior capabilities**

Superior research, design, production, marketing, sales, and administration capabilities can be key sources of advantage.

- **Combinations of advantages**

The most sustainable advantages are systemic advantages that result from combinations of advantages in vision, knowledge, resources, and capabilities.

Marketing and Selling to Existing and Potential Customers

Many SMEs have relatively haphazard marketing and sales processes. A better focus on marketing and selling can improve performance in most SMEs:

- **Focus marketing on firm advantages**

Marketing must be based on reality. It should focus on how the SME creates value for its customers and on the SME's advantages versus competitors.

- **Focus on high-value issues of customers**

Customers have their own strategies and imperatives (expanding sales, cutting costs, etc.). Marketing should focus on what the SME can do to help the customer carry out its strategy and meet its imperatives.

- **Understand the 80/20 rule**

For most SMEs, 80 per cent of sales come from 20 per cent of customers. This means the focus should be on identifying customers that can be part of the 80 per cent.

- **Estimate the cost of acquiring and serving particular customers**

Too many SMEs chase sales that are expensive to acquire and retain. Customers that are too expensive to acquire and retain should receive less sales efforts.

- **Understand the value of "post-sales marketing"**

The majority of sales of most SMEs come from repeat orders. Following up after delivery to ensure customer satisfaction and to get information on future requirements is a good way to expand business with new customers.

- **Use a range of marketing tools**

SMEs should not rely on a single marketing tool, but should use a variety of means, such as word of mouth, trade fairs, advertising in trade publications, cold calls, referrals, and other means.

- **Ensure that payment and credit terms are well understood and due diligence is performed on customers**

Agreement on payment and credit terms should be part of every sale. Due diligence on the creditworthiness and trustworthiness of customers is also extremely useful to the sales process.

Financing Operations and Financial Management

SMEs often have a difficult time obtaining financing for start-up, expansion, and working capital. In addition, many SMEs have rudimentary financial management that can cause problems. The following are some steps that can be taken to improve firm finances:

- **Develop strong relationships with banks**

Outside of family funds and retained earnings, banks are the main source of finance for SMEs. Developing strong banking relations may be critical to receiving bank support in difficult times.

- **Establish credit lines**

Even though there is an expense to establishing credit lines, establishing them in advance of need is always preferable to waiting until the need arises when terms may be more difficult.

- **Consider SME support programmes**

SME support programmes can be sources of loans at low rates. SME managers should be aware of these programmes and the potential benefits of using them.

- **Use asset-backed financing when necessary**

Selling receivables, and borrowing against assets like land, plant and equipment, and receivables may be used as sources of finance.

- **Institute strong cash management policies**

Weak cash management is the most common reason that SMEs fail. Companies should know their cash position on a daily basis and tightly monitor cash inflows and tightly manage cash outflows.

- **Keep enough cash in the business**

In most cases, the primary source of income for the SME owner is the profit of the SME. Enough profit, however, needs to be retained in the company to see it through difficult times.

- **Institute a minimum balance policy**

SMEs should institute policies that require a minimum cash balance that allows them to meet their obligations for several months.

- **Assess creditworthiness of customers carefully**

Before selling on credit, a careful assessment of customer creditworthiness should be performed. Otherwise cash sales should be considered.

- **Pursue payment aggressively**

Non-payment by customers can threaten the survival of the SME. Strategies for identification and collection of debts should be in place to minimise the problem.

- **Take advantage of terms on payables**

Stretch payables to the extent possible under contracts and seek early payment discounts to optimise cash positions.

- **Understand key financial ratios and reports and use them as management tools**

Track cash flows, interest coverage ratios, profitability ratios, etc. on an ongoing basis to monitor performance.

- **“Stress test” the SME’s financial position**

SME managers should “stress test” the firm’s financial position by projecting what the cash position would be if the market had a significant downturn, if a major customer took their business elsewhere, if commodity prices suddenly rise, or if labour rates or other costs were to suddenly shoot up. The firm should seek to ensure that its financial position would be sound even in the face of such stress.

