How to Accelerate Growth in China?

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As the world's second largest economy, China is the key market for future growth and value creation in most industries. A large number of Western companies have in the past few years established significant presence in China, realized strong growth and developed profitable positions.

To continue strong growth and to increase competitiveness compared to Chinese leaders in their home market, Western companies need to address some key issues and shift strategic levers so as not to lose momentum.

Western companies have been successful on premium segments in China

During the past ten to twenty years, many Western players have developed well in China, primarily by deploying successful business models mastered in their home markets into China. Their business model can be summarized as:

- Addressing premium segments in China, where there are high requirements regarding quality, combined with a price premium;
- High level of competitiveness on premium segments thanks to strong technical expertise and innovative products;
- Deploying mainly imported products, with limited need for adjustment to local needs;
- Charging high price for services and spare parts, leading to high margins.

As a result, Western players have managed to achieve strong and profitable positions on premium segments in China, where there is limited local competition.

Outside the premium segment, there often exists a local mid-range market in China which has different characteristics than the premium segment:

- Products of acceptable quality, with some restrictions in terms of features, manufactured locally or partially locally;
- Competitive price, usually at a 30-50% lower level compared to premium segments;
- Standardized products, allowing manufacturers to realize strong scale effects;
- Depending on development stage, strong (more than 8-10% p.a.) or very strong growth rates (>10-20% p.a.), benefiting from crowding out premium segments or non-competitive low-cost segments;
- Depending on development stage, still fragmented segments or with established local leaders, benefiting both from local factor costs and strong scale effects.

The offer on local mid-range segments is increasingly becoming a challenge for Western companies. This is particularly so as the innovation gap between premium and mid-range segments diminishes and local mid-range leaders catch up in overall size, with leading, profitable positions and the capacity to invest in innovation.

Key issues for Western companies in China

In order to continue to benefit from strong market growth perspectives, Western companies need to reconsider their strategic levers in order to encompass the following key issues that have emerged during the past years:

- Toppling market share on premium segments: as most western companies have already achieved high market shares, growth beyond the underlying market will become more and more difficult as premium segments in China tend to be consolidated;
- Diminishing growth of premium segments: due to slowdown of the Chinese economy, and increased penetration and market saturation of some products, some industries that have realized extremely strong growth in the past ten to fifteen years (e.g. automotive, shipbuilding, steel, cement, etc.) are expected to grow at a much lower speed in the next five to ten years;
- Increasing competitiveness of local competitors in the mid-range, who are improving quality and technology, cumulating track records, expanding local networks, building up client portfolios, especially with large SOE clients, gaining in scale effects, and increasing their margins;
- Additionally, Western players typically have limited experience with local business models, which incur other shortcomings in JV partnerships, IP protection, and so on, and further jeopardize their development in China.

In order to continue to be successful in China, Western companies need to find alternative growth levers to capture opportunities and to re-think their business models.

Opportunities for continued strong growth exist

In order to realize accelerated growth in China, it will be key for Western companies to overcome current key issues and to develop competitive business models that allow them to address the full potential of the Chinese market and to capture the full extent of future growth.

To achieve this, a few important development options should be considered and analyzed and key decisions should be taken.

1. Adjust business models to address local clients in premium segments

In order to further gain market share and consolidate premium segments, Western companies must adjust their existing business models, by doing the following:

- Focus of resource on markets (applications, regions) with large demand and strong growth potential;
- Establish strong presence in those selected regions and applications to reach strong market share;
  - Sales, after service, dedicated engineering teams to influence designers, end users and other purchasing decision makers (spec-in), etc.;
- Develop distribution mix in-line with Chinese trends: e.g. strong development of e-commerce in China;
- Define specific marketing activities towards target clients in selected segments:
  - Both online (internet-based search engine optimizations, mobile based product selection apps, etc.) and offline (product demonstrations, seminars, university based sponsorships of research projects, etc.);
- Build up specific back office teams to support training, marketing & communication, order management, etc.

In order to further gain market share and address local clients in premium segments, it is key to focus on selected regions / applications, build up dedicated business model, gain strong market share within these areas, and then expand to other regions / applications.

Beyond organic developments, forging JVs / strategic partnerships with key participants on the value chain (clients, key distributors, etc.) could also strongly facilitate the process.

2. *Mid-range strategy*

Since mid-range segments are large and growing strongly, it is important for Western companies to address this market with dedicated strategy. As this often requires an adjusted business model, the following perspectives should be adjusted:

- Offer definition: features and specifications compared to premium offers, combined with an adjusted design if necessary to deal with specificities of mid-range clients;
- Industrial setup: establish local sourcing and assembly capabilities to ensure competitive costs and fast delivery;
- Deepened channel coverage: establish strong presence in (selected) regions with large potential, to access mid-range clients who are often local companies (or national SOEs while purchasing decisions made locally);
- Price position: possibly on "upper" mid-range (selling better quality with stronger differentiation at a price premium of 10-20% compared to local offers) vs. mass mid-range (same level of quality and price as local products).

