China: The Pursuit of Competitive Advantage and Profitable Growth
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For more than 20 years, China has been experiencing a dramatic transformation from a centrally planned economy to a managed market economy. It is difficult to overstate the achievements of the 1980s and 1990s, culminating in China’s accession to the World Trade Organization (WTO) in 2001. With economic growth in the range of 7 to 8 percent annually and foreign direct investment exceeding $50 billion per year, China is clearly a major force in the world economy whose impact will only grow with time.

Much has been written about the policies that have enabled or hindered this progress. That is not our purpose here. Instead of evaluating the Chinese political system or the country’s macroeconomic and industrial policies, we want to share our perspectives on how to build sustainable competitive advantage and achieve profitable growth within the rapidly evolving Chinese economy.

China: The Pursuit of Competitive Advantage and Profitable Growth is an anthology of articles about China published by The Boston Consulting Group over the past two years and written by BCG’s leading consultants working in the Greater China region. These articles address topical business issues facing both multinational and domestic Chinese companies in a broad range of industries. At the same time, they are informed by BCG’s nearly 20 years’ experience working with such companies on the ground in China. Finally, they draw on the functional and industry expertise of BCG’s extensive global network.

For both multinationals and domestic companies, China offers two major business opportunities. The first is to sell to a large and growing domestic market. In virtually every industry, China represents huge growth potential. It is already a leading global economy and, if current GDP growth continues, it will be among the largest in the world by 2010. China is already the number one producer in more than 100 product categories, and it is the number one market in many.

The second opportunity is to leverage China as a global low-cost supply base. Exports from China have been growing at approximately 15 percent for the past decade, driven by low labor costs but also by favorable industrial policies, an increasingly educated work force, the creation of more than 500 special economic zones, the wide availability of electric power, and pragmatic, probusiness government policies, including specific investment and tax incentives. As a result, exports are growing across the board in textiles and apparel, electronics and home appliances, metals and chemicals, a wide range of industrial goods, and, most recently, automotive components. For most companies, sourcing from China is now an imperative.

Although China’s market is large and growing, and the low-cost supply base continues to expand, the country remains a challenging market for most multinational companies. Each company that competes in China starts from a unique position and to some extent faces unique competitive challenges. Still, some common challenges run like “red threads” across sectors and companies.

**Developing market insights to inform actions.** Making sense of the local market is one of the greatest challenges in China. The inherent complexity of the environment, the rapid pace of change, and the paucity of reliable data are major challenges for leaders who believe in making fact-based decisions. For these very reasons, information—about customers, competitors, distributors, or suppliers—is fast becoming a key source of competitive advantage. Companies that have built successful national distribution networks have had to screen literally thousands of distributors to determine how products flow and which distributors are optimally placed. Evaluating which suppliers are capable of delivering quality goods reliably with sustainable cost structures is extraordinarily time-consuming in a market where suppliers’ capabilities vary by orders of magnitude. Those companies that develop well-informed market insights have a resource that is hard to duplicate.

**Competing with domestic companies.** In fast-moving consumer goods, home appliances, consumer electronics, telecommunications, and industrial goods, Chinese
companies are competing successfully against global players. They are now a force to be reckoned with in almost every industry. Their success formula combines extremely low cost structures, aggressive adoption and adaptation of technology and management practices, advantaged wholesale distribution channels, and increasingly sophisticated branding and marketing.

Managing complexity and change. Another critical leadership challenge in China is managing the complexity driven by the heterogeneity of customers, suppliers, competitors, regions, and government entities. China is really much more like the European Union than it is like the United States. Developing a clear understanding of the business environment is inherently more difficult and is further exacerbated by the paucity of reliable data. As if this weren’t daunting enough, China is also changing at a dramatic pace along many dimensions, including application of the WTO agreements, customer segmentation and sophistication, modernization of distribution channels, emergence of strong domestic competition, adoption of technology, development of regions beyond the east coast, and investments in infrastructure.

Organizing for China. Preparing for hypergrowth, managing complexity and change, deploying resources to cope with a heterogeneous market, finding and developing local talent, and managing the transition from expatriate managers—those are the chief organizational challenges that all companies in China face today. What’s more, establishing a sourcing organization with appropriate operational linkages around the globe brings with it an additional set of challenges, all exacerbated by frequently complex country-and-product-reporting relationships.

Meeting expectations. In addition to all the challenges inherent to operating in China, business leaders increasingly talk about the challenge of meeting aggressive expectations for market growth, cost savings, and, ultimately, profitability. If anything, those expectations are intensifying. For many companies, China has become the panacea for profitability problems in low-growth, high-cost home markets. Pressure from management at the center is often reinforced by investment analysts’ increased scrutiny of a company’s China investments. Thus, leaders in China find themselves under more pressure precisely at a time when they are facing some of their greatest challenges.

In addition to these cross-cutting themes, many of the issues that companies face in China are specific to individual sectors of the economy. Each of the articles in this volume has a specific functional or industry focus.

“Aim High, Act Fast: The China Sourcing Imperative” explores the emergence of China as a leading global producer and exporter, and the competitive implications of a market where now almost anything can be sourced, often at significant cost savings. Just as the opportunities to save money by sourcing in China have broadened, so too have the strategic options that companies face—what the authors call the “Five Levels of Sourcing Advantage.” The article offers advice on how to determine what to source, establish the appropriate infrastructure, and overcome common barriers to action.

“Breaking Out of China’s Value Trap” looks at a common situation facing many consumer-goods companies in China: profitability that is well below expectations. The article highlights how many companies have gotten caught in the China “value trap” and describes the collective strategies that leading companies are using to break out of it. The authors define a success model that includes value pricing, economies of scale, low-cost operation, a deep understanding of Chinese consumers, and effective resource deployment.

“Catching the Wave: Marketing in China” elaborates on one of the core elements of the China success model: the need to develop deep local insight into consumer behavior. To make investments in China pay off, companies must realize that behind the country’s explosive growth in demand is a new generation of consumers. These consumers are characterized by sharply defined but continually evolving tastes, changing worldviews, and unprecedented expectations about their own future and that of their children. The prize for those companies that develop deep consumer insights and translate them into the right products and services is potentially worth more than $3 trillion annually.
“The Dragon’s Revenge: Tough Times for Telecom Vendors in China” recaps the success enjoyed by vendors in China’s fast growing telecom market but argues that the opportunity space is rapidly changing. Slower revenue growth, industry restructuring, postponements of capital spending, and delays in the issuance of new licenses are making the country’s domestic market far more challenging for established equipment vendors. The article explores these challenges and explains the steps that established players must take to succeed in the new environment.

“Competing to Win in China’s Fast Growing Automotive Market” describes the changes occurring in China’s auto market. Rising disposable incomes are fueling dramatic growth and the proliferation of vehicle models. Tariff barriers are crumbling and new-car prices are falling. The necessary infrastructure to support a mass market, including the availability of financing, distribution, and repair services, is emerging. This article identifies five requirements for OEMs that want to win in what is fast becoming an attractive and yet highly competitive market.

“Rethinking ‘Made in China’ Cars and Parts” attacks what until recently was the conventional wisdom: the idea that China is not yet a competitive manufacturing and sourcing base for the automotive industry. The article begins by describing how Honda’s plans to build a plant in China dedicated exclusively to exports hit the industry like a bombshell. It goes on to explore what Honda must believe it can achieve in China for this plan to make sense. It also describes how China has already become an important base for sourcing automotive parts and concludes with five strategic levers that companies must command in order to take advantage of this assembly and sourcing opportunity.

“China’s Growing Drug Market: Will You Be a Contender?” argues that although China’s 1.25 billion people represent significant untapped opportunity, most global drug companies don’t consider the nation a priority. The article explores the powerful forces that are driving the transformation of health care in China and the opportunities this transformation represents for pharmaceutical companies. According to the authors, staking out a position in this frontier market requires multinationals to pursue two goals simultaneously: to create the right drug portfolio for the Chinese market, drawn from their worldwide portfolios, and to build the local Chinese organization necessary to market and sell these compounds.

Whether as a source for growth or a platform for low-cost sourcing and production, China is an opportunity too important to ignore. There are clearly many strategic, operational, and organizational challenges. But success will come to those who take the actions necessary to turn these challenges into sources of competitive advantage and use those advantages to achieve profitable growth.

Many people have contributed to the articles in this collection. I would especially like to thank BCG’s China-based officers—Thomas Achhorner, Douglas Beal, Giles Brennand, Jim Hemerling, Hubert Hsu, Thomas Klotz, Jean Lebreton, and David Michael—as well as Zafar Momin from BCG’s Singapore office and Immo Rupf from Paris (formerly based in Shanghai). I would also like thank our Greater China consulting staff. We hope you enjoy these articles. We welcome your feedback and encourage you to contact us.

John Wong
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For more than a decade, “Made in China” has been a compelling sourcing option. Today, in almost every industry, it is becoming an imperative.

Consider some recent news stories: Ford announced plans to buy $1 billion in auto components from suppliers based in China. Wal-Mart established a sourcing division in Shenzhen to buy directly from Chinese factories. And Philips Electronics’ 23 factories in China surpassed $5 billion in goods produced, most of them for export. For those companies and many others, the story starts with cost savings on components and finished goods—but that is not where it ends. The overarching objective is cost advantage.
Of course, doing business in China, just as in other developing markets, involves significant risks and challenges. But our experience shows that they can be managed and overcome. In fact, the biggest risk may lie in moving too slowly. China is already having a fundamental impact on many industries. (See Exhibit 1.) As a result, companies that are not yet acting—or are not acting as fast as their competitors—are in danger of becoming competitively disadvantaged.

The Quest for Cost Savings

For many years, The Boston Consulting Group’s China team has worked with and studied dozens of companies operating in China, and one finding is clear: a company can now source almost anything from China. The nation has long been the world’s leading manufacturer in categories such as air conditioners, motorcycles, and televisions. But in recent years the opportunity to source in China has expanded to include extremely high-tech products, as well as components that are part of a more complex logistics pattern, such as automobile parts. Evidence is readily seen in the huge new industrial parks outside Shanghai and Beijing. In them, Intel is making semiconductors, General Electric is producing sophisticated medical equipment, and Nokia is building next-generation mobile phones.

For almost any company, China offers three broad opportunities for savings. The first is in labor and raw materials. Manufacturers in China benefit from an enormous pool of workers, flexible working conditions, and an average hourly wage of approximately 50 cents—well below Mexico’s $2.30 and even India’s 80 cents. In addition, raw and processed materials are often cheaper in China and frequently match global standards for quality. (For example, General Motors recently awarded China’s Baosteel its global quality certificate.) Overall, procurement costs generally run 20 to 50 percent below costs for comparable goods in established markets.

The second opportunity, one that is sometimes overlooked, is “capital avoidance”—essentially, lower setup, land, and factory expenses compared with other locations. The reasons for these lower expenses are threefold. First, to the extent that companies can outsource product manufacturing, they can save on factory costs. Second, for products that companies do manufacture themselves, they have the advantage in China of being able to use more labor and less equipment. And finally, for equipment that is necessary, tooling expenses are very low—again largely because of less expensive labor.

The third opportunity, which has emerged more recently, lies in low-cost product design and research-and-development activities. China now has some 2 million students studying engineering. That’s twice as many as in the United States, available at a small fraction of the salary. According to a recent survey, a qualified electrical engineer with six years of experience commands an annual salary of about $7,000 in China and about $83,000 in the United States.

