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Strategy and Change

Winning in China's mass markets

New business models, new operations for profitable growth

Survey in cooperation with

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IBM Global Business Services, through the IBM Institute for Business Value, develops fact-based strategic insights for senior business executives around critical industry-specific and cross-industry issues. This executive brief is based on an in-depth study by the Institute's research team. It is part of an ongoing commitment by IBM Global Business Services to provide analysis and viewpoints that help companies realize business value. You may contact the authors or send an e-mail to ibvchina@cn.ibm.com for more information.

Winning in China's mass markets

New business models, new operations for profitable growth

By Alan Beebe

Foreign companies must alter their business models and operations to tap China's rapidly growing mass markets where scale matters and price is king. Prosperity outside of major coastal cities, an evolving middle class and fierce competition will drive more companies to develop innovative, low-cost business models to reach new markets and customers across diverse regions of China. Companies will need to transform key areas of their businesses – including sales channels, distribution, R&D, procurement and human resources – to capture this historic opportunity.

In recent years, most established foreign multinational companies (MNCs) have enjoyed strong revenue growth and profitability by riding on the back of China's spectacular economic growth. China already contributes on average nearly 10 percent of the global revenues of the 180 MNCs in our 2006 survey. At the same time, in 2006 the American Chamber of Commerce in Shanghai reported 64 percent of its member companies were profitable and 65 percent had profit levels in China equal to or higher than in other countries.[1]

But in China's rapidly changing environment, recent success is no guarantee for the future. Industrial and consumer products companies alike will have to reevaluate their business models and operations to sustain rapid revenue growth and profits.

In industries ranging from automobiles to electronics, lower-end product segments often account for the largest portion of the total market and these segments are typically growing the fastest. MNCs counting on China for strong revenue and profit growth – or simply hoping to maintain market share – will need new approaches to win in price-sensitive mass markets while preserving their market leadership in higher-margin, premium-end market segments.

How can companies capture the China mass market opportunity profitably? What are the business model implications and how will changes impact their China and global operations?

In operational areas such as sales channels, distribution, R&D, procurement and human resources, what are the priorities of companies today and how will they evolve? How can MNCs overcome key challenges?

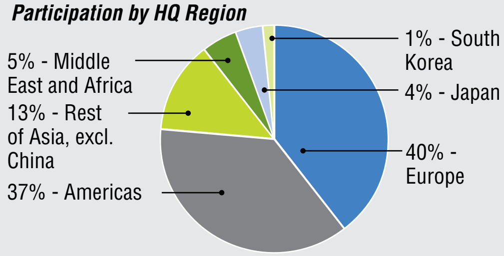
In this paper authored by the IBM Institute for Business Value in China, these and other questions, high on the agenda of global executives are answered as companies increasingly look to China to fuel growth in coming years.

About the study

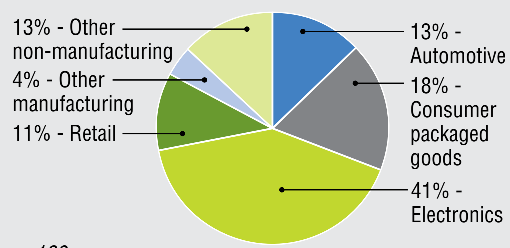
The IBM Institute for Business Value, in partnership with the Economist Intelligence Unit (EIU), surveyed 180 foreign-headquartered companies in China. IBM further interviewed 50 foreign and Chinese executives with front-line China operations experience.

- Functional areas: Sales channels, distribution, R&D and procurement and human resources
- Industries: Primarily electronics, automotive, consumer packaged goods and retail industries, which together represent 85 percent of total revenues of the top 250 foreign companies in China.

Participation by HQ Region



Participation by Industry



n=180

Winning in China's mass markets

New business models, new operations for profitable growth

The "long march" to profitability

The past quarter century has been – until recently – an uncertain quest for profitability for most foreign MNCs operating in China. MNCs' long march to profitability has been marked by both spectacular successes and failures as companies navigated China's opaque pre-WTO regulatory environment. This journey can roughly be divided into three stages: market entry, market "skimming" and market penetration (see Figure 1).

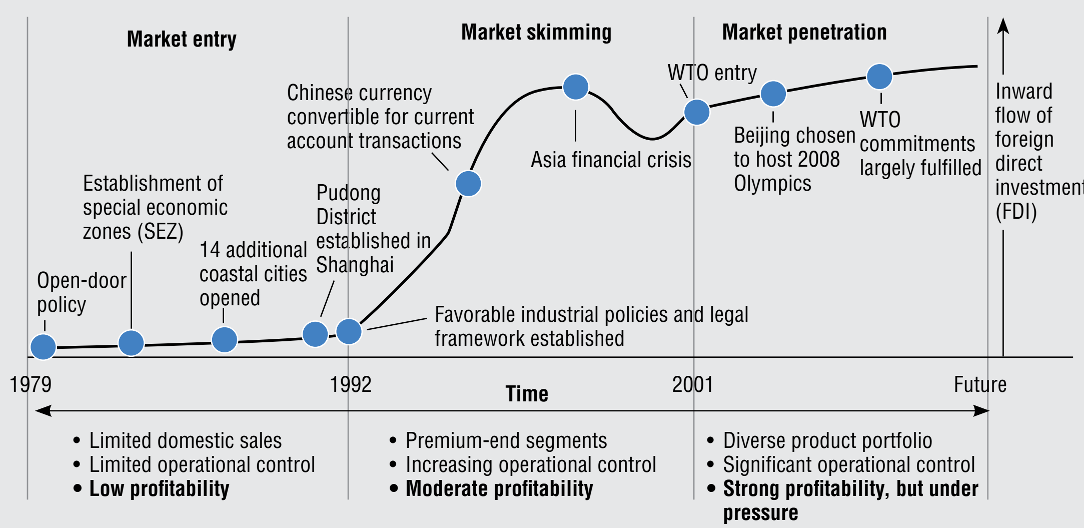
Market entry: From 1979 to 1992, most pioneering companies invested to simply establish themselves in China; often, profits were not a near-term priority. Industries were heavily regulated and business was carried out through intermediaries and joint ventures. Profits were often elusive as Sino-foreign partnerships struggled and seemingly straightforward business deals failed.

Market skimming: From 1992 to 2001, some MNCs recognized the emerging potential of China's consumer class, but most chose a conservative strategy. Using primarily imported goods or global designs incorporating little local content, they began to target the premium end of the domestic market. As industries deregulated, prospects for certain MNCs improved, such as General Motors which turned profitable in China after a decade of losses.[2] Even so, in 1999, 58 percent of U.S. companies had profitability levels below their worldwide averages.[3]

Market penetration: China's entry into the WTO ushered in an era of improved market access and transparency across most industries. Foreign companies began to enjoy unprecedented levels of operational flexibility.

