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Managing
Discontinuities
In China



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Managing Discontinuities in China

China is very different today than it was in the years when it was completely closed off from the rest of the world. Today, in large cities like Shanghai, and dozens of others across the country, shimmering skyscrapers, many completed and many under construction, are ubiquitous. People shop in Western-style malls, surf the Internet, and dream of making their first million.

Per capita gross domestic product (GDP) in China has grown steadily at about 9 percent for the past 15 years and the country is now a top five market in many consumer product categories; in mobile phones, it's No. 1, going from virtually zero subscribers in 1995 to 400 million ten years later. However, many executives from leading companies around the world are still having a difficult time grasping the opportunities and dangers in China.

Its rapid growth and local rules of business do not mean that China will repeal the fundamental laws of economics, but the fact that the country is growing much faster than what most global executives are used to—with the possible exception of the dotcom boom—requires a different frame of reference to operate effectively. In such a tumultuous environment, the demand and supply patterns are often characterized by changes that are sudden and severe. We call these “discontinuities” or “inflection points.”

Not surprisingly, many companies operating in China struggle to cope with the supply and demand discontinuities in this cauldron of new opportunities, new entrants, and new regulations; yet these discontinuities are inevitable, and properly understanding, anticipating, and managing them is critical to succeeding in the Chinese market. Many executives in China readily admit to past mistakes in operating in this environment: They had done either insufficient or excessive planning (a static five-year plan is of little use when you might need to double output next month), allocated resources inappropriately, or did not have market strategies with relevant contingency plans.

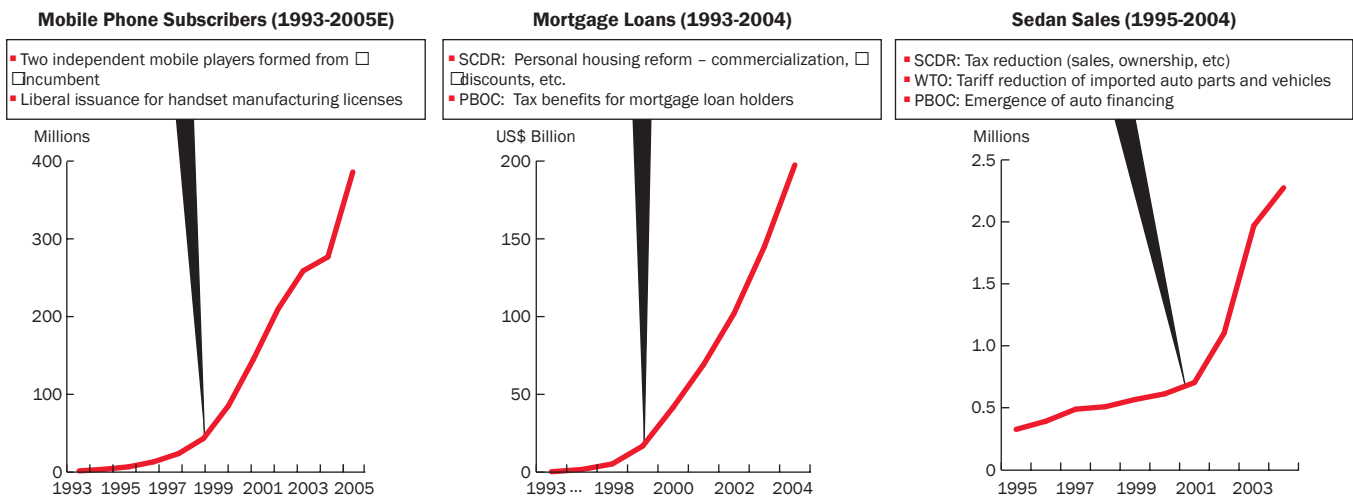
Companies' lack of experience in working in China or in managing the type of discontinuities found in China doesn't need to be a permanent handicap. The fundamental laws of economics are still in place. Companies must choose the right metrics to measure the demand and supply sides of the marketplace and to interpret that data through the unique local context. They need to institutionalize skills to regularly capture and update market information and leverage this knowledge to anticipate discontinuities and to formulate strategies. The most successful companies will have a flexible approach that allows them to leverage successes and opportunities and mitigate missteps or unforeseen events. Collectively, this means that companies operating in China must develop a mindset and an organizational DNA that is entrepreneurial, resilient, and adaptive. Companies must be flexible and nimble, capable of reacting to rapid changes in the market, both known and “unknown,” and they must cope with sustained marketplace ambiguities.