Five Levels of Sourcing Advantage

As the savings opportunities in China have broadened, so too have the strategic options. Our experience suggests that five distinct levels of advantage are emerging in China sourcing. (See Exhibit 2.)

Level 1: Testing the Water. Many companies today still have not undertaken any formal initiatives in China, although they recognize the country’s importance. A number of them may source some basic commodities, but strictly on a trial basis.

There is little competitive advantage, however, to moving so cautiously. One small benefit may be the chance to learn from the mistakes and successes of other companies. But it certainly does not outweigh the opportunity cost.

Level 2: Purchasing Components or Complete Products. Wal-Mart bought $10.3 billion in goods from China in 2001, accounting for 4 percent of China’s total exports that year. Although Wal-Mart outsources a greater volume than almost any other multinational, its efforts represent the type of sourcing activity currently pursued by most large companies in China. For example, in 2002 the French retailer Carrefour sourced $1.6 billion in
China—up 27 percent from 2001. Whether it’s $10 million or $10 billion at issue, most companies are buying or manufacturing basic products and components that meet their standards at the lowest possible cost.

The advantage is a lower cost structure than that of competitors that are not moving as aggressively. In addition, the knowledge gained from working with particular suppliers, as well as a greater understanding of the overall supply base, are very valuable. However, these advantages can quickly be wiped out. Other than their own internal barriers, nothing prevents competitors from eventually achieving the same savings.

**Level 3: Developing Comprehensive Sourcing.** Motorola intends to have $10 billion in accumulated purchase volume from China and to be producing $10 billion a year in goods there by 2006. It also intends by then to have made investments totaling $10 billion inside China, including building a global R&D center in Beijing and hiring almost 5,000 researchers. This type of sourcing strategy goes well beyond procuring simple commodities and components to include services and talent such as product design and engineering.

Because other companies can’t easily replicate the close relationships with key suppliers or attract the best designers and engineers, comprehensive sourcing locks in a competitive edge. Telecom equipment manufacturers, which have the most advanced China-based R&D capabilities, are finding that they can design and manufacture more higher-value-added components in China, thereby reducing their dependence on imports from high-cost countries. There are also potential time-based advantages, such as accelerating product development cycles. One global manufacturer recently found that it could retool a plant in China not only for half the usual cost but also in half the time.

**Level 4: Adopting an Integrated China Strategy.** Until very recently, global automotive OEMs operating in China, as well as their suppliers, focused primarily on serving the country’s domestic market. Today their position is beginning to change. Increasingly, they see China not just as an important market or as a principal supply base for goods sold elsewhere, but as both. For these players and others, operating in China demands an integrated strategy. Each business line must be designed to outsource components for products that will be sold abroad as well as to produce goods that will be sold to the local market.

The advantage of an integrated strategy is additional synergies due to scale, so the potential savings are
greater. Products are designed to compete both globally and domestically. Also, capacity planning is integrated: plants are sized to realize full economies of scale, not just for domestic or export demand, and they are configured to meet both local and global requirements. There may be political advantages as well to competing in both realms: some China watchers argue that it is tougher to be solely an export player because the government views such companies as less committed than players that treat China as an important market in its own right.

**Level 5: Capturing Global Advantage.** Plenty of companies talk about integrating low-cost sourcing into a business model that is truly managed across many countries, yet only a few are indeed close to achieving that goal. For example, Toyota, with its closely coordinated manufacturing and supply between regions, sources subassemblies from across Asia, enabling the company to optimize manufacturing costs and just-in-time delivery.

The economics of globalization—of cost structures and business models—will be relentless. The competitive advantage of a truly global business, which leverages the lowest costs and the best capabilities, is structural in terms of both scale and locked-in relationships. But the advantage is also based on capabilities: it is very difficult to achieve, and also very difficult for competitors to replicate. The outcome is more growth—at a local, regional, and global level.

**How to Proceed**

The five levels of sourcing advantage are not a ladder: a company doesn’t necessarily move from Level 1 to Level 2 to Level 3, and so on. Companies sometimes shift quickly from, say, a cost-focused strategy for basic components to an ambitious integrated China strategy. Similarly, many companies that have been selling in China for some time are now, in a sense, backing into sourcing, and they are also beginning to manufacture for export. Examples include Siemens, Lion Nathan beer brewers, GE Appliances, and several of the global automotive OEMs.

So how should you proceed? Whether the task is to build a China sourcing capability from scratch or to improve an existing operation, our experience points to three essential steps.

**Analyze the opportunities.** Global companies *could* source almost anything from China today. But what *should* they source? Answering that question requires companies to get up to speed on their sourcing options. Then they should segment all the opportunities—both potential products and potential suppliers—and run all of them through a realistic feasibility screen. In addition, companies must determine the total supply-chain cost of securing the potential savings. Is the potential advantage big enough to offset the risks? Finally, companies should install a system that forces them to update their views on China frequently, because the situation will continue to change quickly.

Wal-Mart’s push to buy directly from Chinese factories is a case worth keeping in mind. With its unrivaled bargaining power, in addition to its requirements for relatively simple products, Wal-Mart can place much of the burden for screening suppliers on the suppliers themselves, asking them to provide detailed background information and samples. Nevertheless, Wal-Mart still requires a staff of more than 200 to complete site visits, verify information, and implement sourcing decisions. For other companies, the task is even more complicated. More complex products—especially those components that will go into other products—require considerably more detailed assessments and demand greater interaction with suppliers.

**Establish the infrastructure.** Designing and building a sourcing operation is a significant undertaking. Such an effort means creating processes and policies for everything including supplier selection and assessment, monitoring and compliance, human rights evaluation, and risk management. It also means developing databases to track price quotes from suppliers; building China-specific expertise; and acquiring and tracking important data on benchmarks, site assessments, and supplier capabilities. Ultimately it means establishing tight links and coordination across multiple facilities and operations around the world—an amazingly tricky task. A system and a team must be in place to make the right decisions.
quickly and to execute them in a way that realizes savings and builds momentum.

To carry out such an ambitious project, it is essential to tap a leader who is both senior enough and capable enough to mobilize the organization. Also, because a great deal must happen outside China if a company is to be successful inside China, the importance of having the support of a strong champion at headquarters cannot be overstated. Several multinationals in China have considered following “level plus two”—a rule of thumb placing responsibility for China sourcing two levels above where it would normally reside.

**Overcome the barriers to action.** Many executives today are concerned about the risks of doing business in China. To be sure, China presents a number of serious challenges. For instance, a banking or other financial crisis could upset stability. Progress in implementing World Trade Organization concessions must be closely watched. Just as important are the substantial operational and managerial risks, such as sorting out currency swings, coordinating complex logistics, and identifying capable and trustworthy partners.

Trust is crucial when it comes to sharing intellectual property. When companies transfer expertise in product design overseas, they risk losing their proprietary technology to rivals, to employees who might defect to rivals, and to local entrepreneurs who sometimes pirate everything from cell phones to shoes, shampoo, and software. Yet the companies that would seem to be most vulnerable, such as makers of electronics or fashion accessories, continue to expand their manufacturing operations in China, believing that it is necessary to boost their overall competitiveness. As real and as serious as these issues are, advantage comes from understanding and overcoming risks, not from avoiding them.

One of the biggest barriers of all is resistance from within your own company and even from your vendors. Time and again we have found that companies aspiring to do business in China struggle with cultural and organizational challenges. Among them are a lack of urgency, a “business as usual” mindset, a lack of experience in China and with global sourcing in general, extreme organizational complexity, incomplete information, resistance from current suppliers, and difficulty in setting realistic targets. Before a company can move forward, it must identify and address these organizational barriers.

* * *

“Zhi xiang gao, xing dong kuai,” loosely translated, means “Aim high, act fast.” In essence, this is the imperative in China sourcing today.

Leading companies in several industries have already made big strides in China: they have begun to lock in advantages, and they are on their way toward Level 5 sourcing. However, many companies today—even those purchasing many million dollars’ worth of products from low-cost countries—are already behind key competitors in China. For them, the starting point for any analysis of their position can no longer simply be “How much are we sourcing from China?” but rather “How do we catch up?”

**志向高 行动快**

*Aim High, Act Fast*

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China continues to represent an enormous opportunity for consumer goods companies. With an economy seven times larger than it was 20 years ago, the country is undergoing the greatest economic expansion ever witnessed—anytime, anywhere. It is already the largest market for washing machines and mobile phones, the second largest for beer, and the third largest for carbonated soft drinks.

That growth shows no sign of slowing as consumers’ disposable incomes keep rising. With the full package of World Trade Organization benefits to kick in over the next few years, industries will continue to expand at rates several times those in more developed markets. And although highly regulated industries—such as telecommunications and financial services—must devote significant time and resources to cultivating and managing government relationships, consumer goods companies can spend more of their energy on business because they are among the least regulated in China.

No wonder multinational companies are encouraged by their initial forays into China. But their early success—often a result of skimming off the most affluent consumers in the biggest cities—can create a false sense of confidence in the sustainability of their business models. Because the fastest growth in China’s high-income households is expected to come from outside the largest urban areas, many companies are now trying to penetrate the mass market—and they are counting on those same business models to work for them there. (See Exhibit 1.) When they expand into new locations and categories, however, they typically run into a wall of new problems. These problems include fragmented markets, consumers, and channels; low prices in areas beyond the large urban centers; different competitors in different regions, each employing completely different go-to-market approaches; immature distribution infrastructures and players; and extraordinary strains on organizational capabilities and infrastructure.

Exhibit 1. The Fastest Growth in High-Income Households Will Occur Outside Large Cities

<table>
<thead>
<tr>
<th>Annual projected growth (2001-2006)</th>
<th>Number of households (millions)</th>
</tr>
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<tbody>
<tr>
<td>Shanghai</td>
<td>Beijing</td>
</tr>
<tr>
<td>14%</td>
<td>8%</td>
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 SOURCES: BCG analysis; China Statistics Bureau.
1Households with incomes greater than RMB 3,000 per month; approximately 8.3 RMB equals U.S.$1.
2More than 600 cities.
Most companies respond to these difficulties by allocating additional financial and human resources, only to become ensnared in the China value trap: the more these companies invest, the more they seem to lose as shareholder value drains away. Expatriate and local managers find themselves working harder and harder with no turnaround in sight.

We estimate that more than 50 percent of consumer-goods and retail multinationals are caught in the value trap. In the beer industry, for example, international brewers have experienced annual losses that run into tens of millions of dollars, on top of hundreds of millions of dollars in write-offs from failed investments. Moreover, the problems occur across many sectors, such as packaged food and beverages, personal care, household chemicals, consumer durables, and retail groceries.

A few leading companies, however, are emerging from this trap with remarkable alacrity, and they are developing large, profitable positions across a range of markets. (See Exhibit 2.) Conventional wisdom asserts that the key to success in China is a combination of low costs and low prices. Of course, those advantages are crucial. But a more dynamic and sophisticated model is needed in a market as complex and varied as China’s. The companies that accelerate quickly out of the trap all pay close and early attention to scale, costs, and prices, but they also focus on local market insights and think creatively about resource deployment.