FIGURE 1.

Multinationals in China – the long march to profitability.



Source: China Ministry of Commerce; IBM analysis.

As the lower-middle class expands and economic growth spills over to less prosperous areas of China, multinational companies are realizing the substantial growth opportunities associated with tapping the mass market.

They rapidly expanded their presence, particularly in coastal cities that were easily accessible and had the required purchasing power for premium-end products.

By 2005, over 60 percent of both U.S. and European firms were reporting profitability in China, and 65 percent had profit levels equal to or better than their global averages.[4] Although a small, but growing, number of companies are tapping the mass market, the majority of MNCs still rely on premium-end products in the top cities for the bulk of their revenues and profits.

More growth, more competition, more profits?

In virtually all industries, China is experiencing rapid growth compared to mature developed markets. For example, China's automotive market grew by over 25 percent in 2006, compared to 6 percent globally, and retail consumer spending in China grew by 15 percent, three times the rate in the U.S.[5]

China already accounts for a meaningful share of many companies' global revenues in the industries we surveyed. For example, in 2004-2005, China contributed 14 percent of global revenues for Volkswagen, 30 percent for Sharp Electronics and 32 percent for Amway.[6] Japanese and Korean companies, in particular, are looking to China as critical markets and have been the number one and number two sources of FDI for the past two years.[7]

More growth from mass markets

Increasingly, this growth is being propelled by mass markets as the benefits of economic growth spill over to less prosperous regions of China, disposable income increases and the government emphasizes stabilizing the growing gap between the rich and poor. Based on income distribution projections by Credit Suisse First Boston, the lower middle-class – which we define as a household income of US$3000 to US$6000 – is expected to grow to 41 percent of all households by 2008.[8]

And mass market growth is not just confined to consumer products. A high-technology industrial electronics manufacturer we interviewed expects the market for one of its key product lines to reach US$1.5 billion by 2008. Over 60 percent of the growth is expected from low-end product ranges where they command less than 10 percent market share, compared to 45 percent for their high-end product ranges.

Similarly, the auto market is expected to reach 4.5 million passenger vehicles by 2008, driven by growth in the lower-cost subcompact and micro car segments that currently comprise nearly 50% of total demand.[9]

More competition, especially from Chinese players

But attractive markets naturally lead to more competition, and not necessarily the same competitors that MNCs face in other markets.

In interviews with China-based multinational executives, Chinese players, especially in manufacturing industries, were repeatedly cited as a growing threat. This was particularly true for low- to medium-end product ranges, where Chinese companies with low cost structures excel in developing similar products (admittedly of variable quality) offered at up to 40 percent lower prices.

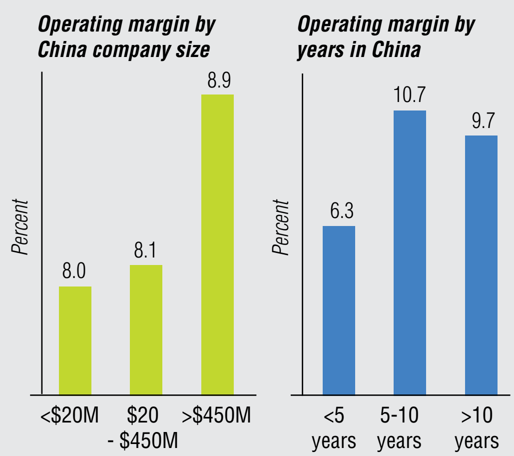
At the same time, larger Chinese companies such as Chery in Anhui, Longcin in Chongqing and Huawei in Shenzhen are working hard to improve their abilities to develop higher-end products, consistent with the country's drive to become an innovative economy.

More profits?

Our analysis of 180 foreign-invested companies shows that profitability performance varies widely among industry peers. In the consumer packaged goods industry, for instance, some leaders enjoy operating margins in excess of 26 percent compared to below -5 percent for market laggards.

What accounts for the differences in profitability between foreign MNCs in the same industry? There is no single overriding factor, but our analysis and work with clients suggests profit leaders share several common traits (see Figure 2).

FIGURE 2.
Size and experience matter...up to a point.



Notes: N=180. Operating margins = revenues less COGS and SG&A
Source: IBM Operational challenges facing MNCs in China survey 2006; IBM Institute for Business Value analysis.

First, companies with China sales of more than US$450 million had operating margins on average 11 percent higher than small companies of less than US$20 million, suggesting that scale matters in China.

Second, leaders have been in China for a longer period. Companies with more than 5 years in China averaged over 10 percent profitability compared to 6.3 percent for relative newcomers (half of our respondents), suggesting that the learning curve is steepest in the first few years.

Surprisingly, companies with over a decade in China were actually slightly less profitable than those with 5 to 10 years. This suggests that pioneers may be struggling to adapt their business models and legacy operations to a new environment with few barriers to entry.

Third, profit leaders have not allowed the allure of rapid top-line growth and low operating costs in China to override the importance of the on-going pursuit of operational excellence – particularly in areas such as channel management, procurement, logistics and fulfillment.

We believe these three key traits – coupled with low-cost business models – will define future profit leaders, as mass markets expand and profits come under pressure from domestic competitors.

Mass markets – are they really a must?

In most cases, yes. If companies elect to ignore the mass market, the decision will most likely limit market share growth, revenue growth and absolute profits, simply because mass markets are generally larger and growing the fastest. Pursuing mass markets may require lower profit margins, but not necessarily.

Companies should leverage their brands and reputation to the extent possible, not simply reduce prices to appeal to aspiring consumers and business customers. For example, Amway, with US$2 billion in sales from China, has built an impressive distribution network in 180 cities, but it offers the same products at the same prices, regardless of location.[10]

Fast-moving consumer product companies such as Procter & Gamble and Nestlé have logically been the early movers. But in the coming years, we believe companies in a wide range of industries will consider mass markets integral to their China strategies and operations.

Mass markets and the emerging China

Winning in the mass markets may conjure up images of successfully selling to 1.3 billion Chinese people. However, our definition of mass markets is rather narrower.

Our focus is on what we define as “emerging” cities in China. In 2005, this group included 305 tier 3 to 5 cities, which collectively accounted for 43 percent of China’s GDP and 18 percent of its total population (see Figure 3). Excluded from our definition are China’s twenty-five tier 1 and 2 cities, 324 tier 6 cities and China’s rural areas.

The majority of the emerging cities are in fact not “remote” or “inland” – 58 percent are located in coastal provinces, with large concentrations in Shandong, Zhejiang and Jiangsu provinces, which are accessible by road or rail from major tier 1 cities, such as Beijing and Shanghai.