Administering and Managing the Firm

Many SMEs have a difficult time administering and managing the firm. This is usually due to a shortage of managerial and office support talent coupled with expanding administration and management tasks. High priority areas include:

- **Ensure legal and regulatory compliance**

Know the relevant laws and regulations and set up an early warning system to monitor changes in laws and regulations. Use outside professionals when necessary to advise on legal and regulatory matters.

- **Implement suitable workplace safety regulations to minimise on-the-job risks**

SMEs should ensure that workers are well trained in the safe use of machinery, and that machinery and vehicles are properly maintained. SMEs also should ensure that there is a culture that encourages safety in the workplace.

- **Provide ongoing training for staff consistent with the needs of the business**

Staff training is crucial across the board. Employees will usually not become more productive without some form of training. Investments in training can be seen as investments in productivity improvement.

- **Seek cost-reducing business processes**

Bookkeeping, accounting, payroll, simple IT functions, and other processes can often be outsourced inexpensively. If not, ensure that in-house personnel can take on these functions in a cost-effective manner.

- **Develop strong human resources policies**

Dealing with employees is one of the most important functions of the firm. SMEs should attempt to ensure that their HR practices are attractive to workers. In a competitive market, workers who feel that they are well treated and respected, who are fairly paid, who receive workplace training and on-the-job support, and who can see a future with the company are less likely to leave to seek opportunities elsewhere.

- **Use IT effectively**

Computers and IT systems can be a huge benefit in administering the SME. Ensure that someone in the firm has the necessary skills to use IT to support the firm across its administration tasks. SMEs also should have computer security, data control, off-site storage, disaster recovery, and data location (where they want their data stored) policies.

- **Set up strong sales procedures**

Often SMEs have rather haphazard sales procedures. The firm should set forth clear sales procedures that identify how much discretion sales people have in making sales, what credit checks of customers may be necessary, what practices are not acceptable from sales staff, and how sales are to be logged into company accounts and systems.

- **Set up strong purchasing procedures**

SMEs should have procedures that govern arrangements with suppliers, quotation requirements, acceptance procedures, and payment processes. The payment system should ensure payments are made in a timely manner, against valid invoices, and without overpayment or duplicate payments.

- **Set up strong monitoring and control functions**

SMEs often do not have strong monitoring and control functions. As a result, they often recognise problems only when it is too late. Inventory control, cash control, fraud prevention, risk management, and internal reporting procedures are all crucial to firm success.

Keeping Up To Date on Market, Technological, and Managerial Developments

Many SME owners and managers are so busy managing their companies that they do not keep up to date on market, technological, and management developments. Doing so is crucial for companies to be able to compete effectively. SMEs cannot afford to lose customers to their competitors on the basis of slow response times or lack of current knowledge. Steps that can be taken include:

- **Keep up to date on market developments**

Meetings with customers and potential customers, the general business press, trade publications, and active participation in industry associations can aid in this area. The Hong Kong Trade Development Council also provides periodic market updates for major markets and industries.

- **Keep up to date on technological developments**

Customers, trade press, industry associations, consultants, and organisations like the Hong Kong Productivity Council are potential sources of information on technological developments.

- **Keep up to date on management developments**

Industry associations, chambers of commerce, business schools, and organisations like the Hong Kong Management Association are potential sources of information on management developments relevant to SMEs.

Reducing Dependence on Individual Customers and Suppliers

Many SMEs rely on individual customers for a disproportionate part of their business. While this is natural in a start-up, overreliance on a single customer puts the SME at the mercy of that customer and makes any downturns in that customer's business difficult to deal with. Many SMEs also rely on a small number of suppliers so that disruption of inputs from a single supplier can create enormous difficulties:

- **Diversify customer base**

Companies cannot rest once they get a single customer, even if that customer takes up the existing capacity of the SME. It is usually advisable to continue to search for new customers to diversify risk and reduce bargaining power of the single customer.

- **Seek guarantees**

If a customer demands exclusivity, then the SME should seek financial guarantees to offset the associated risks.

