MARKETING GENERICS

Strategy Application Note

The Chinese are coming!

Introduction

Chinese companies are changing their business models, approach, strategies and brands to enter mainstream and often highly challenging markets; they are overcoming resistance and finding ways to enter markets where just a few years probably no one would have dreamt they would or could enter. This Application Note evaluates some of the strategies and tactics they have used and identifies implications for Western companies threatened by such new entrants

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Key Words

Entry strategies, Chinese competitors, localisation, Chinese brands, Chinese development strategies, megatrends, competitive advantage

Detail

Megatrends

Chinese companies are increasingly becoming large and global companies. Whilst many today still are state owned or state-linked, and often from lower value activities (raw materials, steel etc), the landscape is changing as China starts to field major corporations in banking, telecommunications, Insurance, aviation, and so on.

In fact today, out of the global top 500 companies, 46 are Chinese, with Sinopec – the local oil company ranking #7 in the world[i] with revenues of over $187bn. Many of the largest Chinese companies are in banking (China Construction Bank, Industrial & Commercial Bank of China, and Bank of China being among the largest), but new industries like telecoms feature (China Mobile Communications being the largest mobile company in the world with $71,7bn of sales), but also companies like China Telecoms (the local POTS), Hutchinson Whampoa, and Huawei all figuring in the top 500. China Mobile for example, has by far the largest subscriber base in the world with 589million subscribers[ii], compared to Vodafone's 341million, and Verizon Wireless's 91million, and China Mobile has over 5,5 million net adds per month.

Two Chinese companies, albeit both banks (Industrial & Commercial Bank of China, and China Construction Bank), are the world's 3rd and 5th most profitable companies (profits of $18,8bn and $15,6bn respectively)

Moreover, Chinese companies are learning the habits of global players, investing in R&D, setting up local sales offices, increasing distribution, and rolling out local, then global branding programmes.

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R&D

Although the US remains the clear world leader in research with 40% share of global R&D, and China's R&D significantly lags behind the Western world, China's R&D it is growing rapidly. Private sector R&D (spending as a % of R&D in 2001 was 0.5% compared to 2,2% in Japan and 1,9% in US, but doubled to 1,1% by 2008) whereas US remained stagnant at 1,9%[iii]. However the number of researchers in China overtook Japan in 2000 and was for the first time larger than the US in 2008, with more than 1,5million researchers and growing[iv].

Whilst the productivity of Chinese researchers is still way below the US, it's catching up, and more venture capital is being directed towards Chinese companies, with 2009 being a landmark year as for the first time there were more Chinese Internet companies had new stock market listings on Wall Street than local US companies. Apart from the growing confidence by Chinese companies and government in Chinese capacity for R&D, R&D growth for western companies will depend upon the economic performance of the home market together with concerns about immigration policies, which could restrict labour flows, higher costs from lack of incentives or lower tax credits, and variable quality of the education and production of engineers in US and Europe, are all factors which could swing the balance in favour towards China.

Infrastructure

China is investing massive amounts in building a modern and efficient infrastructure. Whilst many large cities such as Beijing and Shanghai are becoming clogged with traffic in their inner centres, the Chinese are building large access roads and interconnecting motorways, airports, and rail. China already has a high speed railway, similar to the shinkansen or TGV, and the high speed network is forecast to exceed 13,000km this year[v].

The investments that the Chinese are making in the railway network are simply mind boggling, with $106bn investment planned for 2011 alone, extending the high speed network to over 16000 km by 2015, whilst the total investment between 2011 and 2015 is expected to be between $454bn and $605bn[vi].

This network will link all major cities or conurbations, an example being the new Beijing-Shanghai connection (1,318km long) which will enable the trip to be made in 4 hours. What is also impressive is that this track will be completed in June 2011 in a time of 3,5 years and 1 year ahead of schedule!

As well as increasing communications, the rail network will enable strategic economic objectives, such as more secure routing for importing oil from Middle East and West Africa.