Beyond organic developments, there should also be a consideration of acquisitions, to accelerate the process by leveraging industrial setup and client relationship as well as distribution network of local players, depending on the availability and quality of the targets.

3. *Extend addressed perimeter*

Although overall economic growth is slowing down in China, there are some industries and applications that are expected to show strong growth, either because they are in line with key trends of the Chinese market and its rapidly growing middle class population, and/or because they are strongly supported by the Chinese government. By positioning on these industries / applications, one option is to leverage strong development of these favorable underlying markets – either by addressing them directly or to position on supplier industries to these markets. To name a few examples:

- *China Manufacturing 2025:* continued development of industrialization and informatization of the Chinese manufacturing industry. Strong focus is set on automation, digitization and connectivity; strong development of competences in high-tech products are expected (e.g. CNC, robotics, aerospace equipment, offshore equipment, new materials, bio-medicine, etc.);
- *Electric Vehicles:* strong penetration of electric vehicles to reduce pollution and to re-shape competitive landscape of the global automotive industry. Strong planned investment on the entire value chain of electric vehicles (vehicle production capacity, electrical motor development, battery development, charging infrastructure, etc.);
- *Ultra high voltage grid:* to transmit electricity from western China (rich sources of solar, wind and hydro power) to eastern and southern China (major consumption areas of electricity), strong investments are planned for ultra high voltage grid to reduce power loss during transmission. Strong opportunities exist for equipment used for power transmission, testing and protection, but also testing equipment, smart metering, transformers, hydraulic components, servo control equipment, sealing material and equipment, etc.;
- *High speed railway network:* continued investment to establish comprehensive high speed railway network which connect tier 2 & 3 cities; strong opportunities exist on the entire value chain (electrification, controlling, equipment of vehicles, etc.);
- *Environmental protection:* strong determination from Chinese government to address environmental issues, which leads to strong future demand in equipment / solutions in the domain of municipal waste management, air purification (for industrial plants),

exhaust gas treatment (for automotive and ships), disinfection and purification (e.g. for sewage water), etc.;

Successful examples of Western companies in China

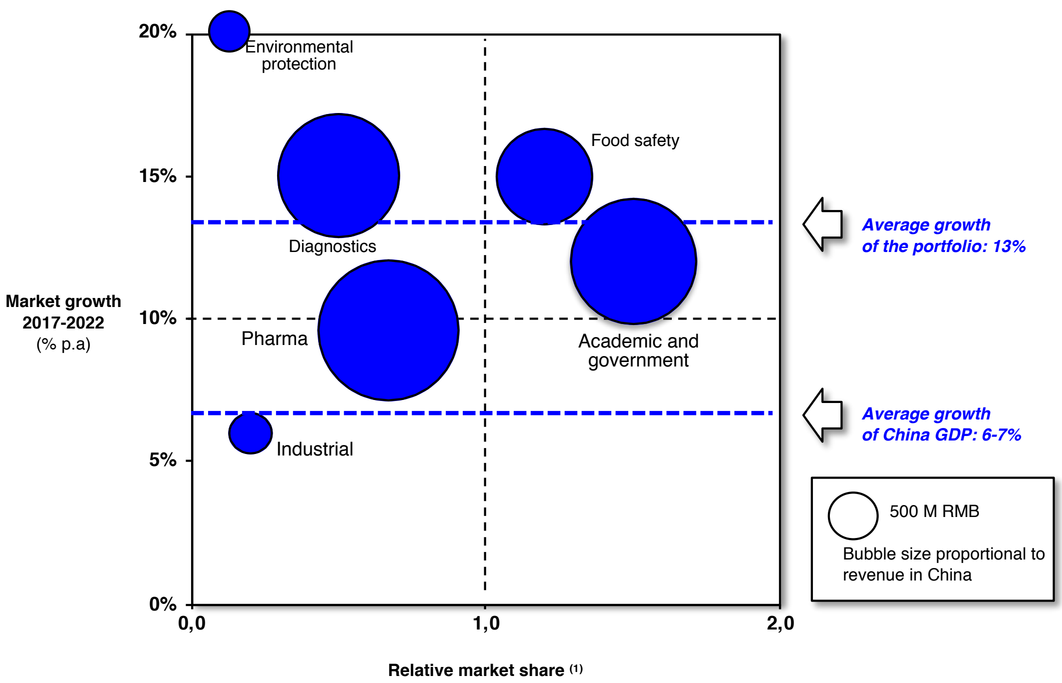
As a matter of fact, there are many western companies that have realized strong growth in China for a long time period while changing strategic levers over time.