Furthermore, 72 tier 3 to 5 cities have a population of over 1 million, more than the size of Frankfurt or San Francisco. For example, Jiangyin in Jiangsu province has a population of 1.2 million, GDP of US$7.8 billion and is within 160 kilometers of six airports, including Shanghai's.[11]

In terms of consumers, we limit the “mass market” definition to individuals who have annual salaries between 10,000 and 20,000 RMB (US$1300 to US$2500). This corresponds to household incomes between 23,000 and 47,000 RMB (US$3,000 to US$6,000) based on an average household size of 2.16 persons.

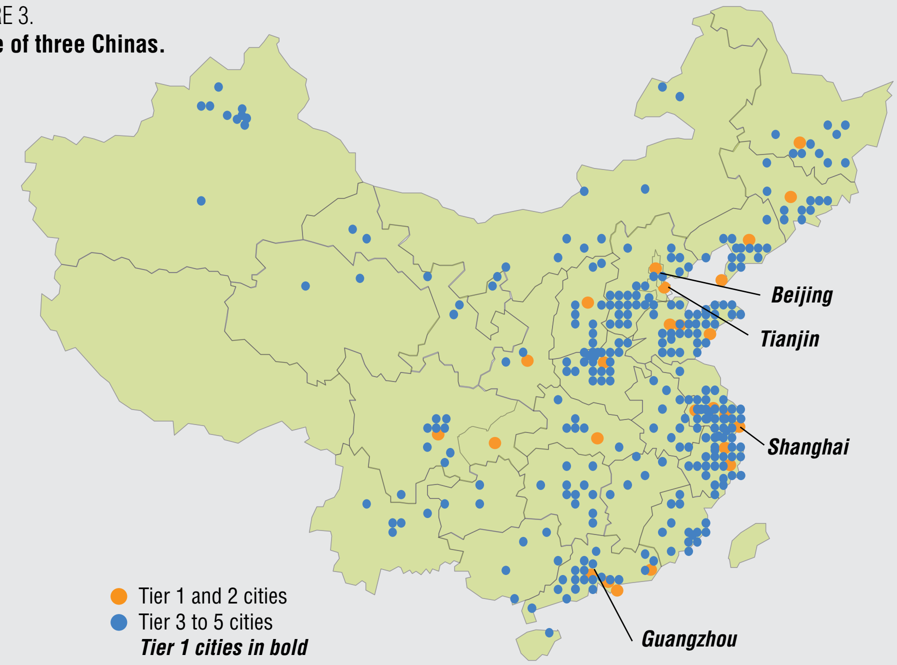
Our analysis of tier 3 to 5 cities shows that 81 percent of the cities have average salaries that fall into this mass market range, compared to 52 percent of tier 1 and 2 cities.[12] It is important to note that these are averages – within individual cities, there will obviously be wide ranges in salary levels.

Finally, companies must keep in mind that China’s mass markets are rapidly evolving. According to the United Nations, about 15 million rural people are expected to migrate to urban centers each year for at least the next ten years, some eventually becoming mass market consumers. At this rate, it is expected that around 150 million people, the equivalent of Russia’s current population, will join the ranks of China’s new urban consumers by 2015.[13]

The city segmentation methodology used in this study is based on generic demographic and economic variables (population, income levels and per capita GDP). To formulate company-specific mass market strategies, companies should develop a segmentation based on these and other variables, such as product demand, geographic location and operational considerations.

FIGURE 3.

A tale of three Chinas.



	Prosperous China *(Tier 1 and 2 cities)*	**Emerging China** *(Tier 3 to 5 cities)*	**Rural China** *(Tier 6 and Rural)*
Number of cities[1]	25 (Tier 1: 4, Tier 2: 21)	305 (Tier 3: 19, Tier 4: 77, Tier 5: 209)	324 (Tier 6: 324, Rural: N/A)
Percentage of China's total population (2004)	9% (119 million)	18% (234 million)	73% (947 million)
Percentage of China's GDP (2004)	34%	43%	23%
Average annual GDP growth rate of cities[2]	16%	16%	N/A
Average population range of cities (thousands)[3]	220 – 10,000	300 – 1400	250-1420 (Tier 6 only)
Average salary range of cities (RMB thousands)[3]	16 - 30	11 – 21	8-15 (Tier 6 only)
Broadband Internet penetration rate[4]	24%	12%	4%
Mobile phone ownership rate[5]	78%	56%	27%

Note:

1. *China's National Statistics Bureau classifies 654 cities that in aggregate account for 92% of GDP. Hong Kong and Taiwan excluded from analysis.*
2. *2003-4 figures. 149 county-level cities and rural areas were excluded due to data limitations.*
3. *Population and salary ranges exclude the top 10% and bottom 10% of values to minimize impact of cities with outlying values; population figures are generally for cities only, not for their metropolitan areas.*
4. *Number of registered dedicated broadband lines divided by population.*
5. *Number of SIM cards sold (representing new mobile numbers) divided by population.*

Source: "China Statistical Yearbook." 2005. IBM Institute for Business Value analysis.

Business model and operational innovation to win in the mass market

Expanding into mass markets will require MNCs to adjust their business models and operations, while maintaining leadership in premium-end segments. Lower cost structures will typically be needed to support profitability. Companies who get this formula right can enjoy a sustainable competitive advantage extending well beyond low prices.

Business model changes

As shown in Figure 4, serving mass markets potentially impacts how companies do business across the entire value chain, from R&D to after-sales service and support.

Will products developed for the mass market be based on global designs or developed from scratch in China based on deep market insights and customer needs? Will global or local suppliers be used? Will manufacturing be in-house or outsourced? How will companies expand their sales, distribution and after-sales service capabilities to reach tier 3 to 5 cities? Is there enough of the right talent at salary levels and locations outside of tier 1 to 2 cities? These questions must be considered as part of companies' mass market strategies.