Telecoms

We have already mentioned China Mobile, but there are other large telecoms companies like China Telecom (the legacy provider) but also China Unicom, a mobile company to rival China Mobile, with 147million subscribers.[vii]

For many years Huawei, a competitor to Cisco, AL, NSN etc, was perceived as bit player in this game. It was claimed by many that they copied the technology of others and didn't really develop their own designs and IP. Today, in reality Huawei is not only developing huge amounts of IP itself, but arguably outpacing the competition in R&D. For example, almost half of the company's 96,000 employees are engaged in R&D. Its latest $340million investment in research centre in Shanghai has the capacity for 8000 engineers. It has 17 research centres around the world, including in Dallas, Moscow, Bangalore and Santa Clara.
Not only is it investing massive human and technical resources in R&D, but it is showing extremely innovative and original thought in its business models. To enter the US market for example, Huawei helped to set up a new American distributor called Amerilink Telecom, just to introduce Huawei products. It recently struck a deal with American internet communications firm Clearwire to test a system based on Huawei's 4G network technology. It's rumoured that Sprint Nextel, the US's third largest wireless carrier, might buy $3bn of Huawei's advanced wireless equipment, giving Huawei its most significant US deal, and paving the way for more reference sales

Huawei is thought by many to be on its way to becoming one of China's first truly global brands. Ross Gan, a spokesman for Huawei, said: "We're an innovative company driven by the business needs of customers."[1]
It's interesting to note Huawei's business tactics, because Huawei has come under criticism in many countries for suspected ties to the Chinese government and even military. In India, for example, where there is long-running suspicion of Huawei and indeed many things Chinese (India and China fought a border war in 1962 and the territory is still disputed), Huawei has sought to increasingly localise. It has recently set up an R&D centre in Bangalore[viii], its Chinese employees are learning Hindi, and many of their Chinese employees are adopting Indian names ('Rajeev' and 'Amit' are amongst those quoted) and wearing local dress.

Internet

The total number of internet users is around 450 million, but this is growing everyday, and is considered to be only at around 35% of penetration, so there is huge potential to grow compared to western internet markets which are getting close to maximum penetration.

Whilst Google may have dominance of the Internet in the West, it's a very different picture in China, particularly following the spat in 2009 between Google and Chinese government. Although Google is still used in China, particularly by more westernised Chinese such as those who work in high-tech and western companies in China, market share fell from 21.6% in 2008 to 10,7% at end of 2010[ix], and Baidu now dominates the Chinese search market with 30% market share, with Alibaba, Sina, Sogou and Tencent having smaller shares, but in total local search engines have larger market share than Google. All other related internet activities (online shopping, social networks and so on) are increasing rapidly, with home grown Chinese companies dominating. E-bay for example fell from around 85% market share at its peak to around 7% now, knocked off its perch by local Jack Ma's Alibaba who founded Toaboa.[x]

Renewable power

Although much attention in the West has been on stories like the number of coal burning power stations China is opening per week, behind the scenes China is becoming a major player in renewable energies. In wind for example, Sinovel Wind is the largest provider of wind turbines in China and the 3rd in the world with 351 megawatts of capacity installed in 2009 and is now going for an IPO.

In solar, Suntech Power Holdings Co Ltd is the world's largest producer of crystalline silicon photovoltaic (PV) modules and the world's third largest solar company with sales to over 80 countries around the world and revenues of around $2bn in 2009. Suntech is definitely one to watch. China has a target to have at least 15% of its energy coming from renewable sources by 2020.

Cars

In 1995, there were 1.3 million cars sold in China, but by 2009 the number had risen to 13.0 million, overtaking the US total of 10.4 million cars and becoming the largest car market in the world. China sales grew an astonishing 48% between 2008 and 2009 and in January 2011 sales were 1,8million cars for the month.[xi]

Whilst these numbers include cars sold by international as well as Chinese brands, local Chinese manufacturers have 46% of share and we can expect to see this increase over time. Whilst the local market is clearly vast and with huge growth potential, the emergence of the Chinese markets poses a huge threat to western car manufacturers in their domestic market. In cars, as with other segments, Chinese companies are acquiring the technology and moving up the value curve. Getting a local brand strategy, then a global brand strategy in place is the typical strategy route, and Chinese brands are starting to impact Western markets as the Japanese and Korean have done before them.

Zhejiang Geely Holding Group Co Ltd may not be a household name in the West, but the shorter form 'Geely' may be more known, and certainly when one realises that Geely recently bought Volvo. Whilst Geely has yet to make an impact in Western export markets, Geely is manufacturing in Taiwan as well as mainland China and is exerting to Philippines, Vietnam and other Southeast Asian countries. Even thought Geely are not the largest of car manufacturers in China, their rate of growth and capability is astonishing. 12 new or upgraded models were launched in 2010 alone, and sales grew by 48% in 2009. Geely is planning to build between 300-50 new showrooms in China between 2010 and 2013.