The Success Model Begins with a Virtuous Cycle

We’ve identified the collective strategies required to break out of the value trap as the China success model. (See Exhibit 3.) These strategies don’t work independently. Rather, their power lies in their integrated nature and the ways in which they complement one another. The value trap, then, may be hard to avoid. But if a company prepares ahead of time or changes course once it is snared, it will find a way out. Indeed, the approach it employs will have a lasting impact on its business trajectory—in both the severity of the losses it experiences and the speed with which it escapes the trap. What follows is a closer look at the components of the China success model.

Exhibit 2. Some Companies Escape the Value Trap Quickly, Whereas Others Remain There Indefinitely

SOURCE: BCG analysis.
Value Pricing and Scale. With a national savings rate of more than 30 percent, China is famous for the frugality of its citizens. To attract value-conscious shoppers, successful local companies focus on the high-volume, lower-price-point segments. Huiyuan in juices and Sanxiao in toothbrushes, for example, price their products more than 20 percent below those of the leading multinational brands and, as a result, dominate the mass market. To compete with these successful local players, many of which have also improved their product quality and positioning, global companies must proactively cut prices. Lower prices will help deepen penetration into the mass market, which in turn will provide scale benefits to support additional pricing and value-enhancement strategies.

Tingyi, a Taiwanese company, has captured the market for packaged noodles by being the value and price leader in the premium segment. Leveraging its scale, it has built its own sales and distribution (S&D) network, which includes more than 300 sales offices across China, serving nearly 34,000 retailers directly. The remaining retail outlets are serviced through distributors, who provide logistics, and wholesalers, who sell to remote locations. That approach has allowed Tingyi to build strong relationships with its retailers and, as a result, dominate their shelves. The brand frequently commands as much as half of the total space allocated to the category. Having established its S&D system, Tingyi has now embarked on an aggressive program of value improvement (larger package sizes), product extensions (an economy-priced noodle brand), and category expansions (ready-to-drink beverages and snacks).

Low-Cost Operations. When global companies focus on value pricing and scale, they frequently complain about low margins. Often, the problem is that they haven’t fully explored how truly low cost their operations could be. Most companies could significantly reduce their costs in at least three ways: by ensuring that economies of scale are fully exploited, by localizing cost structures to benefit from China’s favorable factor costs, and by increasing their focus on the parts of the business that deliver real value to consumers and eliminating or reducing those that do not.
Contrary to what many multinational companies claim, our experience doesn’t support the notion that local companies enjoy significant structural advantages. Some may discover small advantages by locating in lower-cost regions within China, but in relative terms, the savings are small.

Most multinationals believe they can’t reduce costs by much more than 5 or 10 percent. We believe the opportunity is often more than 20 percent and possibly as high as 40 percent. When lowering costs, however, such companies need to ensure that their Chinese operations continue to leverage useful experiences and processes from the worldwide system, while they also develop local management capabilities and a business model that is relevant to serving the Chinese market. For example, when Colgate discovered Sanxiao’s 30 percent cost advantage in toothbrush production and realized it would take significant time and resources to narrow the gap, it acquired the company. Now it not only owns the Chinese toothbrush market with more than 50 percent volume share but it also uses the low-cost facility as an international sourcing center.

Local Market Insights: Understanding the Chinese Consumer

China poses an enormous challenge to multinational consumer-goods and retail companies when it comes to gaining insight into its local markets. The wide-ranging differences across the country—with its 600-plus cities, seven major dialects, and 80 or so spoken “tongues,” not to mention its huge disparities in education and income—are made even more daunting by the severe inaccuracy or lack of published data. Rather than rely solely on market research, successful companies get out and talk directly with channel partners, competitors, and consumers. They also tap into the direct experience of local managers, whose insights into the subtleties of local lifestyles and preferences help the companies tailor products to meet local demand.

Flexible Brand Positioning. Multinational companies often view Chinese consumers only in the context of their global brands. Although such brands provide many advantages, they also bring with them many constraints, especially when it comes to positioning, icons, and messages. Chinese consumers still admire Western products, but they are more inclined to shop for brands they feel serve their specific needs. For example, Shiseido, long ago discovered that many Chinese consumers believe that Asian skin is significantly different from the skin of non-Asians. Acting on that insight, the Japanese company established an early lead in the fast-growing cosmetics categories by noting in its advertising that its products are designed specifically for Asians.

Customized Products. The challenge of offering localized products is made harder by the fact that consumer preferences vary considerably within China. What sells in the chic environs of Shanghai might be rejected in rural communities. That’s why Tingyi tailors its products to regional tastes, marketing sweeter flavors in Shanghai and saltier flavors in the northeast region. Supported by a highly sophisticated regional production capability, the company is then able to revise its formulation continually in order to meet changing tastes, which brings it even closer to consumers.

Unique Service Experience. Chinese consumers also place a high value on superior service. That is an area in which multinationals can gain an advantage because local companies often find it difficult to deliver even the most basic service. KFC and McDonald’s, for example, leveraged their global capabilities to deliver a consistently high-quality service experience that stands in stark contrast to the indifferent service typical in competing local restaurants.

Leading Chinese companies are beginning to catch up, however, and some are offering very high standards of service. Haier, for example, differentiated itself from both local and global competitors by offering a national 24-hour hotline for its appliances. Furthermore, it extended the concept to its channel partners, proactively servicing retailers to support sales, promotion, and marketing. Those actions have contributed to making Haier number one in China’s appliance market.
Effective Resource Deployment

In a country as vast as China, resource deployment can be a complex issue. Like leaders in combat, business leaders must first decide which battles to fight, the optimal configuration of forces to use, and how best to deploy those forces to break through competitive positions. In short, they must adapt their go-to-market models for each regional market. Then they need to organize to ensure that those resources are not overwhelmed by the ensuing complexity of battle. Clear lines of communication and supply, as well as effective processes and policies, are vital to making certain that the troops at the front are aligned and equipped. Leaders must also decide whether to align their forces with others and how to orchestrate that deployment. Mergers, acquisitions, and alliances—together with effective integration plans—are often critical to building scale and capabilities. Although effective resource deployment can seem difficult, many companies in China are already making great progress.

Adapt Go-to-Market Models. Large cities account for a relatively small, albeit very attractive, share of the market in most consumer categories today. What’s more, future income growth will be highest outside those cities. Sooner or later, most multinational companies will decide to expand beyond their initial beachheads to tap into the vast potential of the rest of the country. (See Exhibit 4.) But once they encounter less sophisticated consumers, new competitors, immature distribution infrastructures, fragmented channels, and woefully inadequate data and information, just how many business models will they need? Clearly, one model can’t work for every area. Companies will need to customize products, distribution, advertising, and promotions. But that doesn’t mean that each city requires its own unique model.

We recently helped one of the largest packaged-goods companies in China reassess its business model across the more than 600 cities it served—nearly every urban center in the country. First, we segmented the market into city clusters with similar characteristics, winding up with
a much more manageable number. Then we devised a
go-to-market model for each cluster, which included
channel priorities, media and promotion strategies, sales
force deployment, as well as logistics models. Along the
way, we identified certain regions that were simply
unprofitable to serve and devised exit strategies. The
exercise had a significant impact on the top and bottom
lines, and it allowed the client to focus scarce resources
on its most important geographic markets and channels.

Huiyuan, the leading local juice company, provides
another good example. Unlike most packaged-goods
companies, it eschews a diverse brand portfolio in favor
of collecting most of its products under a single brand
umbrella. That strategy simplifies marketing,
advertising, and distribution; in addition, it enables
the company to enjoy significant marketing scale
advantages. What’s more, the approach allows Huiyuan
to enter new categories—such as packaged juice
drinks—that it can introduce under the established
umbrella brand and distribution network. As a result,
the company has been able to achieve a profitable
growth trajectory while maintaining its leadership
position.

Manage Organizational Complexity. Expansion will
inevitably increase organizational complexity because the
new cities that have a growing mass market will be smaller
and channels and distributors more fragmented. Expanding
an initial beachhead market to 10 or 20 cities typically results
in an exponential increase in the number of staff,
distributors, and customers. Left unmanaged, these factors
result in overwhelming organizational complexity.

When, expatriate and local managers underestimate that
complexity—as happens all too frequently—they find
themselves spending more and more time on the road
working longer and longer hours to deal with mounting
operational problems in one market after another.
Companies can make this process considerably easier by
codifying standard processes and procedures using good
management-information systems. In nascent Chinese
markets, simple approaches are frequently just as effective
as the sophisticated ones that multinationals adopt in
more developed markets.

For instance, a well-managed S&D network is critical, but
China’s market complexities cause many companies to
struggle with even modest expansions. One of the few
exceptions to this is PepsiCo’s beverage division. The
division realized that its core global processes could be
just as effective in China as they are elsewhere, but
success would depend on careful implementation.

Therefore, PepsiCo has piloted selected processes in a
few key regional markets in order to customize them for
China. These sales tools are then codified in manuals and
reinforced across all of the company’s teams. Global
companies such as PepsiCo have found that a profitable
pilot can be a persuasive tool for convincing Chinese
managers to adopt a new system.

PepsiCo’s continued success is also based on constant
process renewal. To encourage innovation, it gives its
supervisors significant decision-making power. Twice a
year, the company organizes a national conference to
bring its sales managers up to date on the latest S&D
information and to share local best practices. Managerial
freedom, however, is tempered by a rigorous monitoring
system that entails regular evaluations by internal teams
as well as third parties on key performance indicators.
With these strategies, PepsiCo has rapidly and
economically built a deep and expansive S&D network
and gained significant share compared with Coca-Cola.

Manage Mergers and Acquisitions. Reluctant to
relinquish any management control in this strategically
important market, many companies opt for organic growth
in China, despite its many—often unique—challenges.
Yet the creative use of mergers and acquisitions can often
be a more effective way to escape the value trap. Rather
than buying a local brand simply for its products and
volume, companies should consider the broader role that
the acquired company could play. It could help establish
a low-cost production base, for instance, or provide a
mass-market S&D system for the accelerated expansion
of a global product portfolio. In addition, it could offer
the freedom to market a local brand—enhanced with
global product technologies but free from global brand
restrictions—to a huge market of price-sensitive Chinese
consumers.
Nevertheless, mergers and acquisitions can involve risks that are unique to China. Due diligence for even a medium-sized acquisition could (and probably should) take months to complete. What’s more, given the complex structure of government in provincial China, it is vital to use a facilitator with solid knowledge of the region. Finally, in the postmerger integration phase, it is easy to overlook the inherent differences in the operating models of acquirer and target. Companies must guard against adding layers of expenses that transform otherwise successful low-cost businesses into general-and-administrative-loaded failures.

Realizing China’s Potential

As some nimble multinationals are proving, it is possible to reduce the inevitable growing pains of expansion in China and quickly return to profitability. To realize your true potential in China, start by assessing your organization’s position today in relation to where you want to go and how soon you need to get there. Answering the following questions will help you guide that effort:

- Where do you stand today in relation to the value trap? Are you confident that your business in China will be in a fundamentally more advantaged position within a year?

- Have you factored in all the complexities that are inherent in your expansion plan? Have you underestimated the challenges and investments required?

- Are you developing a sufficiently deep understanding of the Chinese consumer in order to position your brands and customize your products and services?

- Do you know how to lower your operating costs by 20 to 40 percent in order to support a value-pricing strategy?

- Do you know in detail how you will adapt your go-to-market model as you start to expand beyond your initial efforts?