Demand-Side and Supply-Side Discontinuities

A variety of factors influence demand-side discontinuities and understanding these will help companies catch the S-curves, capturing the upside when the inflection point trends up while avoiding downturns when the inflection point moves the other way. As in all markets, consumer awareness is essential. But consumer demand in China is often not obvious before a product or service is available. We call this “latent demand.” In China, there often needs to be significant market education around a product before demand can really take off. There is also a time element to this pattern. Initial curiosity and hesitation about new ideas must run their course before these ideas are adopted. And predictably, bad ideas usually don't take off, but it is difficult sometimes to know the good from the bad in advance of a real market pilot. Affordability is another factor since there are huge income disparities in China. Once prices fall to levels that are affordable for the massive middle class, adoption can explode. Demand can also be artificially constrained until a product is widely accessible, so there must be proper distribution and delivery channels in place so customers can get the product. And, finally,

Exhibit 1

Examples of Demand Discontinuities in China



Note: PBOC stands for The People's Bank of China; SCDR stands for State Committee of Development and Reform
 Source: China Statistical Yearbook; Booz Allen Hamilton analysis

government policies serve as wild cards since changes in policy can cause step-change market reactions. Exhibit 1 shows some examples of demand discontinuities in China.

Despite the wide array of factors that can impact demand for products and services in China, the demand side of the equation is usually more stable than the supply side—which is where things can get really complicated. This is a result of the substantial investments flowing into China as multinational and local companies crowd into the marketplace. Substantial capacity is being added, intensifying competition. Since companies in the same industry are mostly observing the same macro demand growth, they tend to invest in the market at about the same time, frequently driving up supply in an even more pronounced manner. Indeed, one of the key drivers of supply-side discontinuities is companies' frequent erroneous assumptions that they are the only ones, or one of only few, investing and building capacity in China when in fact many competitors are investing at the same time, unaware of each other. Exhibit 2 (on page 3) shows the rapid building up of overcapacity in China's tire industry, especially during the period from 2002–2004.

But poor intelligence about how competitors are investing is just one contributor to overcapacity; another is arrogance. Some companies are too confident that they will win out even in the face of intense competition. One Western white goods company's head of China operations said in the early 1990s that he did not consider Chinese white goods manufacturers to be relevant com-

petitors because they were "not that capable" and likely never would be. As a result, the company did not even consider, let alone plan for, contingencies that would have included local Chinese companies as real competitors in its business plan. This executive long ago retired, his company incurred a substantial loss in China, and today we see some of the most competitive white goods manufacturers are Chinese companies. Names such as Haier, Galanz, and Broad have become household names in China and in many Western markets, while many Western white goods players from abroad have struggled in China and at home.

Meaningful Metrics

To recognize both demand- and supply-side discontinuities, it's important to choose the right set of metrics and triangulate these metrics in a way that properly assesses the market and spots possible discontinuities in the making. This is no easy task and in a market like China it takes time and patience: both in the actual metrics used and in interpreting the chosen metrics in the context of China. Take one of the most often asked questions: "What is the real income of the Chinese consumers?" Published data on "official income" is readily available and well documented. Yet there is an active and probably vast underground Chinese economy, and its magnitude probably varies by segments. This makes determining actual income tricky, but ascertaining the real income of specific, relevant consumer segments is imperative to understanding China's true consumption power.