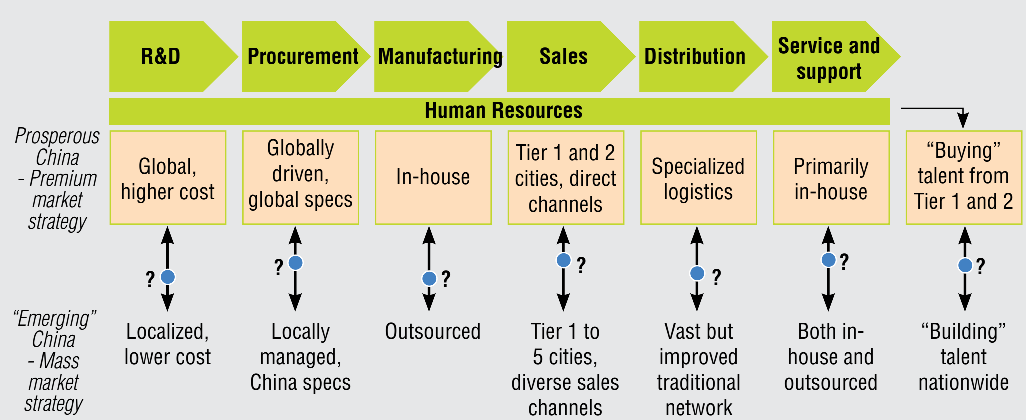
Key operational levers

Our experience and interviews suggest that companies must focus on at least three critical areas to build flexible and cost-effective operations to serve the mass market profitably:

- Sales and distribution channels – Companies must transform inefficient, multi-layered sales and distribution channels suffering from limited collaboration and visibility into far reaching, cost-effective channels that provide valuable information about end customers
- R&D and procurement – Developing products tailored to the needs and price points of the China market is critical for success. New approaches are needed to find, qualify and develop deeper collaboration with cost-effective local suppliers.
- Human resources – New approaches are needed to alleviate talent shortages and develop a large pool of cost-effective, scalable talent with the right skills for mass markets.

Companies should consider partnering strategies to transform these operations instead of making fixed-cost investments that may limit future flexibility in China's rapidly changing environment.

FIGURE 4.
Are your business models and operations aligned with your China strategy?



Source: IBM Institute for Business Value analysis.

Sales and distribution channels: from multi-layered to flat and collaborative

One of the fundamental challenges companies face is how to sell and distribute products across a country as vast, diverse and complex as China. To reach customers profitably requires transformation of traditional distribution networks and the development of innovative partnering approaches. Domestic players may have "home court advantage" but technology can help level the playing field.

China's multi-layered legacy distribution system is giving way to new, flatter channels - essential changes that will provide greater visibility to companies and enable them to sell more effectively and profitably.

Historical roots

China's multi-layered legacy distribution structures are the product of central planning which impeded effectiveness, efficiency and scale. Until recently, poor infrastructure and outdated inter-provincial regulations exacerbated the problem. This resulted in a system with national, regional and local distributors each playing a small role in moving products from factories to market. Information sharing between parties was virtually non-existent.

Due to government regulations in force until 2005, most MNCs had little choice but to rely on the equivalent of a cash and carry model with national and regional distributors. Despite the inefficiencies, MNCs adapted to the arrangement and focused their efforts on manufacturing and branding.

As one interviewed executive recalled, "It was easier to let someone else give us cash immediately and take the risks moving the product." This approach works for premium products with limited or no domestic competitors, but handicaps the ability to sell higher volume, low-margin products profitably.

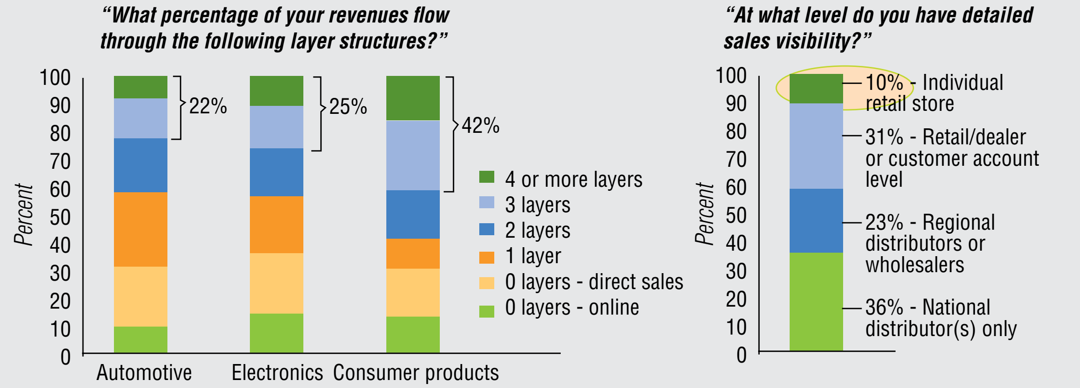
The journey from factory to market

A major foreign business electronics manufacturer with over US$2 billion in annual revenues we spoke with relied on two state-owned national distributors to handle the vast majority of its sales and distribution. These large distributors focused on product delivery to major cities and extended credit to 20 regional distributors who, in turn, managed distribution within cities. Beneath them, a network of 200 resellers and wholesalers managed sales and distribution to retailers, and provided service and technical support.

Multiple layers, no visibility, high costs

In our discussions with executives and operational managers, their number one challenge was how to "flatten" channels to lower costs and gain visibility. Our analysis shows that as much as 42 percent of survey respondents' revenues flow through three or more distribution layers. Furthermore, only 10 percent have visibility of sales at the store level and 33 percent can only view sales down to national distributors (see Figure 5).

FIGURE 5.
Today's channels: Many layers, little visibility.



Source: IBM Operational challenges facing MNCs in China survey 2006.

Not surprisingly, interviewees cited major supply chain inefficiencies and high costs resulting from this multi-layered structure: limited forecasting abilities, high inventory levels, low order fill rates, out of stock positions and SKU proliferation. The impact has been substantial: a separate IBM study found that over half the companies operating in China incur logistics costs twice as high as global benchmarks, where the average is 5 percent of sales.[14] Additionally, 77 percent of those companies had order fill rates below global benchmarks.[15]

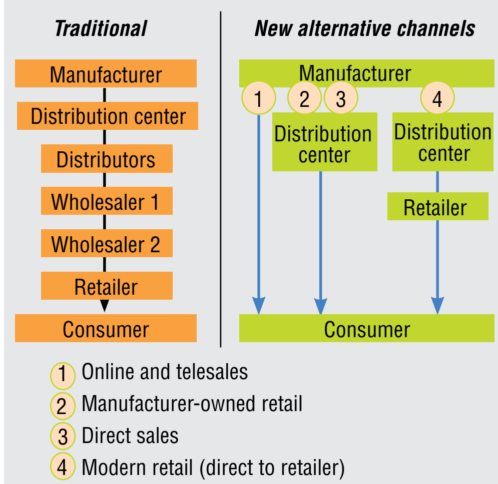
More importantly, multiple layers and limited information inhibit companies' ability to gain insights into customers and their buying patterns, impacting key decisions from pricing to marketing spend.

Colm Rafferty, strategy director for Cummins China, expressed a common frustration: "We are a data-driven company and have a huge appetite for information at the corporate level, but often have challenges with data quality and availability."

Emerging options for flatter channels and insights into customers

Innovative companies focused on the mass market are experimenting with a number of alternatives. All require consolidating channel partners, reducing layers and leveraging technology to enhance efficiencies and improve insights into end customers (see Figure 6).

FIGURE 6.
Evolving channel alternatives: Flatter, more visibility.



