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KPMG Global China Practice

China 360

China shared services: Start now!

April 2014

Does it make sense to consider setting up a shared service center (SSC) in China without a robust business case? Often the initial business case does not appear compelling. In the short-term, setting up an SSC may result in increased costs, rather than delivering immediate cost savings.

China's ambition to become a more service-oriented economy was initially mentioned in 2006 as part of the 11th Five-Year Plan (2006-2010). Since 2006, China's Ministry of Commerce has provided increased support to the service sector, including shared services and outsourcing activities, and continued to support this path in the 12th Five-Year Plan 2011-2015. Since 2006, the government has designated over 20 cities as 'outsourcing centers' across China.

Shared services can provide a multitude of strategic benefits over the longer-term. Many companies (including KPMG China) have indeed reached this conclusion, and moved to set up an SSC in China; companies are establishing SSCs in China to not only serve Chinese and north Asian operations, but also support global operations.

This month's *China 360* will examine the value proposition of SSCs, as well as practical considerations that should be included when assessing the merits of an SSC in China. In addition, insight will be provided on how to develop a strong business case.

Global Business Services (GBS) *refers to strategically aligning a company's regional shared services (internal captive center(s) and outsourcing relationships) to create a 'global' delivery model that tactically aligns activities.*

Companies in China should be looking into how they 'fit' into their organization's GBS strategy

GBS structure

Global Business Services is stragically aligning regional shared services to 'add value' and separate from their competitors

GBS Organization

Shared services have been regionally focused to support both delivery models below

Shared Services

Shared services can be an internal or external part of your organization

Internal Captive Center

Outsourcing (Third Party)

According to HFS research over 75 percent[1] of Fortune 500 companies have adopted some form of shared services. Many of these organizations have evolved into a Global Business Services (GBS) strategy to obtain additional value. GBS has become a key pillar in many companies, including Procter & Gamble, Nestle, and Citigroup, with the head of GBS typically occupying a seat next to the CFO, CIO, or CPO of their respective organizations.

Chinese companies that have established shared services include: Tencent, China General Nuclear Power Cooperation, Guangzhou Power Bureau, and ZTE. They have all set up various back office functions to support their strategic growth initiatives.

> *The resource pool in China is fantastic for shared services. I've set up centers all over the world, and the ability for the workforce here to follow regimented processes and work in a shared service environment is outstanding.*
>
> **– Gary P. Nowak**
> Director, KPMG Management Consulting

1. HFS is 'Horses for Sources'. KPMG US LLP has a strategic alliance with HFS.

Key attributes of shared services

Organizations initially set up shared services with the expectation of a positive impact to their bottom lines, saving companies millions of dollars. After the savings were incorporated into budgets and future plans, the focus turned to other valuable attributes outlined here.

China companies, however, typically won't find an initial compelling business case and should focus on the numerous other ways that shared services can provide value to an organization. **Click on the icons below to read more..**

01

Support growth

Businesses in China (both multinationals and domestic companies) continue to focus on growth, either organically or through acquisitions. Shared services can support this growth in a couple of ways. With shared services in place, not all acquired company resources will be required and newly acquired companies can be integrated more quickly: both of these outcomes would tend to reduce operating costs.

The US food and beverage company General Mills Co. has added over 80 new Haagen Dazs stores in China without increasing the size of their SSC.[2]

02

Compliance and control

As their business in China expands, and the regulatory environment becomes more complex, organizations continue to be at risk of non-compliance with government regulations. A trademark benefit of shared services is the methodical process documentation, which utilizes process flows and standard operating procedures to capture control points, information flow and segregation of duties. This level of rigor provides chief executives with assurance that regulations and policies are properly documented, and through proper reporting, are being consistently followed.

03

Leverage IT investments (ERP, automation)

Creating a critical mass of resources in a single location allows the ability to automate on a scale that can create a business case for technology. For instance, a decentralized organization may not consider automating accounts payable invoice entry, whereas an SSC has the scale to obtain business case justification. Additionally, implementing a new ERP (enterprise resource planning) system is typically a catalyst for changing the service delivery model. Creating shared services and implementing an ERP typically go ‘hand-in-hand’ as processes normally need to change with the new system.