Using a triangulation approach from multiple sources is especially useful and often necessary. From distributors, contractors, and installers a company can get current selling volumes and value by customer segments, estimated market shares, and projected growth. From end-use customers you should look for end-product purchase volume and value by segment, as well as growth by segment. When possible, gather trade data and projections for key customer segments from industry associations and research firms. And, for bottom-up sizing, look for a combination of macro statistical data and data from interviews, as well as customer and channel market sizing.

Of course, not all of this data will be available, but scouring these various sources is the most pragmatic way to estimate the size of an uncertain market. However, companies must be very careful about what they compare. For instance, a cruise line company recently assessed the potential market in China. The company's approach, which had proven successful in other markets, was to use GDP per capita as a measure of market potential. Applying this, the result suggested China was nowhere near the minimum threshold. And yet, Chinese customers do go on cruises in other parts of the world, numbering in the tens of thousands per annum. To get a real handle on the market, the company then applied a set of indirect though revealing metrics, which included the number of people in China who belong to golf clubs, the number who own Mercedes S class sedans, and the number of dollar-

denominated millionaires. This analysis arrived at a very different conclusion from what simple GDP-based measures suggested.

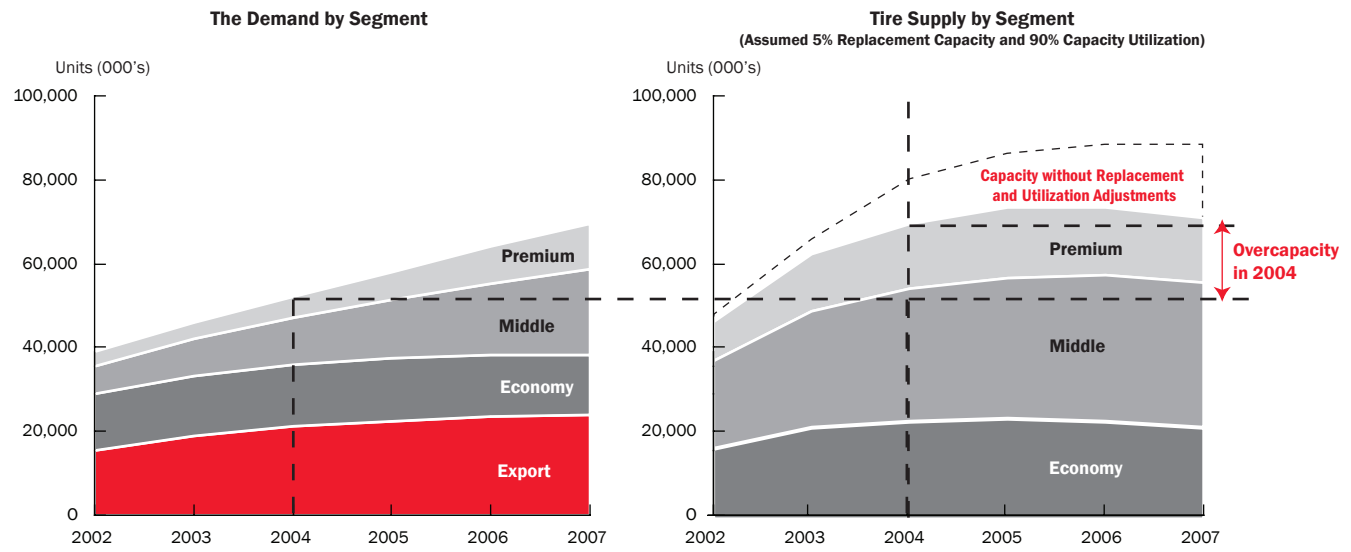
Indeed, one of the great lessons to be learned about assessing the Chinese market is the virtual irrelevance of one of the business world's most popular metrics: the average per-capita GDP. In China, there is a huge disparity in income among its 1.3 billion people. It is not a single, homogenous market, so metrics chosen to evaluate market potential must be relevant to both the customer target and the product or service offering. Deriving the right segmentation and applying the right segment-based metric is essential for reliable business analysis.