- **Identify multiple suppliers**

Even if the SME's present suppliers are satisfactory, additional suppliers should be identified for overflow capacity, to keep pressure on existing suppliers, and to step in case of supply disruption.

Additional Challenges

There are several other challenges that SMEs face. Approaches to dealing with some of these challenges include:

- **Enhance firm reputation and goodwill**

A reputation for reliability, high product standards, fair dealing, and willingness to be flexible when necessary can be a key competitive advantage for the firm. Avoiding situations that might damage reputation and goodwill is also crucial.

- **Seek outside advice when necessary**

While professional services may be expensive, SMEs need to be able to call on lawyers, accountants, consultants, IT specialists, and others when necessary.

- **Manage government relations carefully**

Government relations are particularly important in the Chinese Mainland. SME owners and managers operating in China should find ways of interacting with officials on a regular basis to build up dialogue and understanding.

- **Develop long-term relations with key customers and suppliers**

Long-term relationships allow for better understanding and the potential for developing true partnerships with selected customers and suppliers.

- **Do forward-looking risk analysis**

SME managers often claim to be too busy to do proper risk analysis. However, SME managers need to determine what could go wrong in the external and internal environments and prepare for the potential for such events to occur. Risk assessment should focus on the likelihood and potential magnitude of disruption caused by risk events. Contingency plans then should be made for the most important risks. Ongoing risk assessment and contingency planning is often the difference between survival and death for SMEs.

• **Plan for succession**

Succession planning can be difficult for SMEs, particularly if the founder has no relative ready and willing to take on the task. It is best to think about succession planning early, to groom potential successors, to consider turning over management to professional managers if there is no ready successor, or to identify potential buyers if the owner-operator wishes to sell out.

QUESTIONS THAT HONG KONG SMEs MUST ANSWER

The list of potential strategies may seem daunting, but it all comes down to being able to ask and answer a number of basic questions about the firm's strategy, its customers, its competitors, and how the firm's strategy should address customers and competition. These questions can be used to prioritise the firm's information gathering and strategy setting process.

The challenges and strategies available to Hong Kong manufacturing SMEs lead to many questions that the SMEs need to be able to answer about their business:

- Which strategy or strategies will the SME use to deal with cost pressures?
 - Which strategy or strategies will the SME use to differentiate itself to gain some pricing flexibility?
 - Which strategy or strategies will the SME use to deal with labour market pressures?
 - Which strategy or strategies will the SME use for its business model development?
 - Which geographic markets will the SME focus on?
 - Which strategy or strategies will the SME use to deal with regulatory and policy-related issues?
 - If exit or consolidation strategies are appropriate, which strategy or strategies will the SME use?
- In order to answer these questions, the SME will have to answer several other questions about their business and business environment. These include:
- What is competitive balance among Hong Kong firms, between Hong Kong and Chinese firms, between Hong Kong and foreign firms operating in China, and between Hong Kong firms operating in PRD and firms operating in other locations?
 - What are the sources of advantage and disadvantage for each type of firm? What are the specific sources of advantage and disadvantage for the individual SME?
 - What is the specific cost structure of their own business in the PRD (or wherever they are located) versus other places today, and how is the comparison evolving?
 - Does the sector in which the SME competes have a future in Southern China, or should new locations be sought urgently?
 - What are the customer segments that are available to the firm and what are the customer requirements in the different segments?
 - For companies operating in the Chinese Mainland, how is their sector perceived by the Municipal, Provincial, and Central Governments? Does it get favourable, unfavourable, or neutral attention?
 - To what extent are environmental or product safety regulations important in the sector?
 - What new business models or activities might be open to the firm?
 - Which of the external issues is most pressing for their business?
 - Does the firm have a clear strategy targeting specific types of customers, with plans to satisfy their needs, with specific competitive advantages, and with the resources necessary to carry out the strategy?
 - Does the firm have a clear view of what it can and will do better than competitors?
 - Does the firm have the managerial, administrative, and operational capability to carry out the strategy effectively? If not, how can these capabilities be obtained?
 - Does the firm have sound financial, marketing and sales, administrative, control, and risk management processes in place?