Source: IBM Institute for Business Value analysis.

Alternative #1: Online and telesales
Companies should invest in online channels as a way to reach new customers and build deeper relationships with channel partners. China's online market is relatively small (annual revenues from its US$700 million business to consumer market were nearly matched by the highest volume day in the U.S.), but it is growing at 34 percent annually.[16] Many Chinese consumers are still reluctant to make online purchases and channel partners prefer traditional business methods. However, both Internet and telemarketing channels are inexpensive, effective ways to reach potential consumers and business customers in both tier 1 to 2 and tier 3 to 5 cities for education marketing, information exchange and after-sales service. Potential sales generated from these channels can be referred to channel partners or nearby retail outlets.

In cases where purchases are made online, a growing number of turnkey logistics providers, such as UPS and China's PGL, provides integrated delivery within certain regions, inventory management, and even customer support and returns.

Alternative #2: Manufacturer-owned retail
Some brand owners are developing their own retail presence in China, either self-owned or in partnership with retailers. Motorola, for instance, is partnering with Gome – China's largest electronics retailer – to run Motorola branded shops in 30 of Gome's largest stores. This approach both reduces channel layers and improves Motorola's ability to influence customer behavior and capture point of sale information.

Alternative #3: Direct sales
Many companies, both consumer and industrial products, leverage a direct sales force, but typically focus on premium segments, key accounts, and tier 1 and 2 cities. However, some MNCs have expanded the scope and scale significantly. For example, Amway – China's largest direct sales company – has established a network of 200,000 independent agents in 180 cities. Amway and other similar companies have used the direct sales model to overcome unique mass market challenges. Selling through social networks taps personal recommendations, grassroots training allows scaleable sales growth, and the use of retail outlets as distribution centers facilitates fulfillment.

In December of 2005, China liberalized direct sales regulations. However, companies should be prepared for high minimum capital requirements, mandatory physical sales office locations and agent compensation limits.

Alternative #4: Modern retail (direct to retailer)
The surge in the number of domestic and foreign retailers is quickly changing the retail landscape in cities large and small across China. Foreign and domestic players are consolidating their positions and branching outside of tier 1 and 2 cities, with established players such as Carrefour, B&Q, Wal-Mart, Suning and Gome forging the trail.

Consumer packaged goods companies in our survey predict that sales directly to retailers will double in the next three years, indicating retailers' interests to reduce middlemen. However, manufacturers remain reluctant for two key reasons. First, some cash-strapped Chinese retailers are stretching their payables to the point that suppliers are unwilling to shoulder the financial risk and instead still sell through distributors. Second, retailers' merchandising and placement fees are considered onerous for many suppliers.

One potential solution is for retailers and suppliers to each establish key account managers who build mutually beneficial relationships with high business volumes exchanged for more generous trade terms.

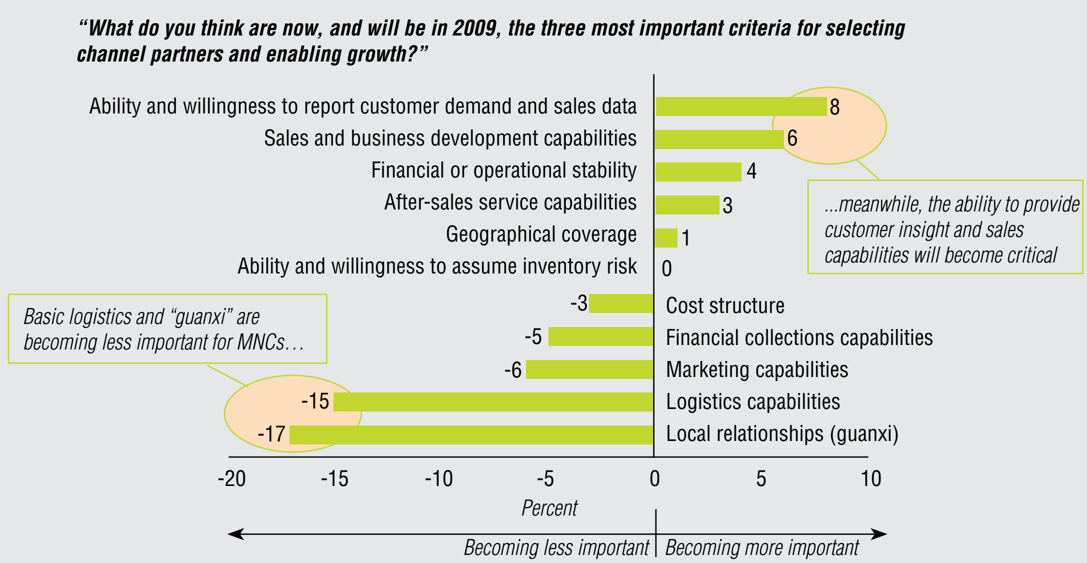
Cultivating the next generation of channel partners

Despite the trends toward flatter channels and end customer insight, distributors in China will continue to be important, particularly in tier 3 to 5 cities. However, MNCs should use fewer distributors, deeper collaboration and differentiated capabilities to build effective, efficient channel networks for the mass market profitably. Our survey shows companies plan to focus on three key areas: sales, logistics outsourcing and information sharing.

More sales, less "guanxi"

Over the next three years, MNCs intend to select and develop channel partners with sales capabilities, rather than simply providing the "guanxi" (relationships) and logistics capabilities that were so essential in earlier years. In the future, MNCs will expect channel partners to focus on sales capabilities such as sales force management, forecasting and product marketing.

FIGURE 7.
Evolving distribution priorities – shifting from basic logistics to more collaboration.



Source: IBM Operational challenges facing MNCs in China survey 2006.

Learning from the locals

Computer manufacturer Lenovo is industry renowned for its extensive sales and distribution system that extends into over 600 cities. Nearly five years ago, Lenovo began offering training to its distributors to increase their sales capabilities.

A distributor we interviewed, one of Lenovo's largest in Western China recalls, "Initially, we had no interest in Lenovo's systems or ideas for growing sales." However, as competition increased, he began listening and received training in marketing, sales management and forecasting. Today, nearly 50 percent of his revenues come from commissioned sales agents, focused on smaller cities, essentially acting as Lenovo's sales force in tier 3 to 5 cities.

Lenovo can largely credit its 35 percent market share leadership – more than twice that of the nearest competitor – to this type of channel partnership initiative.[17]

Deeper collaboration with local partners is possible, but keep solutions simple and focus on mutual benefits.

Outsource logistics to the specialists

Rapid deregulation of the logistics industry is prompting the entry of foreign and domestic third-party logistics providers, and companies developing their own in-house logistics capabilities. In turn, traditional "full service" distributors are gradually segmenting into companies offering either sales or logistics capabilities, but not both.