Geely is ambitious. They recently launched an electric power car and are aggressively pursuing NCAP ratings for their models. Geely's strategic long-term plan included developing 15 new platforms with more than 40 all new or derivative products, 15 manufacturing plants in China and abroad, and global sales of 2 million units all by 2015[xii]. Like with many Chinese manufacturers, their primary emphasis has been on smaller models and engine size, but as they grow and get more ambitious, they are eying up mid-size, large, and even luxury segments.

BYD is another example of a growing Chinese car manufacturer to watch. Founded relatively recently in 1995 it began life manufacturing rechargeable batteries, competing initially against Japanese battery imports. The company grew very quickly from 20 employees in 1995 to a corporation with now more than 150,000 employees, capturing more than half the world's mobile-phone battery market within 10 years and becoming #4 in the world and #1 in rechargeable batteries. In 2002 BYD acquired Tsinchuan Automobile Co Ltd, and BYD Auto was formed.

Figure 1: Geely e6

BYD[xiii], which stands for 'Build Your Dreams', is highly ambitious. Not only has it expanded horizontally from batteries to the much larger venture of car manufacturing, it intends to use its battery know-how to become a world leader in battery car manufacturing. In 2008 Warren Buffett's Berkshire Hathaway Inc. invested $230million to take an approximately 10% stake in the business [xiv], and in 2010 BYD was ranked by Business Week as the 8th most innovative company in the world.

In December 2010 BYD's e6 got its first license in Netherlands[xv], entering European market for the first time, and running a joint programme with German RWE to build power and reaching infrastructure. For the moment, the cars leave a lot to be desired in styling and quality and performance for Western buyers, but the BYD strategy of entering with electric vehicles makes sense, and could enable them to get a foothold in Europe and US.

Electronics and household goods

Not many years ago it would have been uneconomic and unviable to ship large 'white goods' (refrigerators, cookers, washing machines., etc) from a long way overseas, not to mention the marketing challenges of trying to enter mature market, with entry barriers from import duties to a plethora of well known existing domestic brands. But it's happening, more recently with some Japanese companies (Panasonic) starting to make inroads into market share of local manufacturers, and then the Koreans (LG, Samsung, etc). Now, it's the turn of the Chinese to enter saturated European and US markets, and the pioneers are brands you have probably never heard of like Haier, but they are staring to make an impact. Haier today are the world's 4th largest whitegoods manufacturer, with 30 design centres, 50,000 employees and more than €10bn of sales revenues (sorry, but the latest annual reported revenues are from 2006[!]).

It would be easy to rubbish the brand image and perhaps at first sight the quality of Haier – after all, most new entrants are more or less obliged to enter a completely overseas market with low cost being the primary appeal, and then try and move up the value curve (think how Samsung and Hyundai are perceived today compared to 10 years

ago). But be careful not to underestimate Haier. Haier were considered cheap and nasty a few years ago, but their new products are very much leading edge, such as 3DTV, and TVs with power transmitted wirelessly. Haier recently announced their PowerPad, a product which sits on the floor of the shower and can capture 20-30% of the heat from the water draining away which it then converts into electricity. Among new concepts recently announced was the human powered washing machine, and so on. Many of its other products (heaters, washing machines and so) will be connected via the web, creating a 'smart home'.
Even hi-fi, clearly an upmarket segment of consumer electronics is being made in China (Mordaunt Short, Cambridge Audio, Quad and Mission), and whilst these are still high quality British brands, as long as the Chinese manufacture them locally they pick up design and technology tricks and ideas, and soon we will see high quality Chinese brands tying to compete in this space.

Country competitive advantage

Michael Porter wrote a whole book of the competitive advantage of nations, but not even he could have foreseen at that time the emerging competitive strengths of China. As more and more Western companies are obliged by their competitors to manufacture in China, so more Chinese workers acquire the skills, technology and knowledge to manufacture the same products themselves. Among the national advantages are:

Numbers of qualified people: There have been various academic disputes over exactly how many graduate engineers are produced in China compared to say, US and India, and perhaps no one really know the true answer, but what is known is that the numbers graduating in China is very high, so companies can hire several new graduates at very low cost compared to European and US counterparts.