- Do you have the right organization, performance discipline, and processes to support your expanding business model?

- How would a merger, acquisition, or alliance help you climb out of the value trap more quickly? Has your organization explored all the creative options? Are you aware of the challenges and risks inherent in the postmerger integration?

The China value trap is real. Many companies are caught in it today and have seen significant shareholder value destroyed. If your company hasn’t fallen into the trap yet, chances are it will soon. And once caught, it may seem like quicksand, because the harder you try to escape, the deeper you’ll sink. It takes vision, creative strategy, courage, and precise implementation to break out of the value trap. Are you prepared for the challenge?

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Catching the Wave: Marketing in China

China is expected to become the world’s largest consumer market within the next 35 years. Thanks to the country’s emerging middle class, marketers can look forward to the greatest opportunity of their lives. If China remains politically stable, there will be unparalleled opportunities for growth in all sectors of the consumer economy: food, durable goods, entertainment and media, telecommunications, transportation, leisure, education, and housing. (See Exhibits 1, 2, and 3.)

Deep insight into the consumer market will separate winners from losers in those sectors. The prize—potentially worth more than $3 trillion annually—will go to product makers and service providers that understand and target China’s young mothers, who make most major purchasing decisions. To be a winner, a company must establish strong, branded relationships with these consumers, provide the kinds of products that appeal to their aspirations, and be willing to customize offerings to meet the needs of a diverse market. It must also encourage retailers to provide appropriate shelf space, merchandising, and customer support for its products.

Many outsiders are already vying for a piece of the prize—and many more are expected to. Indeed, the U.S. government’s recent decision to normalize trade relations with China, along with China’s anticipated admission to the World Trade Organization, not only should draw more companies to the country but also should make it much easier for those companies to do business there.

To make investment in China pay off, companies must be sensitive to the fact that behind the country’s explosive growth in demand is a new generation of consumers. These consumers are characterized by sharply defined but continually evolving tastes, changing world-views, and unprecedented expectations about their own future and that of their children. We believe that by plumbing the hopes, dreams, and aspirations of this group—China’s nascent middle class—it is possible to anticipate the market and capture a leading position in it.

To that end, The Boston Consulting Group’s Shanghai office created an ad hoc consumer-research team to focus on young mothers in that city. BCG chose Shanghai because its population is relatively affluent, well educated, and interested in Western products. Having been wooed...
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by foreign marketers for more than a decade, citizens of Shanghai best represent how the Chinese are evolving in their attitudes and beliefs.

To be sure, one group of consumers from one city cannot tell the whole story of how to succeed as a marketer in China. After all, the country is enormous, marked by vast demographic, geographic, and intergenerational differences. BCG’s recent experience in China has already produced a number of broad insights:

• The Chinese are still not used to having a wide range of consumer choices. As a result, they are very open to fresh ideas. And because they are exposed to a constant barrage of marketing messages trumpeting the latest product features, they are eager to experiment with different brands.

• Because geographic markets in China are highly localized—each with its own retailers, middlemen, and competitors—brands must be built region by region.

• At China’s current stage of consumer development, point-of-sale marketing and promotions can be as potent as advertising.

• Marketers must recognize that they cannot dabble in China’s consumer markets and expect to win. It takes a big commitment over the long haul to implement a regional, highly segmented marketing strategy.

That said, much can be learned from a carefully chosen group of surrogates, such as the women of Shanghai. We conducted focus groups with married women between the ages of 26 and 35. In the emerging middle class, these are the consumers who determine their families’ budgets and aspirations—as well as most purchases.

The Dreams of China’s Consumers

The women we talked with are articulate, energetic, and interested in the latest fashions, skin-care products, and beauty aids. All work outside the home as nurses, sales associates, accountants, office employees, or bank clerks. For the most part, they live in small, rented apartments—some old, some new—often with their in-laws, sometimes with their in-laws nearby. As a result of China’s stringent birth-control policy, each woman has only one child, who is often cared for by her mother or mother-in-law while she works. We asked the women what makes them most unhappy about their current lives, what goals they are working toward, and what they dream about.

At first glance, Shanghai’s young mothers appear to be like mothers everywhere. They care about their children’s education, their families’ standard of living, and their country’s economic prospects. A closer look, however,
shows significant differences. China has changed tremendously over the past 30 years, and the women expect to see even more change over the next decade—particularly in terms of increasing wealth and freedom, as well as access to a wider range of consumer goods. These changes, however, are creating tensions between old and new customs, Eastern and Western values, family obligations and individual freedom, the need to save and the desire to spend.

Companies that hope to secure these women and their families as customers must take such tensions into account in all their manufacturing and marketing decisions. The women’s stories, told below in the form of three composite portraits, put the tensions in relief. What results is a valuable glimpse into the soul of China’s future and some guidelines for marketers who want to play a part in that future.

**Jin Wang: The Traditionalist.** Jin commutes 40 miles by train to her job as a nurse at a children’s hospital. Her husband, Yougang, is an accountant at a large insurance company, where he often works late. They live with their eight-year-old daughter, Li, and Yougang’s parents in a cramped two-bedroom apartment. But unlike many of her married friends who sometimes complain about living with their parents, Jin is grateful for her mother-in-law’s help with child-care and for the money she and Yougang save by sharing the rent. Although she and her husband make relatively good salaries, Jin worries about future expenses, especially spending whatever is necessary on private tutoring, computers, and software to help her daughter succeed in school.

On the whole, Jin feels that China’s traditional family system—in which parents sacrifice for their children but then are taken care of by the children in their old age—is a just one. “I know the old customs are dying out, and children are becoming much more independent. But who will care for the old people if the children don’t?” she wonders. “I worry that we are becoming too much like Westerners—more interested in careers and social life than in the life of the family.”

Jin’s approach to the consumer marketplace is conflicted for that reason. “Of course, I would like to have more fashionable clothes and a house of my own with my own furniture,” she says. “But how can I justify spending money for my personal pleasure when my daughter or parents might need it? I still believe firmly that the family must come first.”

After spending money on basic education, food, clothing, and housing, Jin devotes any cash that is left over to things that will benefit Li, such as piano lessons. She tends to buy locally made products, saying, “You can find clothes and cosmetics that are just as good as the...
imported ones.” And she does most of her shopping at big department stores on Nanjing Road, Huai Hai Road, or Xujiahui.

Looking toward the future, Jin hopes to travel more: “There is much we’ve never seen in China. And after our daughter is grown, we might also travel to Asia or even the United States. My parents, of course, never had the chance to travel.”

There are great differences between the lives of Jin and her contemporaries and those of her parents’ generation. Still, Jin maintains that her daughter will look after her and her husband in their later years, just as she is committed to looking after her mother and father.

**Hong Chen: The New Age Woman.** Hong, an assistant manager in a recently opened women’s clothing boutique, describes herself as a New Age woman. Her choice of the American phrase is characteristic: Hong loves all things Western; reads British, French, and U.S. fashion magazines; and keeps up with the gossip about Hollywood celebrities.

Hong believes that China is finally emerging from the Dark Ages and into an era of more freedom, independence, and sophistication. She is raising her ten-year-old son, Yin, to be more confident and outwardly competitive than she was brought up to be, and not to display the self-effacing humility that was required of her generation. Hong’s views on child rearing have created some conflict with her mother, who lives with Hong and her husband, Da Gang, and cares for Yin during the day. This conflict is the chief reason why Hong has been saving to buy her own home. She estimates that she is within a year of her goal.

Hong expects to double her salary within the next five years. She hopes that her home will have a large-screen television and a dishwasher, among other amenities. She is saving to buy her son the family’s first personal computer. “I want my son to have access to the university,” Hong says. “I want him to change our world.”

**Rong Li: The Moderate.** Rong, her husband, Hao, and their son, Jun, live by themselves in an attractive apartment near the center of Shanghai. None of their relatives live nearby. When her friends speak enviously of her living situation, however, Rong reminds them that the burden of rearing Jun falls squarely on her and her husband’s shoulders. And because she and Hao work long hours—Rong is a computer technician, and Hao is in real estate—she often wishes she had the kind of help that other couples get from live-in parents.

Rong describes herself as a modern woman who doesn’t want to lose touch with traditional values. She enjoys her relative freedom, and she certainly doesn’t expect to live with her son when he marries. But she also feels that too much “Western-style” independence will weaken the close family ties that are important in her culture. “I definitely want my child to have everything that middle-class Westerners enjoy,” she says. “But I don’t want him to become so acquisitive that he forgets the importance of family.”

Although she admires Western technology and product quality (she is even sending Jun to learn English because it is “the language of computers”), she dreams of a day when her country will surpass the United States in everything—particularly in technology and medicine. “That’s not just patriotism,” Rong explains. “I know that the power and respect China would enjoy as a world leader would also raise my family’s standard of living.”

Rong and her husband are both earning higher salaries than they did in previous years and expect to see their incomes grow even more. Rong’s long-term goal is to start her own business—“something to do with computers.”

When we asked Rong about the kinds of things she currently decides to purchase and how those purchases might change in the future, she says that her decision-
making process hinges on a very complicated issue: “I love Western products. The quality is better, and the styles are more fashionable. But I fear that my generation’s preference for imports will force domestic manufacturers to go bankrupt and ultimately hurt China’s economy.”

There’s also the problem of personal guilt. Rong adds, “Yesterday I bought a new outfit and some cosmetics—things I would have considered too frivolous or self-involved a few years ago. But as much as I love these things, my son’s education is most important to me. I still worry about not spending enough on him.” So Rong saves 20 percent of the family income to spend on her son. “We will buy Jun the things he needs to take his place in society: health care, books, computers, sports equipment.”

Guidelines for Marketers

China’s young mothers are undoubtedly eager to purchase products that will raise their families’ standard of living, improve their children’s chances for a good life, and enhance their own lives. But in manufacturing and marketing these products, consumer companies should understand the tensions that affect, and sometimes squelch, the pent-up desire to buy. They need to find ways around the compromises these women believe they must make in order to straddle the old ways and the new. What follows are some do’s and don’ts for marketing in China.

Appreciate the complexities of the target audience. The women we talked with referred repeatedly to the complicated nature of their household arrangements. In a society where family structures range from large and extended to small and nuclear, the same household tasks might be performed by grandmothers, mothers, aunts, or even children—depending on the family. Therefore, marketers must be able to sell the same product or service across several generations and family members.

In fact, one family member may be responsible for purchasing a product even though another one uses it. Young working mothers, for example, often purchase the household cleaning goods and appliances that their parents use in the home. As a result, the younger purchaser might be more likely to buy a product that is the favorite of an admired celebrity, whereas the older person using the product might be more interested in convenience and effectiveness. Marketers, therefore, should take into account the needs of both the purchaser and the user. The process is analogous to marketing children’s books in the United States: because parents buy books for their children to enjoy, the bestsellers appeal to the sensibilities of both age groups.

Understand the benefits the market is seeking. The women in our focus groups have many unfulfilled needs. Chief among them is the desire for an improved home environment, including more living space. Therefore, products that help make a home seem less crowded or cleaner—such as personal stereo systems, screens, air purifiers, and noiseless, self-cleaning appliances—are likely to be highly appreciated. Eventually, as families move to larger apartments, products that enhance the new homes, such as appliances and furniture, and services that provide home-decorating advice and cleaning will also become important.