Where possible, companies should gradually shift to logistics specialists. Logistics providers are eager to develop their role as value-added logistics providers who promise not only timely delivery and cost transparency, but also shipment consolidation, warehousing, inventory management, fulfillment, product tracking and other value-added services.

Nonetheless, China's outdated and complex distribution environment will evolve only gradually, meaning most companies will still need a range of logistics strategies and partners to serve diverse regions of China in the coming years.

Information sharing to enable collaboration

Companies in our survey want partners willing and able to share information about sales and customers to drive closer collaboration and improve business decisions. Such information is critical to move from "push" to "pull" models that can dramatically improve decision making in such areas as product development, manufacturing, marketing and pricing.

Some companies we interviewed already use a variety of methods for information sharing. These range from daily sales data transfers by mobile phone text messages (SMS) to sophisticated ERP systems. However, for partners to adopt them, the systems need to be user-friendly and offer clear benefits.

Anheuser-Busch is an example of a company that successfully convinced its 160 distributors to adopt its Web-based sales management system. Dubbed "BudNet," the system offers distributors more accurate delivery dates, promotional information and other tools to reduce inventory.[18] Detailed customer purchasing information has enabled Anheuser-Busch to target marketing efforts accurately and has paid off with market leadership in the ultra-premium beer category.[19]

In summary, given China's complexity, there are no simple solutions to overcome companies' legacy distribution systems that have evolved over the past decades. A combination of channel approaches – coupled with fewer, but more strategic partners – will be needed to transform sales and distribution for both premium and mass markets.

R&D and procurement: Developing innovative, lower-cost products for the mass market

Winning in mass markets requires creating quality products that satisfy the need for simpler functional products at lower prices. While consumer packaged goods and consumer electronics companies have been early movers, we believe both consumer and industrial product firms alike will need to accelerate the introduction of products for the mass market to expand revenues, market share and absolute profits.

Low-cost innovation in China, for China

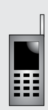
Foreign companies are expanding their R&D investments in China to get closer to market requirements and to leverage low-cost science and engineering talent. In 2006, there were about 750 foreign companies with R&D operations in China with over US$4 billion in investments, most made after 2001.[20]

Sectors with considerable investment include semiconductors, software, automotive, chemicals and pharmaceuticals. Furthermore, despite hurdles such as IP protection, 45 percent of the 165 companies in a 2006 AmCham survey said they will increase their R&D investments in China by at least 15 percent over the next three years.[21]

Currently, many are tweaking global products or supporting global R&D efforts, not developing new products specifically for China. But we believe low-end innovation in China, for China (see Figure 8), will become more prevalent for three reasons.

First, as the mass market increases in importance, MNCs will find globally designed products insufficient to satisfy the price points and functionality desired by Chinese customers.

FIGURE 8.
Low-cost does not necessarily mean low-tech.



Motorola Motofone F3
- **Low price:** < US$40
- **High-tech:** Slimmer than a RAZR, battery life of 400 hours, voice-activated calling
- **User-friendly:** Icon-based interface and local language voice prompts are easy for new users or limited literacy
- **Localized:** Large, low-cost, high-contrast screen

Peugeot 206 Compact Sedan
- **Low price:** Starting at US$9000, a segment above ultra low-cost Cherry QQ, but competitive with domestic offerings
- **High-tech:** Most fuel-efficient car in category(1.4 liter) and winner of 30 industry awards
- **Mass appeal:** European styling and quality at local price has resulted in 30,000+ cars sold in first year launched. Popularity of the 206 and 307 models have doubled Peugeot's China sales in 2006

Source: Motorola and Peugeot company websites, Sohu.com auto portal.

Expand R&D capabilities for low-end products and tailor specifications for the mass market.

Second, domestic and regional competition from companies such as Lenovo, that plans to offer PCs for US$100, and India's Tata Group, that plans to introduce a four-seat car in India priced under US$3000, will likely spur MNCs to seek more low-cost innovation.[22]

Third, the Chinese government's drive to develop a more innovative economy will provide the impetus for MNCs to complement their global R&D efforts at the high-end with R&D for the low-end by leveraging China's large pool of technical talent with costs as little as one-fifth of those in western countries.[23]

But new mindsets will be needed. Developing simplified products with low price points does not come naturally for many global R&D organizations accustomed to focusing on next generation products aimed at global markets with minimal country-specific customization. Creating products at low, but profitable, price points is an engineering and business challenge. It will be important to allow R&D teams in China to focus on this challenge with sufficient independence from global R&D directives and cost structures.

Expanding R&D in China will likely take several years to establish, and involve considerable trial and error. In the shorter term, companies can reap benefits from two other related initiatives – namely, reevaluating global specifications and increasing sourcing from Chinese suppliers.

Local specifications, more local suppliers

Executives and procurement managers we interviewed frequently complained that global specifications used to qualify suppliers are preventing them from considering lower-cost Chinese suppliers who are otherwise qualified. The result is often over engineered products at uncompetitive prices.

For example, an industrial electronics executive stated that his company's global procurement policies required their products made in China to be able to withstand temperatures below 40 degrees Celsius. A frustrated auto parts executive said Chinese competitors were offering similar products priced 40 percent less, primarily due to less stringent product specifications. In his view, the Chinese products were still of satisfactory quality and met local needs.

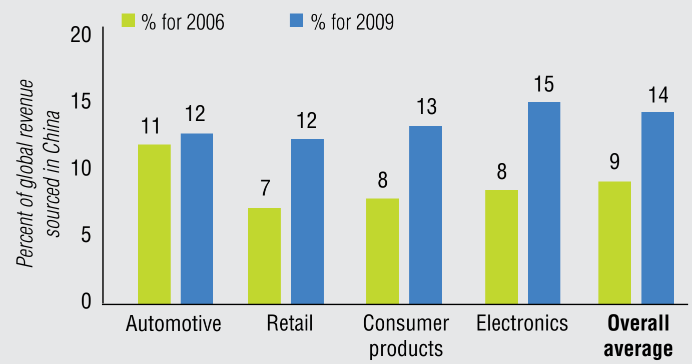
True, insisting on global specifications for products made and/or sold in China reduces the risk of product failure and helps reinforce premium branding. However, it also leads to higher raw material and component costs and sacrifices potential savings.

While care must obviously be taken to ensure quality and other standards are met, the savings potential from using Chinese suppliers can be so significant that a reevaluation of global specifications is worth the effort.

More sourcing, more potential savings, but more challenges

Strikingly, our study shows that while foreign companies as a whole already source about US$600 billion from local suppliers, they plan to increase this significantly in the coming years (see Figure 9).[24]

FIGURE 9.
Companies are aggressively sourcing from China and plan to continue across all industries.