- Who will manage the firm into the future?
- When might it be necessary or beneficial to engage in collective action with respect to supply chain development, relocation, or other issues?

It will be very difficult for Hong Kong's manufacturing SMEs to survive and thrive if they do not have good answers to these questions. On the other hand, developing good answers to these questions is the first step in facing and meeting the challenges that confront Hong Kong's manufacturing SMEs.

POTENTIAL FOR COLLECTIVE ACTION

The strategic options listed above focus for the most part on what the individual firm could or should do. However, there are some responses to strategic challenges that may be appropriate for collective action. While SMEs often find ways of collaborating in terms of lobbying efforts and the general provision of information and management training, it is far less common to find SMEs collaborating on operational business matters. The list below is a partial list of the sorts of collective action that SMEs may engage in to overcome the disadvantages of small scale. Some of the items focus on dealing with external issues, others focus on trying to obtain the benefits of scale through collective action. They include:

- Investments in effluent control that are effective only in large scale. Some industries, like electroplating, semiconductor production, leather tanning, fabric dyeing, and others are by their nature polluting. In some cases, there are means of handling the effluent that are only technologically effective or cost-effective if they operate at relatively large scale. By definition, such investments or scale will be beyond the means of individual SMEs. However, SMEs banding together to either invest in appropriate technologies, or relocating to the same place to the investment can be made, may bring these technologies into play. In Spain, for example, a group of leather producer SMEs cooperated to set up a third party firm to handle the effluent from the tanning process for all of them. A group

of Hong Kong electroplating companies have been negotiating to relocate to a single industrial park in Guangdong.

- Relocation of production chains. Relocation due to high costs can be difficult for individual SMEs because if they move on their own they may separate themselves from their supply chain. On the other hand, if a sufficient number of firms relocate to the same location, they may provide enough of a critical mass to pull the supply chain with them. In Northern Italy, a group of footwear manufacturers decided to all set up production in the same town in Romania. This induced enough of the supply chain to follow to make the move viable. A few years ago, 11 Chinese mobile phone manufacturers all moved in concert to Huizhou. They were able to negotiate with the municipal government for facilities and even the establishment of a mobile communications research centre to support their activities.
- Bulk purchasing. SMEs often cannot purchase inputs and materials at the same prices of larger firms with higher volumes. This disadvantage can potentially be overcome through coordinated bulk purchasing. There are many examples of this worldwide with groups of firms coordinating to purchase, raw materials, components, warehouse space, transportation services, market intelligence, consulting services, accounting and payroll services, and other business requirements.
- Full line provision. Some customers, particularly large retailers or OEM customers, may desire to purchase a full line of products from a single source. Normally SMEs cannot hope to supply such customers. However, in some cases it may be possible for SMEs to join forces to supply the full line that the customer desires. This requires a unified approach and clear division of labour among the SMEs.

- Joint or place branding and promotion. Many products and services around the world are known to come from a particular location. Scotch whisky, champagne, and burgundy are made by several companies from particular areas. In Hong Kong, numerous players in the tourism sector support joint branding and promotion of Hong Kong as a tourism destination. Many SMEs participate in Hong Kong's trade fairs, in a sense cooperating to provide a wide range of sellers to attract the highest number of buyers, but then competing in the fair itself to sell their own products. In the process, Hong Kong gets a reputation as the "place to be" to purchase in particular industries.

There are several obstacles to collective action of the types mentioned above. First, someone has to identify the potential for collective action, which may be difficult if individual SMEs each have only part of the relevant picture. Second, someone has to investigate whether the potential collaborative action is viable. Third, SMEs usually do not have forums in which they can discuss and negotiate the details of collective action. Fourth, SMEs usually need a neutral party to facilitate discussions and plans for collective action. Fifth, if the collective action requires government approval or permission of some sort, the SMEs usually find it hard to organise who will negotiate on the part of the group.

Overcoming the obstacles to collective action can often only be accomplished by industry associations or more general associations of companies. Such groups are often the only ones in position to understand the immediate challenges and opportunities their members face and to act as a catalyst to bring firms together to explore, develop, and implement collective strategies. This could become an ongoing role for the Federation of Hong Kong Industries, which already engages in some activities of this sort.