04

Minimize operating costs

There are a number of ways an SSC can assist a company to reduce operating costs. First, economies of scale can drive down overall operating costs, as processes can be made more efficient if they are centralized, and duplication of effort reduced. Second, delivering services from a lower cost location can also reduce costs: businesses in China’s tier-1 cities can see savings of 15 percent[3] or more by locating services in tier-2 and tier-3 cities. Finally, establishing business outcomes (see below) can also contribute to an improved bottom line.

2: James Wu, General Mills Co., VP Finance, Greater China

3: Based on company discussions throughout China, as well as KPMG experience.

05

Talent cost and retention

The cost of quality talent in China is rising each year. Salary increases in major China cities are growing above the rate of inflation, with annual wage inflation exceeding 10 percent according to China's 12th Five-Year Plan[4]. Shared services is a proactive way to manage talent and get the most out of rising salaries, while creating a structure to accept a high yearly attrition rate (sometimes reaching over 20 percent)[5]. Allowing businesses to focus on high-end value added services allows an organization to pay a bit more to those employees, while shared services pay much lower (but still locally competitive) salaries.

> *"But for many foreign companies, things are getting harder (in China). That is partly because growth is flagging, while costs are rising. Talented young workers are getting harder to find, and pay is soaring"*
> *The Economist, January 25th, 2014*

06

Reporting and metrics (increased visibility)

Shared services provide increased visibility of operational metrics and information allowing an organization to compare common cost components across locations or business units. Since an SSC has access to systems and operational data, this structure is perfectly suited to perform these functions. Key executives are enabled to improve their organizations with proper information through consistent reports and metrics. Providing a single point of contact to the global HQ organization can be invaluable to responding to ad hoc requests for information.

07

Business outcomes

Business outcomes are a level beyond service level agreements (SLAs). SLAs are based on the concept of giving assurance that the SSC will perform functions accurately and timely. Today, however, Global Business Service organizations are focusing on business outcomes to impact the bottom line. Typical business outcomes include reduction in DSO (Daily Sales Outstanding), increased strategic sourcing compliance, reduction of reconciling items, increase in accounts payable days and fewer days to close the books. GBS organizations increasingly stress this concept and will want to share in the benefit of these tangible business improvements.

08

Data and analytics

The new 'darling' of every organization is improving Data and Analytics capabilities: CEOs are grappling with how best to grow their business using information and analytics. Established shared services or Centers of Excellence (COE) organizations are a logical choice to build this capability; the key consideration is the level of talent available who have the ability to perform this function.

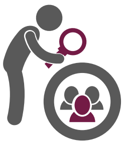
> *Within China an SSC and COE can logically be co-located, making a very strong case to move up the value chain and incorporate some type of Data and Analytics capabilities.*

4. http://www.reuters.com/article/2012/02/08/us-china-economy-jobs-idUSTRE8170DY20120208
5. Based on industry knowledge and speaking with over 50 SSCs and service providers in over 20 cities worldwide.

09

Business focus and flexibility

Transactional processes are the typical foundation of any shared service center. By 'removing' these activities and locating them in an SSC, the business can focus on what really matters: top line revenue growth and increasing margins. In contrast, activities related to handling vendor complaints, collecting receivables or managing internal personnel administration will not directly grow the business. As companies adopt an SSC strategy, it is imperative to realign the corporation for success. And in a dynamic business environment such as in China, an SSC structure offers the flexibility to adapt to changes in business models and directional changes within the organization.



10

Accessing third party expertise

'Going it alone' is a tough journey: moving more quickly up the maturity curve is a challenge that typically requires third party expertise. In China as elsewhere, such expertise can be delivered through relationships established with third party providers in the areas of technology, consulting services, software and real estate. Shared services has the ability to provide the size and scale needed to establish these strategic third party relationships. KPMG finds that as companies move up the maturity curve, they tend to build multiple strategic relationships. KPMG has been very successful in working with companies and building these strategic relationships to assist with their GBS strategy.