In addition, many of these women have very specific personal needs and wishes regarding fashion, cosmetics, and health care products. To overcome the conflicts that can dissuade consumers from purchasing such products, marketing messages should stress the benefits that these aspirational products bring—in terms of, for example, better health or general well-being. The messages should also make clear that these benefits accrue not only directly to the woman who purchases and uses the product but also indirectly to her family.

Finally, the women in our focus groups are extremely interested in anything that can help their children become successful and relatively independent. Educational toys and lessons that encourage creativity and independent thought are sure to be well received.

Recognize the special importance of the brand experience in a developing market. Don’t underestimate the amount of time Chinese consumers spend making purchasing decisions for high-end or new items, such as electronic appliances and travel packages. Consumers
typically spend a few months browsing in different 
channels to gather the most information about product 
features and brand differences. During this process, word-
of-mouth recommendations from friends who have 
purchased a given product often carry much more weight 
than advertising on TV or pitches from salespeople. To 
get the word out on their products, companies need to 
work hard to convert past users into brand disciples. That 
means establishing and nurturing a service and marketing 
relationship early with first-time purchasers.

Don’t stress foreign origins. Branding should represent 
superior (not necessarily “Western”) technology and 
design. Although Western products typically represent 
high quality and cutting-edge technology to Chinese 
consumers, they fear that too many imported goods will 
put domestic companies out of business. Therefore, 
Chinese consumers tend to favor Chinese brands as long 
as they aren’t sacrificing quality or paying too much. 
Adroit marketers can sidestep this issue by clearly 
explaining the benefits of a product while underscoring 
its quality. They should establish a local manufacturing 
base to secure a local connection while maintaining the 
benefits of foreign technology and design. And they 
should act quickly to stave off local competitors that are 
emerging in numerous consumer goods sectors and using 
their own powerful customer propositions to jockey for 
market position.

Don’t underestimate how much China is changing. That 
China has undergone a major transformation is obvious. 
What isn’t so obvious is the extent to which significant 
changes are still to come. The women we spoke with were 
externally optimistic about the coming decade, envisioning 
a very different China with a much higher standard of living. 
In fact, they believe the economy and culture will change 
so drastically that their children’s lives will be remarkably 
different from their own—so different, some parents fear, 
that their children will be unable to relate to them. Although 
these fears may be exaggerated, the degree of change 
expected in the society is probably not. Therefore, 
marketers must not assume that they understand the 
essence of China’s culture. Instead, they must constantly 
seek to deepen their understanding of China—its 
consumers are changing as rapidly as the environment is.

Don’t discount the value of educating consumers. 
Although China’s consumers welcome new products and 
services, Western marketers should realize that they aren’t 
as familiar with them as Western consumers are. In many 
cases, they will need to be educated to appreciate the 
benefits of a particular product. For example, many of the 
women we spoke with had no understanding of or 
appreciation for insurance products. But after attending 
a seminar on insurance, they were eager to buy the 
products. China’s consumers want to learn about 
products, and they bring open minds to the educational 
process. Sophisticated marketers will seize this 
opportunity and devote time and effort to educating them.

* * *

Understanding the hopes and dreams of China’s emerging 
consumer class will be a critical factor for success in this 
huge emerging market. Developing and marketing products 
and services that help resolve the tensions that accompany 
a society in transition will take sensitivity, flexibility, and, 
above all, a continuous effort to know the customer.

The stakes are very high, but so is the payoff. Future 
marketers in China should ask themselves today: What 
do I have to do to be in the right place to meet the first 
wave of increasing consumer demand? And how do I 
make sure my brands will respond to this new generation 
of consumers?

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For the past several years, the rapid development of China’s telecom industry has been a boon to the world’s telecom-equipment manufacturers. Indeed, as the global telecom sector has sputtered, China has been the only major market that has continued to grow. Fixed-line penetration—now at about 200 million phone lines—has doubled since 1999. China’s mobile industry has also seen spectacular growth, with total subscribers now exceeding 175 million—up from 100 million two years ago. The major equipment providers have been reaping the rewards. In 2001, Motorola’s revenues in China totaled $5.6 billion—equal to the company’s sales in all of Europe and nearly three times its sales in Japan. Nokia had sales of about $3 billion and sold more in China than in any other country except the United States. Alcatel had revenues of about $2 billion in China.

The opportunities are changing quickly, however. Several factors—including slower revenue growth, industry restructuring, postponements of capital spending, and delays in the issuance of new licenses—are making the country’s domestic market more challenging for established equipment vendors. This is occurring just as China enters the World Trade Organization and as China-based vendors increasingly vie for business in important markets worldwide. Established players will need to understand how to compete in this new environment.

A Shifting Market

China’s market is becoming tougher on a number of fronts. First, in both the fixed-line and mobile businesses, there has been a noticeable slowdown in both revenue growth and near-term capital spending. In the fixed-line arena, for example, China Telecom, the dominant operator, spent only about 80 percent of its capital budget during the past two years. The company has also put a large share of its capital expenditures on hold in the wake of a major industry restructuring—one that has led to the spinoff of the northern portion of its business and the creation of a new rival operator, China Netcom Group.

Beyond the cutbacks in spending, there have been shifts in investment priorities—away from traditional network deployment and improvement and toward the creation of new services and improved customer-service capabilities. Indeed, China Telecom has already started to make investments in Xiaolingtong, or “Little Smart”—its limited-mobility product that is based on the Personal
Handy-Phone System (PHS)—and in systems that permit higher levels of customer service.

Mobile operators are also in the midst of rethinking their capital-spending plans. China Mobile, the leading player, recently announced a 20 percent reduction in spending in response to slower growth in average revenue per user. China Unicom is expected to trim its spending plans as well. Having completed much of the initial work on the deployment of a new network based on Code Division Multiple Access (CDMA) and having experienced slow market acceptance, the company is increasingly conservative about new investments.

Adding to the overall market uncertainty is the delay in the issuing of new licenses to mobile operators. The government was slated to award new licenses in 2002 but now seems unlikely to do so until 2003 or 2004, at the earliest. The recent sell-offs of China Mobile and China Unicom shares, together with disappointing adoption rates for CDMA mobile service, appear to have dissuaded regulators from introducing more competition at this time. Taken together, these developments further reduce the likelihood that major new infrastructure investments will be made in the near term.

Finally, there is the general impact of competition among China’s telecom operators and pressures from the investment community. Today all of China’s operators face some degree of competition, and all either are publicly owned or have plans to become so within the next two years. These forces mean greater scrutiny on spending and an increased focus on areas such as IT, customer service, and branding—at the expense of additional network deployment.

New Global Threats

Beyond the market and industry trends, we are also witnessing the rapid rise of China-based telecom-equipment vendors. Some of these companies are already major players in their home markets and have begun to pursue global ambitions. Four players are of particular note.

Huawei Technologies, a privately owned company that is particularly strong in optical transmission and switching, currently has the most visible international presence. With revenues of $3.1 billion in 2001, the company has more than a third of China’s fixed-line switching business and employs more than 10,000 engineers in R&D. Huawei has already established overseas sales offices in Asia, Europe, and the Americas; and although it focuses heavily on developing countries, it has recently won contracts in Germany and Spain.

Zhongxing Telecommunication Equipment, which had sales of $1.6 billion in 2001, is especially strong in switching and mobile infrastructure. Like Huawei, ZTE, which is affiliated with the Chinese government, has begun pursuing business elsewhere, especially in emerging markets. It attracts engineering talent from all over China. ZTE and Huawei differentiate themselves from their more established competitors by offering low prices on relatively mature lines of products—something that is increasingly attractive to operators worldwide. In the future, however, both ZTE and Huawei are likely to stress innovation and service capability.

UTStarcom, which had revenues of $627 million in 2001, supplies network equipment and limited-mobility handsets for China Telecom’s PHS system. These products enable fixed-line operators to tap unused switching capacity for local wireless voice and data services. UTStarcom’s organization is unusual: although the company operates primarily in mainland China, its headquarters are in the United States and it has received funding from Japan’s SoftBank. Many of its managers are veterans of Lucent and other Western vendors. The company already generates about 20 percent of its revenue in areas outside China and aims to move more deeply into growing markets such as India.

China Putian, a holding company owned by the Chinese government, has been involved in several joint ventures with foreign telecom-equipment suppliers, including Ericsson, Motorola, and Nokia. The company has a new,
well-connected CEO and a mandate from the government to prepare for an IPO and to expand aggressively. Putian has already introduced three domestic mobile-handset brands and is in the midst of restructuring to become more competitive. Although its international commercial experience is more limited than that of other domestic telecom vendors, it has the connections and the resources to become a significant force. It had revenues of $7.7 billion in 2001.

**Implications for Established Vendors**

The recent developments in China’s telecom market and the new competitiveness of Chinese vendors have dramatic implications for established equipment vendors. For companies looking to succeed in this new environment, there are several critical steps that must be taken.

**Realign your product portfolios to target new areas of growth.** Telecom equipment vendors need to reassess the near-term growth opportunities. Among the most interesting areas are PHS equipment and handsets, metropolitan area networks, selected elements of next-generation networks, and billing and customer care systems. In the meantime, demand is weakening in other areas, such as backbone transport and core switching. Vendors must consider the implications for adjusting their own portfolios and decide whether and how to enter new lines of business.

**Take advantage of the new regulatory environment to improve efficiencies.** Most established telecom-equipment vendors set up their China operations based on regulations that existed a decade ago. These regulations required investments to flow through joint ventures with local companies and put restrictions on how companies’ import businesses and sales and marketing activities could be conducted. Today China permits more flexibility in organizing such operations. At the same time, leading joint-venture partners such as Putian have started to compete head-on with their erstwhile partners, creating major conflicts. In light of these changes, foreign-based vendors need to rethink their business configurations and future options, as some are beginning to do. Alcatel, for example, recently bought a controlling stake in its Shanghai Bell joint venture, and Ericsson recently consolidated some of its Chinese ventures. Most players are now putting new investment into wholly owned companies rather than joint ventures.

**Restructure your local operations in response to the changed economic environment.** Most players established their China-based organizations to capitalize on a period of buoyant growth. However, the new environment requires them to have both leaner operations and new capabilities. Successful companies will need to find ways to cut costs significantly. They will also have to bolster their capabilities in marketing and in sales of new products, and improve their relationship-management skills in order to satisfy increasingly demanding customers.

**Prepare for intensified global competition from China’s emerging equipment vendors.** Many of China’s telecom-equipment vendors pose formidable challenges for established players: their abilities to compete should not be underestimated. Senior managers need to determine which vendors to fight head-on and which ones offer interesting partnership—or perhaps even acquisition—opportunities. For example, both Huawei and ZTE have demonstrated the ability to pursue multiple strategies. On the one hand, the companies are effective at licensing technologies and cooperating with competitors; on the other, they have shown that they can attack overseas markets on their own. Established companies need to understand how to weigh this potential threat.

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China’s telecom market is undergoing sweeping changes. It will not return to the boom years of aggressive capital spending driven by a few monopoly operators. Though China’s continued economic development means the country will remain an important technology market for many years, the conditions for doing business will become
increasingly difficult as local equipment suppliers gain market experience and jockey for position. Established players seeking to secure their place in the Chinese market will need to understand how to compete in this new environment. Simultaneously, they will need to counter the growing competitive threat that China’s domestic companies will pose in the global arena. Advantage will go to players that recognize the new realities and act upon them quickly and effectively.