Conclusions

Hong Kong manufacturing SMEs face many issues going forward. These include uncertain global markets, rising costs in their traditional production locations, changes in legal and regulatory environments, an increasingly difficult competitive environment, Chinese Mainland Policies affecting operations in the Mainland, and a host of operational and strategic issues. All of the issues identified above are significant in and of themselves, but they must also be put into proper perspective and context in order to understand what the future may hold.

Perspectives on Key Issues

The global economy has been experiencing a downturn, but the global economic environment has actually been quite good for most of the last 30 years. The RMB is under pressure to appreciate, but the consensus among economists everywhere except the Chinese Mainland has been that it has been severely undervalued for a long time. Labour costs are rising in the Chinese Mainland, but for well over a decade previously they were virtually unchanged in real terms. Utility costs are rising in China, but some utility prices, like electricity are still well below global norms. Legal and regulatory changes in China are affecting Hong Kong SMEs operating in the Mainland, but the Chinese legal and regulatory system allowed them to set up and operate in the first place. The competitive environment is becoming tougher, but it was the initial lack of Mainland companies with knowledge of processes, products, and markets that allowed many Hong Kong companies to become established in the first place. Chinese policies about industrial development are affecting SME operations in the Mainland, but again Chinese development policies allowed the Hong Kong firms to set up as well. SMEs by their nature face strategic and operational issues, but successful SMEs find ways to overcome these issues.

Some interviewees expressed a view that Hong Kong manufacturing companies, particularly SMEs, became established through a particular set of circumstances that may indeed change forever. If so, then many Hong Kong manufacturing SMEs will face difficult times. However, with change also comes opportunity. It will be the ability and willingness of the Hong Kong companies to change and to exploit existing and new opportunities that will determine their future.

LOOKING BACK

Hong Kong industry has evolved enormously over the last few decades. Thirty years ago, few would have imagined the important role that Hong Kong industrial corporations would play in today's global economy. Fewer still would have imagined that the key to this importance would not be artificially trying to keep industrial activities within Hong Kong, but rather it would be adjusting to changing circumstances and pioneering new production locations outside of Hong Kong. This is just one example of the constant reinventing of Hong Kong industry that has occurred over the period.

Looking back, the success of Hong Kong industry has depended on its ability to take advantage of opportunities resulting from major developments in the global economy, such as reduction of trade barriers, increasing affluence in global markets, improvements in transportation and communication technology, containerisation, the emergence of modern supply chains, the separation of production from other corporate activities, and the re-integration of the Chinese Mainland into the world economy. Similarly, looking forward, the success of Hong Kong industry will depend on its ability to take advantage of opportunities resulting from future developments in the global economy. It therefore makes sense to project what some of these developments might be.

New Opportunities

One major development going forward will be the rise of consumer markets in the Chinese Mainland. By the middle of this century, the Chinese Mainland will have the world's largest economy by a significant margin. According to some estimates, Chinese consumer demand accounts for around six per cent of global consumer demand today, but is expected to rise to over 25 per cent by 2025, and its share will continue to grow thereafter. What will be the world's largest market is right on Hong Kong's doorstep, and it will be a market in which Hong Kong companies have had production and other activities since the 1980s. Yes, there will be intense competition in the China market, from Chinese companies and from companies from all over the world, but the China market still will offer enormous opportunities for Hong Kong industry, and some Hong Kong companies will undoubtedly grow large serving something they have never had before, a huge domestic market.

By the middle of the century, the Chinese Mainland will also be by far the world's leading industrial country. The industrial sectors in the OECD countries are diminishing in relative importance and even though costs will rise in China and resources will become somewhat constrained, there is simply no other country, or even set of countries, that will have the population, the infrastructure, and the international supply chains necessary to keep up with China. Southeast Asian countries are too small and will saturate before they become true competitors to China. India will have decades worth of infrastructure to construct, educational policies to develop, and regional geo-political problems to resolve. Africa is too fragmented and lags too far behind. The world's largest industrial economy will be right on Hong Kong's doorstep, but it will not be the same industrial economy we see today. Instead, as cost pressures mount on the coast and infrastructure improves in the interior, we will see a much more geographically balanced production profile around China and companies managing an industrial portfolio in China will need to manage in more than a single location.