Getting a business case in China

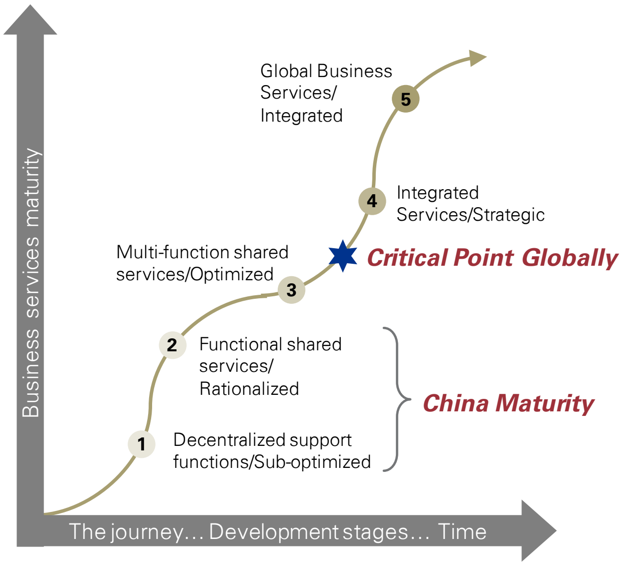
When evaluating a China-based SSC, a positive business case can result if the potential to provide services to business units in higher-cost regional or global locations is considered. Many companies have located regional SSCs in China to serve China, Japan and Korea, with Dalian a popular choice for such SSCs. As China develops deeper competencies, such as language skills, it will be a very viable alternative to more mature SSC locations, such as India or the Philippines.

China on the maturity curve

China is a relative newcomer to Global Business Services, and although the past few years have seen rapid development, China's maturity on the GBS maturity curve compared to some other developed economies is, as you would expect, at a much lower level. Companies in the US have had their hand in shared services since the early 1990's and can be at Level 5: this typically took 12 to 15 years of hard work and laser-like focus to accomplish.

Below are stages of maturity and attributes at each stage, in our experience each stage takes two to three years for companies to accomplish.

KPMG Global Business Services Maturity Model

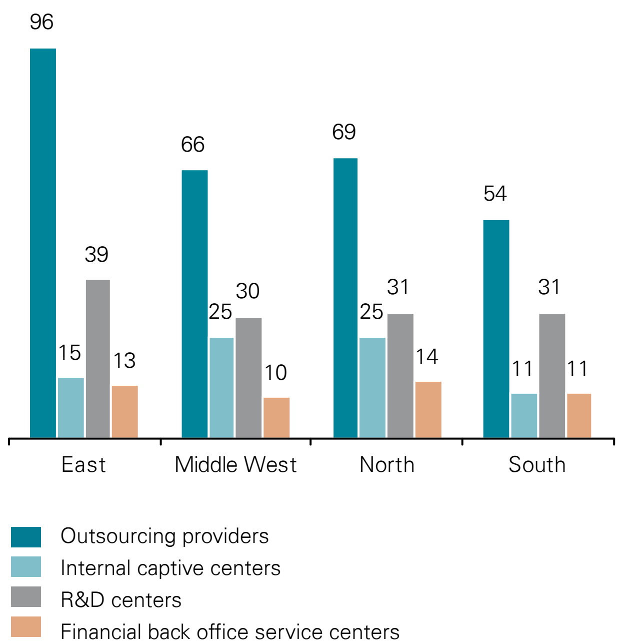


5	True end-to-end processing Customer focused High value
4	High-end processes Global process owners
3	Multi-function shared services Strategic outsourcing
2	Single-function shared services Majority of businesses supported by shared services
1	Decentralized functions No outsourcing

However, the advantage for China-based SSCs is that the 'trail' has already been blazed and they don't have to re-invent the wheel. Once businesses in China realize the benefits of GBS (as outlined above) they can follow an established roadmap. The timeframe to reach a more mature level will be much steeper (i.e. shorter) since the vision, tools and methodology to get there are readily accessible.

Gary P. Nowak, a seconded Director to Shanghai from KPMG in the US, recognizes the opportunity for businesses in China to build their shared services capability now. *"Companies need to strategically support future growth and more importantly build efficiencies to reduce costs and streamline processes. The day is quickly approaching where reducing costs will become just as important as increasing revenue."*

Regional location of major SSCs and R&D Centers in China



Source: KPMG Research – Inside the Dragon

Locating an SSC inside the dragon

Finding a shared service center location in China is no easy task. An SSC is not a temporary or short-term facility, and given the range of locations across China there are a variety of options from which to choose.

Costs are clearly one set of considerations: rent, labor, overhead and how these costs are expected to rise over time. In addition, however, are many other factors that should not be overlooked, including transport; access to resources (are there large universities and colleges nearby); the IT and communications infrastructure; proximity to existing operations; and the business attraction efforts or incentives provided by local government agencies or zone management.

When US logistics giant FedEx was evaluating locations, they chose Wuhan, in the province of Hubei. For FedEx, an important reason was that Wuhan has China's second largest concentration of universities (behind Beijing); it has eight national universities, 35 institutions of higher education and over 800,000 students[5] – many possessing strong language skills.