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Competing to Win in China’s Fast-Growing Automotive Market

By 2010, China will be one of the world’s five largest automotive markets. Already, the jockeying for position in this fast-growing market is intense. Virtually all the major original equipment manufacturers (OEMs) and global suppliers have significant investments in China or are in the process of investing there. Moreover, the huge deals with Chinese companies announced over the past several months by Honda, Hyundai, Nissan, and Toyota have further raised the stakes for all participants. (Although most OEM activity centers on China as a domestic market, farsighted companies are also investing there as an increasingly important base for both manufacturing and sourcing for export. See the next article in this volume, “Rethinking ‘Made in China’ Cars and Parts,” on page 32.)

To date, the handful of OEMs that got to China first have dominated the market. The field is now crowded, however, and keen competition from the rash of relative newcomers is very likely to erode incumbents’ market share. By the end of this decade, when participants’ entry strategies have played out, we will no doubt see some very big winners—and some big losers.

The Burgeoning Chinese Market

The Chinese car market is growing even faster than anticipated. In the first six months of 2002, 470,000 cars were sold in China—more than 125,000 were sold in the first half of 2001, which represents a 36 percent growth in demand. Total sales for 2002 are expected to reach 1 million. We anticipate that the market will grow at 10 to 15 percent per year for the next several years, to reach annual sales of approximately 2 million cars in 2006. (See Exhibit 1.)

The engine driving this voracious appetite for automobiles is China’s continued strong economic growth. In particular, sales of passenger cars are benefiting from rapidly rising disposable incomes (especially in...
China’s 50 largest cities); the increasing development of infrastructure such as roads and highways; the proliferation of vehicle models; falling new-car prices; crumbling tariff barriers; and the emerging availability of car financing.

Leading global OEMs and suppliers are already in China in force, and the more recent arrivals are investing rapidly to ramp up their presence. Volkswagen, Citroën, and Audi entered early, followed by General Motors and Honda. BMW, Fiat, Ford, Hyundai, and Peugeot are recent entrants with one-factory joint ventures. Nissan’s and Toyota’s recently announced megadeals with Dong Feng Motor Corporation and China FAW Group Corporation, respectively, involve multiple sites, multiple products, and cooperation along the whole value chain.

Clearly, with the field already packed, the battle for share in this high-growth market will be increasingly intense. What will it take to emerge as one of the winners?

Winning in China

Naturally, each company’s strategy for participating in China’s automotive market will need to reflect its current starting point and its particular aspirations. In all cases, however, companies that end up among the winners in this market will get there by tailoring their businesses to China’s unique requirements. Among the many things they will need to do well, the following five are critically important.

**Develop a deep understanding of Chinese consumers’ product requirements.** Up to now, most vehicles sold in China have been fleet and government purchases. However, consumers represented only 35 percent of auto sales in 2001, and we expect that share to double by 2010. But because consumer purchases are just now attaining scale, carmakers have not yet fully understood Chinese auto buyers’ needs, wants, fears, and aspirations. The market segmentations that are now available are devised primarily on the basis of features and price points, not on consumers’ characteristics and requirements. We do know that private car buyers are becoming more informed and sophisticated in terms of their requirements. We also know that, in addition to price (which is always a primary consideration), consumers consider body style, quality, reliability, brand image, and service availability in their purchase decisions.

In China, as in other emerging markets in Asia, carmakers have generally sold cars designed to Western or Japanese specifications. Exceptions include the Audi A6 and the Volkswagen Passat, which provide extra back-seat legroom in China, where buyers often ride as passengers driven by chauffeurs. Adaptations of this kind, which cater specifically to the preferences of the mass market, are likely to win market share. In India, for example, Tata’s homgrown Indica car, fitted with a diesel engine, has done very well; it offers customers a cheaper fuel alternative in a car that is comparable in price and performance to its foreign rivals. In China, some key considerations include providing interiors that are ergonomically better suited to carrying passengers, as well as suspensions that can handle rough roads.

The long-term winners in China will be those companies that make the right tradeoffs in terms of product styling,
performance, features, and price to meet the needs and preferences of consumers in each market segment—and then bundle these products with the right service offerings to meet customers’ cost and convenience requirements. Creating the right customer and product strategy will require very careful planning, incorporating reliable demand forecasts, extensive qualitative and quantitative consumer research, competitive gaming, and creativity. Companies will need not only solid market information but also considerable knowledge of competitors, suppliers, dealers, and social and political fixtures in China’s various provinces. Understanding Chinese consumers’ requirements across the full life cycle of car ownership will be key to delivering the right value proposition and building customer loyalty.

**Create an economically viable distribution network.**

World-class distribution networks are already emerging in China. Most of the OEMs we talk with are planning to develop their own proprietary, single-brand dealer networks. Although this model may be desirable, it won’t work for everyone. China consists of vast, relatively underdeveloped, heterogeneous regional markets. Our research suggests that only a handful of major players will have the volume required to support economically viable networks that offer national service coverage.

Nonetheless, each company’s distribution network will play a crucial role in delivering its value proposition to customers. Given the vast expanse of China, companies will need to come up with innovative business models for providing both geographic coverage and full functionality (such as new-car sales, used-car sales, service, repair, and financing), while achieving viable economics and ensuring customer satisfaction. One of the biggest challenges will be providing service in rural areas, such as quick-service dealers with lower breakeven volumes.

**Deliver a superior brand experience.**

Branding in China, as in more established markets, will entail orchestrating the entire purchase-ownership- repurchase continuum. Although the products themselves will remain at the core of the brand experience, the brand wars will increasingly be fought in the before-sales, sales, and after-sales experiences. OEMs that have scale and margin will be able to afford to invest; others will find it extraordinarily difficult and will have to look at creative alliances and outsourcing arrangements, very likely in cooperation with other OEMs.

First impressions will be critically important as the market grows and changes. As new consumers enter the market each day, the oversupply of rapidly proliferating new models will give them considerable choice for the first time. Moreover, as tariffs fall and capacity from existing and new players expands, we expect to see tens of thousands of vehicles go unsold.

Therefore, it will be a buyer’s market. Because many Chinese consumers will make their first-time car-buying decisions on the basis of word-of-mouth referrals from other first-time buyers, OEMs would do well to ensure that these consumers enjoy a positive sales and after-sales experience, as well as excellent product quality. Focusing on this experience will have far more impact on market share than will broad-based advertising or expensive brand positioning.

Branding may become a sticky issue in the future as Chinese car manufacturers intensify their efforts to create or strengthen their own brands, thus complicating their relationships with their foreign partners. The key question will be whether Chinese consumers will prove more loyal to Chinese brands than to global brands for nationalistic reasons (as, for example, Korean and Japanese car buyers have been). Our view is that the winners over the long term will be those companies, regardless of national origin, that can deliver a superior value proposition consistent with their brand positioning in the relevant customer segment.

**Maintain a lean cost structure.**

Although 1 million passenger cars will be sold in China in 2002, the market is splintered among multiple OEMs, brands, and models. As a result,
players are seriously subscale and high cost relative to low-cost manufacturers in Japan, Europe, and North America. With their profitability already under pressure from price wars and the need for continual investment, participants in China are finding that high vehicle and distribution costs pose serious challenges to their survival. Costs must be kept lean not only in plants and assets but also in distribution networks, overhead, and information systems. All infrastructure must be kept consistent in scale with the size and growth of local operations.

Establish the right relationships with the right partners—fast. A complex web of automotive joint ventures is developing in China. (See Exhibit 2.) Each of the three largest Chinese manufacturers—Shanghai Automotive Industry Corporation, China FAW Group Corporation, and Dong Feng Motor Corporation—already has two or three partners, and a host of other players have also entered into joint ventures. Some of these players will survive as independents, whereas others will be merged into the large manufacturers (as in the case of Tianjin Automotive Industry Corporation recently becoming part of FAW).

Although the future is far from clear, it is certain to include joint ventures. Thus far, the Chinese government has shown no sign of intending to relax the 50 percent limit on foreign ownership of automotive assembly. However, Honda is now lobbying for majority control of its new plant, and it remains to be seen whether the government will prove flexible on this issue for the right deal structure.

Foreign companies entering into joint ventures in China should be prepared for a healthy tension between themselves and their partners with respect to the scope and pace of investment. Generally, Chinese partners prefer more and faster investments and greater technology transfer, whereas foreign companies like tying investments to revenue growth rather than overinvesting initially and then “bleeding” for a long time.

With so many OEMs jockeying to choose the right partners, align interests, and compete for scarce resources, the joint venture arena will be a particularly ferocious battleground. Those at the top of the pecking order will have a strong advantage. Of course, partnerships by themselves cannot ensure success. In some cases, they could even become stumbling blocks for future growth. Nevertheless, having the right partners and connections in China can play a pivotal role in a company’s success or failure in delivering the right value proposition to the customer.

*                           *                           *

Exhibit 2. Car Joint Ventures Form a Complex Web in China

<table>
<thead>
<tr>
<th>Shanghai Automotive Industry Corporation</th>
<th>2001 sales of passenger vehicles</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shanghai Volkswagen FAW</td>
<td>361 (thousands) 44%</td>
</tr>
<tr>
<td>Shanghai General Motors</td>
<td>58 7</td>
</tr>
<tr>
<td>DongFeng Chery</td>
<td>54 7</td>
</tr>
<tr>
<td>Guangzhou Honda</td>
<td>51 6</td>
</tr>
<tr>
<td>Changjiang Suzuki</td>
<td>43 5</td>
</tr>
<tr>
<td>DongFeng Nissan</td>
<td>17 2</td>
</tr>
<tr>
<td>Yueda Kia</td>
<td>6 1</td>
</tr>
<tr>
<td>Beijing Hyundai</td>
<td>6 1</td>
</tr>
<tr>
<td>Fiat Yuejin</td>
<td>6 1</td>
</tr>
<tr>
<td>Beijing Automotive</td>
<td>5 1</td>
</tr>
<tr>
<td>Changjiang Ford</td>
<td>4 0</td>
</tr>
<tr>
<td>Haiman Mazda</td>
<td>4 0</td>
</tr>
<tr>
<td>Tianjin Toyota</td>
<td>0 0</td>
</tr>
<tr>
<td>FAW Toyota</td>
<td>0 0</td>
</tr>
<tr>
<td>Brilliance BMW</td>
<td>0 0</td>
</tr>
<tr>
<td>Other OEMs</td>
<td>150 18</td>
</tr>
<tr>
<td>Total</td>
<td>815 100</td>
</tr>
</tbody>
</table>

SOURCES: DRI; press searches.
Participation in China’s vast, fast-growing, and highly competitive automotive market is not for the faint of heart. But those who have the will, vision, and tenacity to tackle the immense challenges the country presents—as well as the insight, experience, and wisdom to undertake meticulous preparation and execution—are likely to be among the winners.
Rethinking “Made in China”
Cars and Parts

by Jim Hemerling
Zafar Momin
Immo Rupf

China not only represents the fastest-growing car market in the world, but also offers some of the lowest labor costs, at just 3 percent of European or Japanese manufacturing wages. Moreover, China can be expected to retain its labor cost advantage for a long time, thanks to its enormous pool of increasingly mobile workers, both skilled and semiskilled. (See Exhibit 1.) To date, however, global auto OEMs and suppliers have focused primarily on establishing positions in China’s domestic auto market, and have paid far less attention to developing China as a low-cost base for assembly and sourcing for export. Until very recently, general “wisdom” had it that China just was not yet a competitive manufacturing and sourcing base.