Another major development will be closer economic integration between Hong Kong and the Chinese Mainland. By the middle of the century, Hong Kong and the Mainland may have decided that "one-country, two-systems" has been so useful to both sides that it should be retained in some form or another even beyond 2047. Certainly, Deng Xiaoping once stated that such might be the case. No matter what the exact circumstances of the political situation at the time, in economic terms there is likely to be complete or nearly complete integration by the middle of the century. The integration will be facilitated by arrangements such as CEPA, the Hong Kong-Guangdong Framework Agreement, and their successors. It will also be facilitated by infrastructure such as the Hong Kong-Zhuhai-Macao Bridge and the linking of Hong Kong with the national high speed rail network. Closer economic integration with the Chinese Mainland means that Hong Kong industry is likely to be far more diverse than it is today, as Hong Kong will be a prime location for headquarters, management, finance, marketing, sales, corporate communications, design, research, and logistics, not just for traditional Hong Kong companies, but for companies originating in the Chinese Mainland, elsewhere in Asia, and elsewhere in the world. The diversity will be reflected not only in the location of origin of companies that will either move to Hong Kong or carry out important functions in Hong Kong, but also in the industrial mix as the full industrial diversity that will be present in South China will be reflected by companies with a presence in Hong Kong as well.

Another major development will be the internationalisation of companies from the Chinese Mainland. Today, China's outbound investment is dwarfed by its inbound investment. By the middle of the century, in all likelihood this situation will have been reversed, or at least the investment flows will be far larger and better balanced. Despite common belief, the vast majority of China's outbound investment to date has not been in the resource sector, but in the service sector. This investment will set the stage for much larger outbound investments

by Chinese industrial enterprises in the future. It is quite likely that several of these outward industrial investors will run their international operations, or make their international investments, from Hong Kong-listed and / or domiciled subsidiaries, and it is quite probable that some will even place their corporate headquarters in Hong Kong.

Rising affluence in China and India, as well as in the rest of the developing world, will result in complex segment structures across a wide range of industries. While more affluent countries and segments within developing countries will see greater fragmentation and specialisation in demand and supply, at the same time hundreds of millions of developing country consumers will create mass markets of unprecedented size. The result will be that there will be a wide range of strategies, cost structures, and production locations that will be able to succeed, even within a single industry. This will make identifying, understanding, and serving specific customer niches even more important, and potentially even more valuable, in the future than they are today.

NEW PRESSURES

There will be pressures on Hong Kong industry as well as opportunity. Costs will continue to rise in the traditional production locations of Hong Kong firms. Chinese officials will continue to work to restructure the economy of the Pearl River Delta. Mainland companies will rise to compete directly against Hong Kong companies in more and more industries. Foreign buyers and retail chains will continue to exert tremendous pressure on their suppliers to reduce prices while improving quality and expanding service levels. In addition, we can expect that over the next several years resource constraints and environmental considerations will continue to grow in importance. The rise of China and India imply resource demands that will strain global supplies. Companies will have to develop products and processes that use resources more efficiently. Under all these pressures, we would expect to see some industries in which Hong

Kong companies compete to consolidate, others to be transformed, and some to diminish or even disappear. And even in those that remain, success and even survival might be difficult to achieve for individual companies.

But while many existing companies will come under pressure, the overall picture remains one of opportunity for Hong Kong industry: opportunity to serve the world's fastest growing consumer markets, opportunity to participate in the world's largest industrial base, opportunity to take advantage of closer interaction with the Chinese Mainland, opportunity to benefit from the influx of corporations into Hong Kong, and opportunity to ride the wave of increasing specialisation. This is not to say that opportunity will automatically lead to business success. In fact, in order to take advantage of the opportunities it will be necessary for Hong Kong industry to reinvent itself one again.