Source: IBM Operational challenges facing MNCs in China survey 2006, IBM Institute for Business Value analysis.

In total, the companies in our survey are sourcing from China the equivalent of 9 percent of their global revenues, on average. And, they intend to grow this to 14 percent within three years, an increase of 57 percent. Of this amount, our 180 survey respondents said 46 percent is for the domestic, not export, market and will continue to rise.

Companies can accelerate sourcing from local suppliers to offer products priced for the mass market profitably.

These growth plans are virtually across the board – regardless of industry or current level of sourcing. Of the companies in our survey, 30 percent are currently purchasing at least US$100 million from China, but only 8 percent more than US$1 billion; within three years, these percentages are expected to grow to 48 percent and 13 percent respectively. Several auto parts companies we interviewed are planning to increase by at least ten times their purchasing in China for export and the domestic market.

Why are companies planning to source aggressively from Chinese suppliers? Simply put, huge savings. Companies we surveyed have, on average, realized nearly 20 percent savings a year by buying from Chinese suppliers. Furthermore, they plan to achieve savings of 26 percent annually over the next three years as they accelerate the shift to local suppliers for more sophisticated product categories.

MNCs face many challenges when sourcing from Chinese suppliers, with today's key challenge simply finding and qualifying suppliers (see Figure 10). Other top challenges include quality management, intellectual property management, total cost effectiveness, and supplier management and collaboration.

FIGURE 10.
Procurement priorities are shifting sharply from finding suppliers to collaboration.

Source: IBM Operational challenges facing MNCs in China survey 2006. Total exceeds 100% due to multiple answers allowed.

Nonetheless, MNCs are generally confident they will gradually find suitable Chinese suppliers – at which stage, their focus will shift to supplier collaboration.

Supplier collaboration – such as volume commitments, sharing of best practices, operational support and strategic investments in suppliers – was considered by many multinational executives we interviewed as important for success, with the caveat that strategic suppliers must be carefully qualified to verify adherence to ethical business practices and typically nurtured for six months or more before the relationship becomes fully productive.

For example, when one of its suppliers was unwilling to move to China, a major Japanese automaker invested in a Chinese supplier with high quality plastic molding capabilities but no auto industry experience. After an assessment, the automaker committed volume to the supplier, helped them develop a business plan and offered extensive on-site training. They have established a win-win relationship with the automaker assured exclusivity and attractive pricing while the supplier enjoys higher operating margins.

Upgrading organizational procurement capabilities

To realize the potential savings from sourcing in China, MNCs will need to upgrade their own China procurement organization's capabilities and elevate its influence within their global organizations.

Some executives we interviewed reported that the tactical nature of their procurement organizations in China presented obstacles to optimizing savings and developing innovative approaches to surmount China's many procurement challenges. For example, local procurement managers cited a host of administrative procedures to qualify suppliers requiring approvals from their China, Asian and global headquarters.

World-class procurement organizations are developing and empowering local staff and suppliers by sending some of their best people to China.

Given the strategic importance of procurement in China, now is the time for established companies to revisit their procurement strategies, processes and procedures. Often, these were put in place during the early stages of market entry a decade or more ago, when procurement organizations were more tactically-oriented.

Leading companies are elevating the role of procurement in China and upgrading their China procurement operations by relocating senior staff from their global organizations. Four companies we interviewed – including IBM – have recently moved their global procurement headquarters to China.

Strategic procurement starts from the top

In 2006, IBM relocated its Chief Procurement Officer to China in anticipation of the increased importance China procurement will play to IBM's global success, not just in China. Among the CPO's many objectives are to nurture and develop strategic suppliers, recruit and train procurement staff, and improve coordination between China and the global operations of multiple business units.

"Today's young Chinese suppliers are tomorrow's Foxconns. But we need strategic level managers on the ground to help them get there."*

– John Paterson, IBM Chief Procurement Officer

** US$28 billion Taiwanese electronics contract manufacturer*

In summary, local R&D and procurement are key levers to be successful and profitable in the mass market. Bringing simplified, low cost products to market requires MNCs to innovate in areas such as: product design, product specifications, strategic sourcing, supplier selection and management, supplier collaboration and improving their own procurement operations.

Human resources: massive challenges, innovative strategies

Human resources – including recruitment, training and retention – is another key challenge for MNCs operating in China. In 2005, the American Chamber of Commerce in China identified human resources as the top operating concern of its members.[25]

Implementing a mass market strategy exacerbates this challenge – companies will require not only the right people, but also enough people in diverse locations to run low-cost, high-volume mass market businesses.

The human resources paradox

How is it possible there is not enough talent in a country with 1.3 billion people? There are three simple answers, each with complex explanations: a shortage of qualified talent, strong demand for talent and high attrition rates.

Shortage of qualified talent

In 2006, China produced 4.13 million new university graduates that excelled in academic disciplines, such as mathematics, sciences and engineering.[26] However, many of these graduates are not well-suited to join multinational companies.

A recent study by the McKinsey Global Institute estimated that less than 10 percent of fresh Chinese university graduates are suitable for employment in foreign firms.[27] Indeed, at the entry level, hiring managers we surveyed cited soft skills and English-speaking abilities as their top two limiting requirements.

For mid- and senior-level positions, the shortage is even more acute. The Cultural Revolution impacted the education opportunities of those who would otherwise be

Without new approaches, China's talent shortage will only get worse as companies pursue mass markets.

managers today, creating a gap being filled by younger, inexperienced staff and expatriates (including ethnic Chinese from Taiwan, Hong Kong and other countries).

Highly marketable Chinese managers have experience measured in years – not decades – and may not have been mentored by senior leaders who can help them acquire leadership, communications, problem-solving and other softer skills.

Strong demand for talent

This shortage of qualified talent is compounded by growing competition from both foreign and Chinese companies. Between 2000 and 2004, the number of employees hired by foreign companies grew 14 percent per year.[28]

At the same time, Chinese companies eager to move up the value chain and expand globally consider multinational companies fertile recruitment ground for employees. Chinese companies offer a work environment that is culturally familiar, has nationalistic appeal and opportunities for rapid career growth without the constraints of rigorous global HR management systems and what some employees perceive as a glass ceiling.

High attrition rates

The shortage of qualified talent and brisk demand naturally leads to higher attrition rates than global averages, as high as 20 percent among the companies we surveyed. Although entry-level professionals are the most likely to leave, their turnover is manageable since MNCs are able to hire replacements relatively quickly. It is at middle management levels where high attrition is most problematic.

Why do employees leave? The allure of higher salaries is a key reason, but certainly not the only one. Based on our survey for mid-level professionals (with 2 to 6 years of experience) high attrition rates are closely correlated to employees having weak direct managers and perceptions that their career development opportunities are limited.