Today, however, that assumption is being challenged. This past July, Honda declared that it planned to build a plant in China dedicated exclusively to export, to produce 50,000 cars in 2004 and ultimately 300,000 cars per year. Ford, meanwhile, has announced plans to source $1 billion worth of components from China in 2003. Other OEMs are also increasing their reliance on China-sourced components.

For both OEMs and component manufacturers, the message is clear: you need to expand your view of China, from seeing it only as a domestic market to viewing it also as a base for assembly and sourcing for export. And because moving from planning to assembly takes years, not months, you must start making that shift now.

China as an Assembly Base for Export

To date, China has not been considered a viable base for manufacturing cars for export. Why? Although China does have cheap labor, this advantage is outweighed by lower labor and asset productivity; expensive raw material; joint-venture-related inefficiencies; and much higher costs in the supplier base, along with quality problems and weak design and logistics capabilities. OEMs report that compared with best costs elsewhere in the world, China operates at a cost disadvantage of 10 to 20 percent for large established car ventures and up to 40 percent for smaller operations. Although China is working to close the gap, estimates of how long it will take to achieve parity range from five to ten years.
In this context, Honda’s announcement that it plans to build a factory dedicated to exports hit the industry like a bombshell. Particularly noteworthy was Honda’s claim that it would achieve a 20 percent per vehicle cost advantage in relation to production in Japan. What must Honda believe it can achieve in China for this plan to make sense? First, it must believe that consumers will be willing to buy vehicles bearing the “made in China” label, despite that label’s historical associations with inexpensive, low-quality products. Second, it must believe that it can manufacture these vehicles at an advantaged cost. Let’s examine both assumptions.

The “Made in China” Label. Because China exports virtually no vehicles today, to examine Honda’s first assumption we need to look at automotive experience in other markets, as well as experience with nonautomotive exports from China. Increasingly, global auto makers are using plants in the developing world to make cars for their home markets. For example, Ford will produce its Fusion mini-SUVs for the United States in Bahia, Brazil, starting in 2004. BMW is producing 3-series sedans for Japan, Australia, and the United States in Rosslyn, South Africa. Honda is about to start making the Fit compact car for Japan in Ayutthaya, Thailand, and GM has been producing Opel Zafira minivans for Europe and Japan in Rayong, Thailand, since 2000. Clearly, these OEMs have concluded that consumers in developed markets will not be overly concerned about products manufactured in emerging-market plants.

Meanwhile, the reception given exports from China in a host of other categories, from name-brand running shoes and clothing to high-end cameras, electronics, and medical equipment, suggests that the “made in China” label no longer carries the stigma of low manufacturing quality. We believe that, with the right quality control and communication, resistance to “made in China” vehicles should not pose an obstacle, particularly for entry and mid-level vehicles. Let’s not forget that not too long ago, observers expressed the same concern about vehicles made in Korea—and earlier about vehicles made in Japan.

The Quest for Cost Advantage. To determine whether vehicles produced in China will be cost competitive, and if so, when, we first looked at the global cost structure of a typical passenger car and then assessed costs today in China and what it would take for Honda to achieve a 20 percent cost advantage. Having completed that analysis, we believe that achieving a cost advantage of 20 percent is feasible. How might Honda do it?

As noted above, Chinese auto plants now operate at a cost disadvantage of 10 to 40 percent in relation to world-class plants. This disadvantage arises primarily from two factors: high component costs, due to the lack of competitiveness of the supply base, and low capital productivity—most car plants in China are underutilized, producing significantly fewer vehicles per dollar of invested capital than their rivals elsewhere. So Honda will need both to reduce component costs and to increase capital productivity.

Reducing Component Costs. Most automotive suppliers in China are relatively subscale and inefficient and have low first-pass yields. Although they have come a long way over the past decade, they still have much ground to cover. Government policy and regional protectionism have led to a fragmented industry in which individual suppliers are tied to individual assembly plants and thus limited in size. Import tariffs on components (of approximately 30 percent) and local-content requirements have further protected suppliers, enabling them to pass along inefficiencies in the form of higher prices. Although government actions, falling tariffs, and market forces are driving consolidation and rationalization, most OEMs in China will continue to suffer a component-cost disadvantage in the near term.

Honda’s strategy to reduce component costs is likely to rest on two pillars. The company will probably import those parts for which China offers no structural cost advantage, such as most categories of engine and drive train components. Importing such parts will pose no cost disadvantage beyond freight costs, because the Chinese government waives import taxes on components destined for reexport.

For labor-intensive parts, such as wire harnesses and radios, China’s low labor rates can give Honda a
significant advantage, provided that productivity and quality can be brought up to competitive levels. Japanese OEMs will no doubt require their Japanese suppliers to relocate to China, and will also develop local suppliers. Honda is already doing both.

**Increasing Capital Productivity.** Capital costs can destroy profitability, particularly when plants operate below world-class volumes. Honda’s expertise in flexible manufacturing will be a big factor in enabling it to achieve scale economies even with lower volumes. The key to operating in China lies in achieving high levels of utilization while optimizing the tradeoff between automation and labor. In the body shop, Honda can use relatively low-tech welding lines with only limited automation instead of expensive welding robots. The same approach can be applied to the paint shop. Honda is already familiar with such tradeoffs; in India, its assembly line has very limited automation, and even its assembly track is not motorized.

Alternatively, OEMs can try to reduce the capital outlay itself. For example, Tata in India imported an old Nissan assembly line from Australia for its car venture, thus significantly reducing its total investment in plant and machinery.

When we combine the effects of lowering component costs and increasing capital productivity, it appears that a 20 percent cost advantage for car manufacturing in China could be feasible in the medium term. (See Exhibit 2.) In today’s best cases, the cost disadvantage of car production in China is about 10 percent, arising from the cumulative effects of smaller-scale operations, low utilization rates, and high component costs. Today, these effects outweigh China’s advantages in low labor rates and low prices for land and commodities. However, it should be possible to move from this disadvantaged position, represented on the left side of Exhibit 2, to the 20 percent cost advantage represented on the right side, by avoiding import duties on parts assembled into exported vehicles, achieving an optimal mix of Chinese and non-Chinese sourcing, optimizing capital-labor tradeoffs, and ensuring full facility utilization (for example, by dedicating operations to export).

In our view, the export of fully assembled vehicles from China is not only feasible but inevitable. Some OEMs, such as Honda, will build capacity explicitly dedicated to exports. Other OEMs that cannot find the sales volumes they had planned for in China will be forced to export out of China to remain viable. Either way, vehicles will be exported. The only question is who will do it best, and how soon.

**China as a Base for Sourcing Parts**

In contrast to the export of fully assembled vehicles from China, the export of components is already a reality. How is this possible, when domestic OEMs face a cost disadvantage in components? First, OEMs looking to source Chinese-made components for global operations can be selective, focusing on those commodities for which China’s inexpensive labor—and in some cases local materials—give China a global advantage. Second, components for export benefit from a full rebate of duties and VAT. Third, unlike domestic assemblers, which are tied to individual suppliers and hence get average costs at best, OEMs sourcing from China can pick from among all suppliers and get the lowest cost. And fourth, some suppliers—and regional governments—are willing to price more aggressively for export business. These factors
combine to give China an advantage in some parts categories—an advantage that will only grow as the restructuring and capability upgrading proceed.

Over the long term, these advantages will help China evolve into a much larger and more competitive supply base, as global tier-one suppliers relocate capacity to China and local competitors upgrade. In the short term, however, we believe there will be a shortage of capacity. On the supply side, numerous forces will combine to impede the relocation of tier-one capacity to China, and it will take time for Chinese suppliers to develop. On the demand side, pressure is building from the rapid growth of domestic vehicle sales (at 10 to 15 percent per year) and the increased sourcing efforts in China of global OEMs.

Because of these constraints, OEMs that want to use China as a low-cost manufacturing and sourcing base in the next few years need to mobilize quickly. The race is on.

Exploiting the Assembly and Sourcing Opportunity

Although component supply may be constrained over the next few years, China today offers a considerably more developed and comprehensive assembly base than it did just two decades ago—and that base is developing fast. Back in the 1980s, companies beginning to assemble models such as VW’s Santana and the Peugeot 505 took eight to ten years to be able to manufacture cars with 80 percent local content. In contrast, later models such as Citroen’s Fukang and VW’s Jetta, which were introduced in the early ’90s, took just three to five years to achieve the same results. Even more recently, the Buick Regal, which started with 40 percent local content in 1999, took only three years to get to 80 percent.

To exploit the Chinese assembly and sourcing opportunity successfully, companies must command five key strategic levers.

Integrate China into global capacity planning. To succeed in China, OEMs will need to create global production systems that combine China-based suppliers and assembly facilities with supply operations in other countries. Japanese OEMs are taking the lead in incorporating China into global capacity planning for both assembly and components, building capacity and shifting the supply base. Just as Toyota rationalized sourcing in ASEAN, we believe it will now incorporate China in ways that will give it a powerful additional advantage. The recent deal with FAW Group Corporation, one of China’s top-four car makers, will ensure a strong partner in China with which Toyota can build a strong assembly base for the region. Looking ahead, OEMs will also need to explicitly factor potential exports from China into their plans, building in the flexibility required to meet variations in local and global standards.

Revisit the economics of assembly and components—regularly. China’s supply base is evolving very quickly through rationalization, investment by global tier-one and tier-two suppliers, and the continuous improvement of local suppliers. In such a dynamic environment, cost, capacity, quality, and capabilities change from week to week. Serious players must be in the market and have their fingers on the pulse of what is happening.

Organize for global sourcing. Realizing the sourcing opportunity in China requires tremendous leadership, from the most senior levels down and across the organization, to mobilize the necessary resources, create the essential capabilities, and overcome the inevitable organizational resistance. Global companies will need to establish organizations at the corporate center, in various sourcing regions, and in China; to set up a sourcing capability—including processes, skills, and information platforms—to enable global communication and decision making; to forge links between this capability and suppliers located across China; and then to manage the day-to-day execution. All of this takes a staggering amount of effort.

Encourage your suppliers to relocate to China. Although some 200 global suppliers already have operations in China, most have focused on the domestic market. Few have made the tough decision to relocate large-volume facilities for key components to China, or have made investments to ensure lowest global cost. This must happen. Japanese suppliers are already moving
aggressively; others must step up their efforts or risk losing out to those who are committed.

**Develop and secure local suppliers.** Many of the leading suppliers exporting from China today are private entrepreneurial companies and state-owned enterprises that already have state-of-the-art equipment, excellent manufacturing processes, and strong management. Although most lack full-service supplier design capabilities, they are eager to create those as well. Developing deep relationships with these suppliers—and investing to improve quality, cost, design, and management further—will be critical to winning the export battle.