THE NEED FOR REINVENTION

This reinvention will involve a clear understanding of economic, business, and policy trends. It will involve developing the skill sets to develop, design, produce, and sell products that can meet market tests in China, the rest of Asia, and elsewhere. It will involve developing the capabilities to manage operations in Hong Kong, in South China, in the rest of China, and elsewhere. It will involve mastering modern communication and information technologies as research, management, and marketing tools. It will involve moving beyond the limited set of industries in which Hong Kong was once a leading production location to embrace the entire range of industrial possibilities afforded by access to China. It will involve learning how to serve rapidly emerging niches in rapidly emerging markets. It will involve taking on more activities than the simple OEM "order taking" pattern of much of Hong Kong's traditional companies. It will involve developing compelling business strategies that identify specific unmet needs and tailor a business proposition to meet those needs. It will involve higher levels of professionalism in internal

management, especially when it comes to finance, human resources, and government relations. It may also involve more creative use of collaborative strategies among Hong Kong SMEs than has generally been the case in the past.

We note that success for Hong Kong industry will take on a variety of forms. In some cases, it will be traditional Hong Kong companies that succeed; in other cases it will be brand new companies founded by Hong Kong people that will succeed; in still other cases it will be companies founded in Hong Kong or moved to Hong Kong by entrepreneurs that originally came from elsewhere that will succeed. Perhaps the most important characteristic of Hong Kong industry in the past has been the ability to recognise new opportunities and to develop business out of opportunity. It is this same characteristic that will determine the performance of Hong Kong industry in the future.

THE PRESENT REPORT

The present report indicates that even in the face of challenges, that there are some sectors in which Hong Kong firms and Chinese production are likely to continue to be very competitive. There appear to be no viable alternatives to Switzerland and China as production locations in the watch sector, and Hong Kong firms continue to have strong positions. China's position in the toy sector is so strong that it is unlikely other nations will make strong inroads in the near term and the position of Hong Kong firms remains strong. Hong Kong firms are coming under increasing pressure in the mould and die industry, though in a context in which China is easily the world's largest growth market. While there is increasing pressure in the low end of the garment industry from South Asia and other locations, China is expected to be the dominant player well into the future, and Hong Kong companies remain well-positioned. In electronics, China as a whole has been expanding its position, and Hong Kong firms continue to find interesting niches. None of this means success for Hong Kong firms is guaranteed. In fact each of these sectors is going to get more

difficult for Hong Kong firms. However, the individual case studies show specific examples of strategies that Hong Kong companies have used to continue to succeed in the midst of difficult economic and business circumstances.

In addition to providing some specific examples, the report aims to set out the strategic options that Hong Kong SMEs have in order to meet the challenges and take advantage of the opportunities they face. We note that there is no single recipe or path to success, but rather several potential recipes or paths to success. The industry situation reports and case studies should make this clear. The right strategy for an individual SME will depend on its sector, the segment it chooses to address, the nature of customers and competitors in the segment, and its own skills and capabilities. Instead of trying to provide a single recipe, we have tried to set forth in a comprehensive manner the options that are potentially available to Hong Kong firms and the strategic and managerial principles they will need to successfully formulate and implement their strategies. This report and the accompanying "SME Advisory Kit" should be viewed as guides and tools to aid them in this process.

- 1 The minimum wage for Huadu, Panyu, Nansha, Conghua, and Zengcheng Districts of Guangzhou as of mid-2010 were RMB 960 per month for full-time employees and RMB 5.52 per hour for part-time employees. www.gzlss.gov.cn.
- 2 The Zhuhai Municipal Government has set the minimum wage for full-time employees at RMB 960 per month and the minimum wage for part-time employees at RMB 9.2, per hour, higher than that mandated by the Guangdong Provincial Government. www.zhldj.gov.cn. www.gd.lss.gov.cn.
- 3 On 27 May 2010, the State Council approved the expansion of the Shenzhen Special Economic Zone to the whole city. Therefore, Bao'an and Longgang districts have been included in the Special Economic Zone since 1 July 2010.

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