As China continues to advance up the maturity curve, it is likely that different cities will emerge as preferential destinations for specific industry verticals. For example, Shanghai – despite tier-1 city status (and costs) – is home to a number of financial services SSCs due to the nature of Shanghai as a financial and business center.

Overall, however, there is a trend toward China's tier-2 and tier-3 cities. Relatively cheaper cities like Suzhou, not far from Shanghai, are potentially attractive locations for companies from a range of sectors; inland cities, such as Chengdu, are also home to an increasing number of SSCs. This trend toward lower tier cities is significantly more rapid than the more established outsourcing countries, such as India.

5. www.amcham-shanghai.org/

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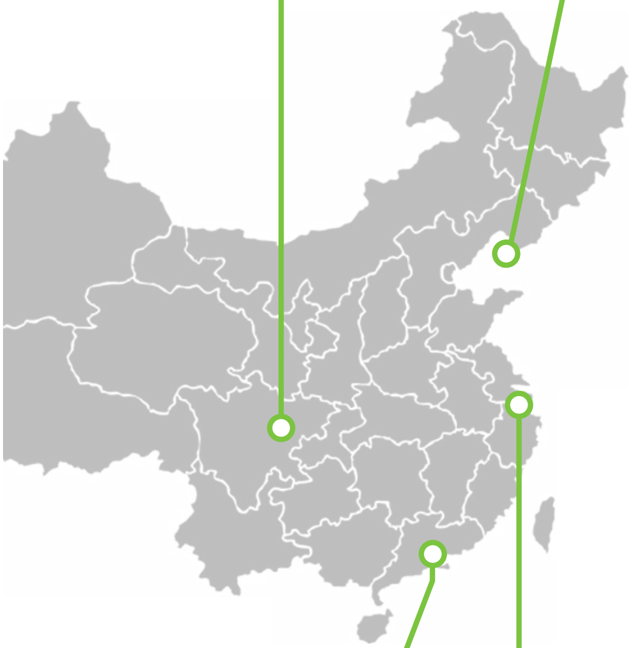
Representative shared service locations

Dalian has a good technical and financial skill base and multilingual capabilities due to its proximity to Japan and Korea.

Chengdu is located in the western part of China. This city is a growing destination for shared services focusing on information technology, digital content and finance.



Foshan is home to KPMG's new KDC shared service center and with close proximity to Guangzhou and Hong Kong is quickly becoming a popular destination.

Suzhou is very close to Shanghai, has the natural and physical resources to maintain service center expansions.

KPMG recently updated "Inside the Dragon" which provides detailed analysis of top locations for SSCs in China. The 2013 version covers 29 cities, to include information on quality of living, government incentives, infrastructure and existing shared services operations in each location.

Case study: World's leading learning company

A world's leading learning company, guiding individuals from pre-school to professional certifications, had the vision that significant growth wasn't possible for them in China without a solid shared services strategy.

To reach ambitious sales and market share goals in China, they needed to establish a partner relationship with a well-established service provider who could support various functions to include finance and accounting, human resources, information technology and procurement.

KPMG assisted with a rapid selection process that evaluated three service providers across 11 evaluation criteria. KPMG established subjective and objective evaluation methodologies during a 12-week process and constantly communicated with each potential service provider to allow them to adjust where necessary. A contract with a global service provider was ultimately reached and is currently transitioning processes in China.

"We have gotten to a really good place with our service providers thanks to a brilliant process from KPMG. The star of the show in all this has been the service provider selection process, with great communication throughout, lots of evidence-based data and a true partner in KPMG."

– Global Chief Operating Officer,
World's leading learning company

Case study: KPMG's Delivery Center (KDC)

After 20 years in China, KPMG saw the potential to establish a national SSC to support a growing network of offices and staff across the country. In 2013, KPMG opened its SSC in the city of Foshan in Guangdong Province.

KPMG's Management Consulting practice assisted throughout a 16-week transition process, establishing both Service Level Agreements (SLAs) and business process design.

The benefits of the KDC to the Firm are numerous. For our clients, it will enhance quality and delivery times. For our people, it will free up time for them to focus on more challenging, value-added work and provide earlier responsibility and exposure to clients. For our business, it will improve efficiency by centralizing and standardizing processes.

– Steven Parker,
Partner and Audit COO, KPMG China

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