The stakes in China’s burgeoning automotive market are high and rising fast. Participation in China not only as a market but also as an assembly and sourcing base for global export raises the stakes even higher. Winning the domestic battle is now only half the game. Success is by no means assured; but for the companies that get it right, the rewards will be tremendous.
China’s Growing Drug Market: Will You Be a Contender?

by John Wong  
Xudong Yin

Even though China’s 1.25 billion people represent significant untapped opportunity, most global drug companies don’t consider the nation a priority. That’s because few of the multinational firms that have operated there since the 1980s have yet realized the country’s immense potential as a drug market. Frustrated by China’s complex regulations and distribution networks, its seemingly unenforceable intellectual-property laws, and its comparatively low expenditures on health care, foreign players foresee minimal near-term success in China. They have responded by investing cautiously in the market—many overly so. Most important, these players have withheld their most innovative drugs from the market, fearing that China’s traditionally weak patent protection would expose breakthrough drugs to copycat versions and price erosion.

Despite the challenges, however, analysis by The Boston Consulting Group indicates that China is fast becoming a major opportunity that pharmaceutical companies can’t ignore. Indeed, by 2010 we expect the country to emerge as the fifth-largest pharmaceutical market in the world, with revenues of over $24 billion—more than triple its current size.1 (See the exhibit “China Will Become the Fifth-Largest Pharmaceutical Market.”) Such growth would catapult China’s market, which currently ranks seventh behind the markets of Italy and the United Kingdom, to a position right behind the drug markets of France and Germany. Driving this growth are China’s ongoing economic development and its recent entry into the World Trade Organization (WTO).

The most promising opportunities will emerge in the areas of greatest unmet need: innovative ethical, or prescription, drugs and differentiated over-the-counter (OTC) products. The market for ethical drugs in China, valued at $5.8 billion in 2000, will climb to approximately $19 billion by 2010. Innovative drugs will fare particularly well, commanding 30 percent of revenues and, more important, about 70 percent of the profit generated in the ethical

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1 All market sizes are calculated in nominal local currency at 2001 exchange rates.

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The OTC market, practically nonexistent today as defined by Western standards, will grow at a compound annual rate of 19 percent, from about $1 billion in 2000 to about $5.7 billion in 2010.

Best positioned to fill these needs are multinational companies (MNCs), which possess superior R&D capabilities as well as scale and experience in marketing, distribution, and sales. But if they are to become major players in China, MNCs must move forward more aggressively as changing regulations and economics open the window of opportunity. That means better anticipating the needs of the market as it evolves in order to build true local capabilities as well as relationships with regulators and distributors.

The Transformation in China

Several powerful forces will converge over the next decade to transform China’s competitive landscape. First, China is a rapidly developing nation with a rising gross domestic product. As the country and its economy modernize, demand for advanced health care will increase, and with it health-care expenditures. The population will move beyond the basic anti-infective treatments common in China today to embrace drugs that will improve the quality of their lives. This latter category includes medicines that address chronic conditions that are widely treated in already developed nations.

Second, although China’s rural areas will remain less developed, pockets of wealth are already emerging in urban areas such as the Shanghai Delta and the Beijing-Tianjin and Guangdong-Pearl River Delta regions. Increased affluence in these areas will usher in increased demand for—and ability to pay for—world-class ethical and OTC drugs. In fact, this trend is already taking shape, as evidenced by the success of Heptodin, a treatment for hepatitis B. Although not currently covered by the state, Heptodin has become a top-selling drug in China, largely because patients demand it and are willing to pay for it.

Third, China’s entry into the WTO in December 2001 promises to bring the country’s regulations and distribution networks in line with world-class standards over the next five years. Among its most important changes in the pharmaceutical arena, the WTO agreement specifies that China will do the following:

Enhance its protection of intellectual property rights (IPRs). China is now obligated to enforce foreign and international patents in accordance with the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) of 1995, the most comprehensive multilateral agreement on IPRs. TRIPS mandates that drugs receive at least 20 years of patent protection.

Reduce import tariffs on pharmaceuticals. Within three years of joining the WTO, China will reduce tariffs on imported pharmaceuticals from, on average, today’s 9.6 percent to 4.2 percent.

Increase foreign participation in the drug distribution industry. China has already opened pharmaceutical retail in Beijing and Shanghai to foreign companies. Within three years, the nation’s retail and wholesale markets will open entirely.

Comply fully with global regulatory standards. As a WTO member, China must guarantee efficiency and quality when licensing drug companies and approving or denying drugs. In addition, the WTO requires transparency from regulatory agencies; this will ensure that companies have information about regulatory decisions that affect drug pricing and availability.

Significant changes will sweep China in the wake of its entry into the WTO, thereby providing foreign players with new opportunities in health care. We focus here on the largest of the opportunities: branded ethical drugs and OTC products.

Delivering Innovative Ethical Drugs: From Me-Too to Breakthrough

In China today, the pharmaceutical market is awash in me-too drugs, with almost all of the approximately 6,000 local manufacturers producing primarily generics and competing almost entirely on price. Three factors drive this glut of undifferentiated drugs:
The Chinese government has concentrated initially on basic medical needs, such as anti-infective products.

In doing so, it has focused the state-owned local industry on generics and hasn’t been particularly effective in preventing local manufacturers from infringing on foreign drug patents.

At least historically, new drugs in China have been quickly copied and their price points eroded by the resulting generics. Thus, MNCs in China have found it difficult to justify the investments required to bring new, innovative drugs to market.

In this environment, where as many as 40 knockoffs may compete illegally with a patent-protected drug, enforcing the provisions of TRIPS will naturally take time. Nonetheless, we expect that within five years, significantly enhanced intellectual-property protection and reduced import tariffs will give MNCs a greater incentive to introduce breakthrough drugs that address illnesses that otherwise go untreated—or are treated inadequately by existing or generic drugs. In fact, we have found that executives at MNCs are increasingly foreseeing a future for innovative drugs in China. More than two-thirds of the 35 senior executives BCG surveyed at multinational pharmaceutical companies said that they expect the WTO agreement to strengthen IPR protection.

The shift to breakthrough drugs will be further fueled by the enormity of the opportunity: the unmet need for sophisticated drugs is vast in China, and the potential payoff is significant. China is, after all, a nation where 100 million to 150 million people carry the hepatitis-B virus and where neck and head cancers are more prevalent than anywhere else in the world. China also has its share of patients with chronic conditions routinely treated in the West, such as high blood pressure, high cholesterol, diabetes, depression, osteoporosis, and arthritis. In addition, AIDS is just beginning to be acknowledged in China, and demand is emerging for the pharmaceuticals used to treat the disease and its related complications.

Differentiating OTC Products for Consumers

Like branded ethical drugs, OTC medications are significantly underrepresented and often misunderstood among the Chinese today. That’s because OTC drugs tend to be dispensed and reimbursed as prescription medications, are not widely available for purchase, and are not marketed. Many Chinese also have a strong attachment to traditional home remedies.

As the country phases out government reimbursement for OTC drugs, however, consumers across the nation are likely to behave as we have already seen in China’s more affluent areas—where a willingness to self-medicate with home remedies translates quickly into demand for Western OTC drugs. In addition, as Chinese authorities encourage growth in the retail pharmacy arena and open it to foreign players, consumers will gain an outlet (which they currently lack) for selecting and purchasing OTC drugs on their own—further accelerating the development of the OTC market. In this transformed environment, the key to succeeding in the OTC sector will be a company’s ability to market directly to the consumer.

To date, the prohibitive cost of establishing a strong OTC brand with consumers—exacerbated by the lack of clarity in OTC regulations as well as a general lack of marketing expertise in China—has deterred most drug companies from aggressively pursuing the OTC sector. There are, of course, some notable exceptions, such as Harbin Pharmaceutical Group, Xian-Janssen, and Tianjin Smith Kline & French. Eventually, however, we expect that on the heels of China’s entry into the WTO, a handful of large, international players will emerge to lead this segment. Today that space remains open and up for grabs.

Positioning for Competitive Advantage in China

In an increasingly competitive and global business environment, multinational pharmaceutical companies cannot afford to ignore the real opportunities imminent in China. To stake out a position in this frontier market, MNCs must pursue two goals simultaneously:
Assemble and prioritize a portfolio of patented and OTC products tailored uniquely to the Chinese market. The first step is to review your existing global portfolio of drugs. Your company may be able to meet the needs of the Chinese market simply by tweaking its current product offering. You may, however, need to make a more significant investment in overhauling the portfolio, either by accelerating well-suited products still in the late stages of development or by inlicensing promising drugs from other players.

The best drugs for China will be those in therapeutic areas likely to experience the highest growth, including medicines for chronic diseases already treated in the developed world. Following this logic, your company might want to focus resources in the cardiovascular, central-nervous-system, and endocrine areas, addressing conditions such as heart disease, depression, and diabetes.

Once the right mix of products has been identified, corporate and local resources should coordinate closely to begin securing Chinese regulatory approval for these offerings—a process that could take as long as 48 months. Because we believe that the window for enhanced IPR protection in China will begin to open in about 18 to 24 months, it is critical that MNCs initiate this step immediately so they can best exploit the impending opportunities.

Focus the head of Chinese operations on assessing and sharpening local capabilities in the sales, marketing, and distribution of ethical and OTC products. Your marketing capabilities in particular will become more critical as self-pay patients and commercial insurers become more common. Of course, you should keep in mind that when it comes to consumer marketing, the superpowers in consumer products—Procter & Gamble, for example—may currently exceed pharmaceutical companies in scale and skill. But MNCs in the drug industry do not have to cede this space automatically. Certain drug players, for example, may determine that they themselves possess superior skills that they can enhance for greater advantage. For instance, companies such as GlaxoSmithKline and Johnson & Johnson are well positioned to exploit their current strengths in marketing to consumers in China.

Other companies, concluding that they lack the capabilities required to succeed in China, can buy or borrow them. Some may gain the needed skills through acquisition, a strategy that is already being used frequently as consolidation ripples through the industry. Still other players may borrow the capabilities of others by opting to license their most promising products to companies that already demonstrate marketing prowess in China. Note, however, that another alternative—building the required capabilities from scratch—will likely prove to be prohibitively expensive and take too long.

Ultimately, to accomplish both goals—improving the portfolio of drugs and developing marketing and other capabilities—MNCs must build critical mass in human resources, supporting their Chinese operations with world-class regulatory specialists and marketers. Future contenders will need to staff up now to gain scientific and marketing expertise in all the therapeutic areas critical to China, including those that may not even be recognized there yet. Consider, for example, that although cholesterol and obesity are not yet prevalent among the Chinese, as the economy changes, diet and health trends will also change—and so, too, will treatment needs. Companies seeking to stake a claim in China will also need to hire more systematically and train more intensively the human resources they deploy “on the ground.” Relying solely on a handful of Western expatriates or less-expensive and less-experienced locals will expose a foreign company to the high risk that its few key experts could be lured away.

Because none of these tasks will be easy, MNCs will also need to engage their corporate and local leadership in an ongoing dialogue about which expectations can be realistically achieved—and when. Previously, without such alignment, many corporate leaders entered China overly enthusiastic about the near-term potential. Once disappointed, many have since become too conservative about investing in the market. In contrast, by understanding local realities, MNCs will view China more accurately: as a burgeoning opportunity that will
take a few years—and some investment—before it blossoms fully.

Over the next decade, as the pharmaceutical market in China continues to evolve, drug regulations will become clearer, enforcement of IPRs more stringent, distribution systems more efficient, and the country’s medical needs more advanced. In concert, these factors will no doubt sweeten the attraction of China for drug companies and heighten the competition there. But most important, they will also level the very playing field on which the competition plays out—making victory more likely for foreign drug companies.

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