Thermo Fisher has realized strong growth of ~23% p.a. in China between 2012 and 2017, reaching revenue of over 13 bn RMB. Thermo Fisher is positioned on multiple fast-growing industries, having a portfolio with strong growth potential (Chart 1) and has activated several strategic levers to achieve it:

- Adaptation of business model to address local clients: focusing on establishing presence in regions with large demand (Guangdong, Jiangsu, Shanghai, Zhejiang, Hubei, Beijing, Sichuan, Yunnan, Shaan Xi) and with the establishment of an innovation e-commerce platform to facilitate client purchasing;
- Mid-range strategy: establishment of large local production footprint (8 plants) and R&D facilities (5 R&D centers) to develop China mid-range offer; beyond serving Chinese market, Thermo Fisher also uses the Chinese local setup as a production base to serve other mid-range markets (50% of products manufactured in China are exported), providing strong scale effects and further improves cost competitiveness;
- Extend addressed perimeters: covering industries and applications that are strongly supported by the Chinese government (e.g. food safety, environmental protection, etc.).

- Chart 1 -

Thermo Fisher has established a portfolio with strong growth potential in China

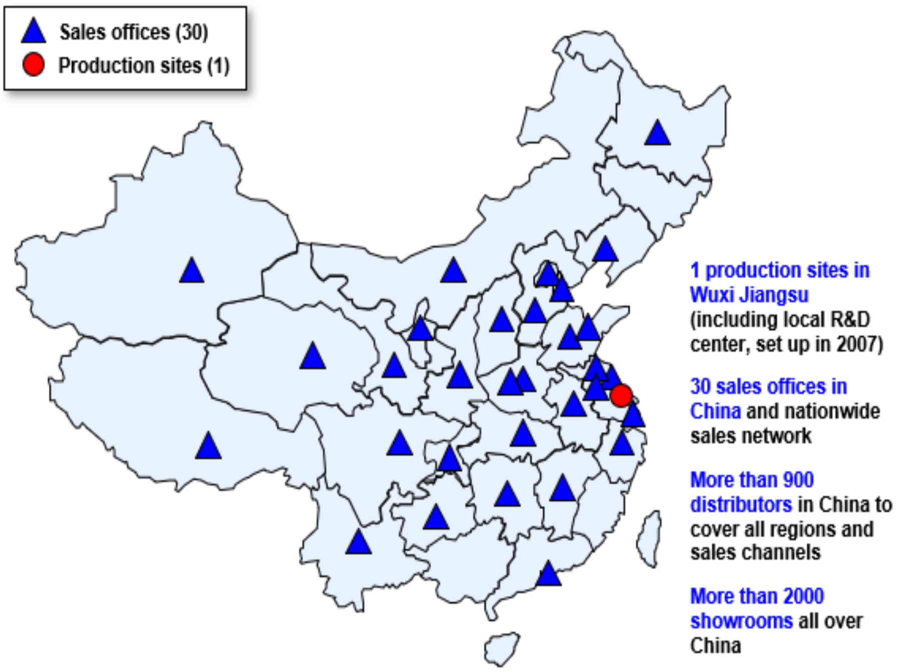


Vaillant has realized strong growth of ~25% p.a. in China since 2010, reaching revenue of over 1 bn RMB by 2017. Vaillant has been focusing on the premium segment of heating boilers and has successfully developed an adjusted business model for the Chinese market (Chart 2). To do so, the company has invested in

- Local assembly plant and R&D center, to realize fast delivery and integrate specific requirement of Chinese households;
- Developed local sales channels with more than 30 sales offices to cover all relevant regions in China (1 office in each province);
- Deepened other distribution channels: with more than 900 distributors to cover all tier 3&4 cities and some well-developed counties;
- Marketing: with more than 2000 showrooms all over China, which are key to influence local influencers and decision makers.

- Chart 2 -

Vaillant has established strong local networks



Conclusion

Although the Chinese market has changed dramatically during the past two decades, there are now and will in the future still be opportunities for western companies to continue to grow. To grasp these opportunities, Western companies need to adapt business models, enter specific segments (e.g. mid-range), or extending business perimeters to address fast growing industries / applications. Long term growth requires the activation of different strategic levers over time, and levers that will be successful for the ten years to come will be different from those of the ten years past.

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Estin & Co is an international strategy consulting firm based in Paris, London, Zurich, New York and Shanghai. The firm assists CEOs and senior executives of European, North American and Asian corporations in the formulation and implementation of growth strategies, as well as managers of private equity funds in the analysis and valuation of their investments.

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