Leading an unconventional Chinese industrial turnaround

Cutting costs and boosting free cash flow while stabilizing headcount and improving public profile: some unconventional lessons from a Chinese industrial turnaround.

Even in China, the uncertainties shrouding the economic recovery have had a significant impact on companies' operations, leading multinationals with operations in the Middle Kingdom to slash headcount. Head offices in America and Europe have demanded cost cuts, which in many instances have translated into hiring freezes and even headcount reduction at the executive level, with local subsidiaries attempting to ramp up output in the face of unexpected inventory orders. Faced with these seemingly conflicting directives, Western subsidiaries operating in China have responded by stabilizing overall employee headcount, while reducing their comparatively higher-cost executive workforce. At the same time, these companies have sought to reengineer internal processes, methods and procedures. While such policies may have achieved the desired effect of reducing overall costs and temporarily boosting operating profits, they have also, albeit unintentionally, increased working capital requirements, staff turnover, and fraud, leading to acute managerial issues.

Raising the red flag

In my second such mission in the Middle Kingdom, I was entrusted by an industrial conglomerate with the restructuring of a large industrial factory in Zhejiang Province. The effect of high executive staff turnaround was particularly obvious, from the critically diminished effectiveness of the plant's internal controls, to the increased risks for fraud, not to mention the greatly diminished reputation of the firm. Rapidly vanishing internal controls, combined with increased head-office and internal auditors' pressures on inadequately-trained, yet inexpensive, local mid-level staff, translated into unusually high levels of absenteism, fraud, and a general lack of motivation. Staff turnaround at all levels reached almost fifty percent, and floor workers were demanding twenty-percent pay rises, threatening with strikes while the firm was building up mountains of unsold inventory and rapidly losing its clientele.

When executive forces downsize – or actually disappear, as was the case with this company – management functions at all levels become increasingly susceptible to collusion with clients, suppliers and competitors. What happened at this plant was that everyone was seeking job unemployment insurance by actively "betraying" the firm in the hope of gaining favors from its key outside stakeholders. A one-week audit of the firm taught me that this was happening essentially in four ways:

- First, sales engineers, led by the sales manager himself, were actively collaborating with clients by granting them steeper sales discounts, as well as refunds over alleged poor quality and workmanship (discounts were up 14%, while alleged quality defects were up 29%).
- Second, purchasers were actively seeking commissions on everything from plane tickets to equipment repair. Some machines were being "repaired" twice in the same week, by contractors with family links to key technical personnel. An employee with the capability to write checks had the responsibility for balancing the books; and the list went on.
- Third, crucial information pertaining to the firm's value chain, internal costs as well as sales and marketing data was being sold to competitors.
- Fourth, a local partner was siphoning off workers, supplies, equipment, and funds, leaving a small and hopeless

team of dedicated mid-level managers tasked with taking the brunt of managerial responsibilities outside of their original scope of expertise, and facing foreign auditors whose demands and language they ill understood. In response to these increasingly tough demands, local staff reported a strange ability to meet most operational, financial and sales projections. The truth was the entire set of data was falsified.

Taking action

In response to this situation, I took the unusual steps of boosting the comparatively high-cost executive headcount, through the hiring of two top managers, one of whom was the former head of the local *Wujing*, or armed police.

Wujing in China is known a State within the State. I was either exceptionally lucky, or well-introduced enough, to be able to recruit a man of high moral standing who was well known for his integrity, and feared for his political clout.

The new general manager took a number of steps, including the establishment of a list of clients and vendors with family ties to key personnel, as well as checks on the latter's lifestyle. In most instances, ties between personnel and external stakeholders were seemingly remote enough to guarantee their secrets. We "grilled" these persons, replacing them with carefully-screened newcomers, to whom we provided intensive training sessions, both in China and overseas. Of particular relevance was training pertaining to the issues of working capital management, workflow simplification, and process re-engineering, as well as leadership and ethics. We were able to deliver these training sessions through the help of Hong-Kong and Singapore-based consultants. While these steps temporarily translated into higher staff costs, we were able to reduce both DSO and inventories by more than 60 days within less than three months, meaning we actually unlocked large sums of free cash flow, which we used to pay for new staff, training, machinery upgrades, and procedures.

Fraud vanished almost overnight – police proceedings were launched, and the word was out that very tough action was being taken. At the same time, realizing that we would not have succeeded through stern actions and punishment alone, we sought active engagement with local stakeholders, particularly at the city level. The firm's public profile was raised through the financing of several projects with "citizenship" objectives. Within months, the firm was back on track, achieving levels of worker engagement, sales, product quality and financial results never witnessed before.

The lessons from this turnaround can be summarized as follows:

- Never assume that Chinese budgets met at any cost are true;
- Watch out for strong loyalties to any particular contractor;
- Do not employ a manager in a function for which he or she is not qualified;
- Watch out for abnormal levels of inventory, as well as claims over poor quality, sales returns, and sales discounts.
- Maintain updated information on your key personnel.

Securing long-term viability

Experience teaches us that success can be undone within weeks. In responding to human, operational, financial and other issues, it is important to remember that these are bound to reoccur, absent long-term corrective action.

As an interim executive, I take particular pride in achieving long-lasting results through the careful selection of adequately-trained managers and implementation of corrective steps. Firms that seek a long-term response to their managerial issues in China ought to retain their interim or turnaround management executive by asking him yearly audits in the years following his deployment. Such missions do not cost much, and can be limited to just a few days. The original change agent is best suited to keep things as confidential as possible as follow-up assessments are performed, and corrective actions are suggested.

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