Easy money: There are large loans at relatively low cost available to state-owned enterprises (SOEs) with generous credit provisions. Not only does this enable companies to access money and grow, but it can be a deal changer when closing deals. Some telecoms companies for example have complained that when a Chinese telecomms provider bids for a deal in Africa for example, they may offer to build infrastructure projects, roads, schools etc, included as part of the deal. For private companies, there is growing number of IPOs profiteering from the capital base available in Hong Kong or mainland China.

Government support and strategic intention: The government supports and favours Chinese capability in certain strategic industries, prompting regular skirmishes with Congress, G20, the EU etc, but conferring considerable advantage to indigenous companies. Spats between companies and government (be it Australian mining companies, or Google) end up with the local providers being further favoured and subsidised

Critical Mass*:* The sheer size of the market is irresistible and un-missable. Look at the volumes of cars sold, or the number of subscribers for the mobile networks

The balancing view

Despite these stories or astonishing growth and success, and the confident hope of China that they will soon overtake the US in GDP and become the largest economy in the world, it's not all plain sailing for the Middle Kingdom. Inflation hit an annual rise of 4,9% in January 2011 despite 2 recent interest rate rises, but food prices rose 10,3% in January after a tough winter, combined with soaring cost of imported materials will drive increased inflation, higher prices and ultimately less competitive economy in export markets. Low value industries such as textiles are now hurting badly as Chinese workers are increasingly less willing to work for low wages and can seek employment in other higher paid work (construction, etc), and we could see the dismantling of low value and low cost Chinese industries over the next few years.

There is some underlying social discontent, but ultimately all depends upon how the economy continues to be managed. As long as the unwritten pact that the government will provide continued prosperity for its people continues, China should maintain political stability. But riots and protests are not unknown in China. Working conditions are variable to say the least, with Honda facing riots, and even manufactures like Apple are struggling with compliance and social responsibility issues. According to a recent report in the Daily Telegraph[xvi], Apple's recent Suppler Responsibility report [2010] showed less than 1/3 of Apple's suppliers are meeting requirements on working hours with 2/3 of their factories making their workers work more than 60 hours per week and no days of rest over a 7 day week.

The Chinese government is trying to migrate demand from exporting to the domestic market, but whilst domestic consumption is increasing so is inflation, and as soon as for whatever reason the RMB floats to a more realistic value, China will cease to have the exporting advantage that it has enjoyed up to now. The significant increases in raw material costs are a major issue, and for example the recent huge rises in cotton have been a significant factor in dismembering the textile industry in China.

Conclusions

It's natural that Chinese companies will grow in their internal market, but also seek export markets and to become global players.

Localisation is a major reason why a western company can fail or a Chinese company can succeed in the domestic Chinese market. E-Bay's fall in China is in itself a whole case study about David and Goliath, and the pitfalls of trying to impose a global or international or western centric approach to a strong local market like China. As the founder of Toaboa, now the largest C2C website in China said "*eBay may be a shark in the ocean, but I am a crocodile in the Yangtze river. If we fight in the ocean, we lose, but if we fight in the river we win*".[xvii]

Fighting Chinese companies in China is one thing, but western companies will find themselves increasingly competing with Chinese companies in western domestic markets, as Chinese companies become stronger and more capable, and with money have more resources.

Much like their Japanese and Korean predecessors, companies with little or no brand recognition are often forced to start their trade in western market by entering small niches, and frankly, selling variable quality goods but at low prices, to find a small entry point. Once they have the initial entry point, they start to enlarge it, and meanwhile the parent company in China is ever expanding its R&D, patents, quality and capability.

Haier's development strategy is interesting and quite transparent[xviii], comprising 4 phases: first, build the quality and the brand reputation on the domestic market; second pursue diversification of products and technologies; third phase, internationalise; fourth phase establish a global brand, but with localisation *"international strategy phase is based on China, radiating to the whole world while global brand strategy is to create localized Haier brand in each market"*[xix]

Whilst some governments will try and impose trade restrictions, Chinese companies have shown a willingness and ability to overcome them. When the US placed tariffs on Chinese Solar Panels in 2009, Suntech decided to set up manufacturing locally. Suntech also reportedly got their US execs into top posts in American solar panel industry groups.[xx]

This canny, long-term approach will succeed in parts, combined with the Chinese ability to adapt, be flexible and adopt local customs and behaviours, and we can expect to see more and more Chinese companies competing in western markets, and more brand recognition for previously unknown Chinese names.

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