HR challenges are even bigger for the mass market

Penetrating the mass market exacerbates current HR challenges and also presents new ones. HR challenges specific to the mass market include:

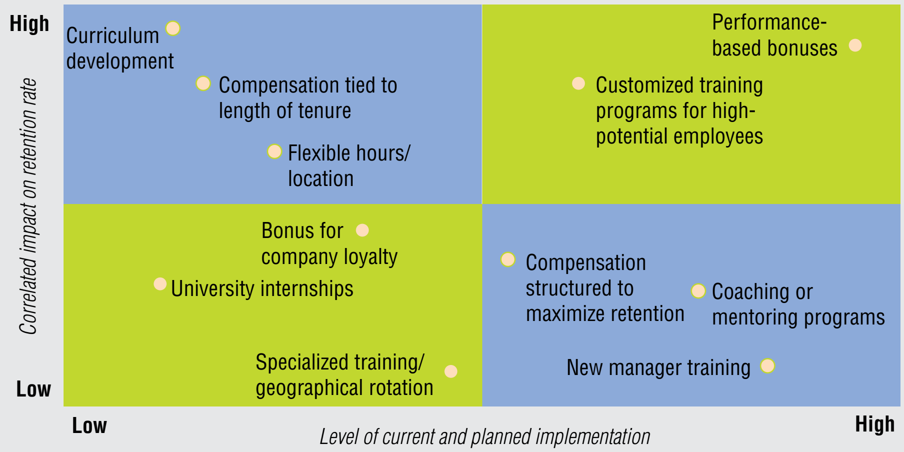
- Recruiting large numbers of employees
- Keeping employee salary levels in check to control costs
- Physically expanding into tier 3 to 5 cities
- Building specialized management and operational skill sets such as in sales, channel management, R&D and procurement.

Get back to the basics by focusing on retention

MNCs are implementing various HR programs to address today's challenges. Much of the attention is rightfully focused on retention due to the direct business impact of the loss of valued employees. However, as shown in Figure 11, the degree of impact that HR programs have on the reported retention rates of surveyed companies varies greatly.

On the bright side, as shown in the upper right corner, performance-based bonuses and customized training for high potential employees have a very positive impact on retention and are being implemented by most companies.

FIGURE 11.
Some HR programs that improve retention are not being fully implemented by MNCs.



Source: IBM Operational challenges facing MNCs in China survey 2006. Correlation to retention rate of mid-level professionals.

By contrast, as depicted in the lower right corner, companies are implementing programs – such as coaching/mentoring and compensation schemes – which actually have a low impact on retention. Worse yet, as seen in the top left corner, three programs positively correlated to retention are not being implemented aggressively.

Though program effectiveness will vary by company and industry, companies should ensure that their HR implementation strategies are aligned with retention impact.

Innovative approaches to prepare for the mass market opportunity

By improving retention rates, organizations will be less distracted and better equipped to focus on two innovative HR strategies to acquire, develop and retain talent required for the mass market opportunity: “building” instead of “buying”, and localizing talent.

Strategy #1: “Build” instead of “buy”

“Buying” talent has been an effective way to accelerate operations and gain a foothold in China, particularly during the early stages of expansion.

But once scale is needed, companies should consider both “building” and “buying” talent. A surprising number of human resource managers we spoke with admitted they do not hire fresh college graduates, preferring instead either to promote internally or hire experienced professionals.

“I don’t want to be the one training my competitors’ new hires,” said one Asia Pacific Director. While this preference for buying talent may be suitable for incremental hiring, it is not sustainable for large-scale recruitment efforts.

Instead, companies should build their own talent pipeline by partnering with selected universities and vocational schools for curriculum development and structured internship programs. This will not only lower recruitment costs, but also give companies preferential access to people with critical skills needed for mass markets.

What's more, internships provide companies an opportunity to test and prepare candidates for operational positions before making hiring decisions. Additionally, our analysis shows a strong correlation between partnering with universities and lower turnover rates.

Strategy #2: Localize talent

Similarly, scaling up with expatriates is not cost-effective – on average, compensation packages of expatriate managers are 83 percent higher than those of Chinese professionals.[29] Our survey respondents intend to accelerate localization of operational managerial positions in sales, logistics, manufacturing, procurement and marketing over the next three years. Retailers in our survey have the most aggressive localization plans and automotive the least. To achieve these targets, companies need to accelerate many of the localization programs leaders are putting in place, such as "local plus" packages for overseas/returning Chinese and expatriate mentoring programs for local employees slated to replace them.

Diversity can be a competitive advantage in China's mass markets.

But localization is not just about replacing expatriates. Recruiting with ethnic and geographic diversity in mind also brings new market insights and an improved ability to develop business in diverse regions of China.
For example, while glitzy coastal cities may attract new hires, returning home is attractive for some mid-career professionals in tier 1 cities who are originally from other parts of China.

Ethnic diversity creates business advantages

Cummins, an engine manufacturer, has a dealer and service network that spans China. When one branch manager in the western province of Xinjiang had to be replaced, Cummins replaced him with someone who was a member of the local Uighur ethnic minority, spoke the local dialect and had ties to neighboring Central Asian countries. Business was soon booming.

These and other human resources strategies should be pursued to enable companies for the mass market opportunity. At the same time – through scale and localization – companies will be able to offer new, exciting opportunities for Chinese professionals to innovate and leverage what they perhaps instinctively know best – how to compete and win in China's challenging mass markets.

Conclusion

Transform your business for the mass market opportunity

The majority of MNCs are enjoying rapid and profitable growth in China by focusing on premium-end markets. But achieving growth targets over the coming years will require many companies to penetrate China's mass markets, while sustaining leadership in premium-end segments.

Companies will need to focus on the right operational levers in their enterprises – whether in R&D, procurement, manufacturing, sales channels, distribution or others – to bring lower priced products to the mass market profitably.

Innovation in business models and operations in China offers MNCs an opportunity to not only profit from the mass market, but also transform the role China plays in their global enterprises. High volume, low-cost business models developed in China can be leveraged for global competitive advantage, particularly in other emerging markets.

Is your company prepared for China's mass market opportunity?

- Where will your future growth and profitability in China come from – lower priced products and less prosperous regions of China?
- Have you carefully evaluated the mass market opportunity for your company's products and services in China? Do you have a strategy in place?
- Have you developed the right business models to pursue the mass market opportunity? What adjustments need to be made both in China and globally?
- Are your operations prepared for the mass market opportunity in key areas, such as sales and distribution channel management, R&D, procurement and human resources?

To learn more about this study and the IBM Institute for Business Value in China, please contact us at ibvchina@cn.ibm.com. For a full catalog of our research, visit: http://www-900.ibm.com/cn/services/bcs/iibv/

Related publications

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