Correct Context

Once the right metrics are in place to understand the demand and supply side of the equation, the next step to recognizing and managing discontinuities is interpreting the data in the Chinese context. China may be the most complex market in the world, defined by the number of uncertainties, the multidimensional and nonlinear nature of the growth drivers, and the pace of change.

An essential part of understanding the context is recognizing the heterogeneous consumer base, with people from a wide range of geographic and cultural backgrounds. There are significant gaps in the level of wages between wealthy urban dwellers and the rural population—and thus, major differences in their familiarity with products and services. The labor market is also a mix of foreign workers, Chinese expatriates

Exhibit 2
Demand and Supply in China's Tire Industry



Source: Booz Allen Hamilton

returning, and homegrown labor—younger workers emerging from graduate schools and older workers at state-owned companies. Competition is intense and diverse, with a large variety of international brands from Europe, America, Japan, South Korea, and from the rest of Asia. These go head to head with established and aspiring local brands. There is also the well-known issue of brand and intellectual property piracy.

Layered upon this diversity of customers, skilled and unskilled workers, and companies, are diverse laws and guidelines for specific industries; there are different local interpretations of central guidelines in smaller versus larger cities; there is a broad variety of approaches to organization and investments; there are industry- and sector-specific sourcing and distribution channels; and there are vast disparities in development across industries. Some Chinese industries are at a level comparable to the mid-1900s, while others are 21st century—creating economies within an economy.

Understanding the regulatory context is also vital to doing business. The government has been gradually deregulating the economy—step-by-step, industry-by-industry, for the last 15 years. And deregulation is continuing as China marches purposefully forward to build a modern, productive economy. China's entry into the World Trade Organization in December 2001 was merely one event, albeit a major one, within this ongoing program of deregulation. Western companies competing in a newly opened industry must quickly grasp how different the new operating environment is and, just as important, how differently competitors—be they local or foreign—are going to behave. Companies need to develop a quick but deep understanding of the new competitive dynamics. Drawing conclusions about a company or its industry today based on past behavior—even those in or from China—can quickly lead to wrong decisions. Traditional benchmarking practices prevalent in mature markets and ingrained in many companies often backfire in China.

Capturing Market Knowledge

Metrics and context are what form the core of market knowledge, and it is a company's ongoing ability to capture market knowledge, and act on it, that results in success. Developing this capability and institutionalizing it takes a systemic yet entrepreneurial approach. We have found that the foreign companies that do the best job capturing market knowledge have built market research organizations on the ground

and have institutionalized their market research capabilities in China.

However, even companies with established best practices still need to adjust their research methodologies to the realities of China, for several reasons: Demand is often latent; the supply side remains highly unpredictable; and proper metrics and market segmentation must be defined. Companies need to make a trade-off between achieving an amount of data deemed statistically significant; relying on sound business judgment; and making prompt business decisions.

In addition to having homegrown research adapted to China's complexities, the most effective companies have executives who spend much of their time on the ground—going to the trade, talking to customers, visiting different markets, and finding out what their competitors are doing. Having one's nose on the ground often generates valuable and surprising insights that published data cannot provide, or at least cannot deliver in a timely manner. A good case in point: The China leader of one of the world's largest consumer goods companies described to us the disparity he found by driving a mere 30 minutes outside of a city in an eastern Chinese province where his company had just opened a major production center. The retail structure and format was drastically different—much more primitive—than those in the large city. Interestingly, despite the company having been in China for several decades and spending tens of millions of dollars on advertising, he found that retailers on the outskirts of this important city had very little awareness of his company's brands. The company was present but not known.

Because it is so important to capture evolving market information, the best companies in China make a point of encouraging formal and informal exchanges of market and regulatory information within their organizations, often through people in the field and across different organizational units, so the most can be made of what information they do gather. Unfortunately, many foreign executives simply don't get out into the field enough. Instead of spending time out in the market, they spend time in their plush offices. They ask for reams of data to be delivered to their desks so that they can make decisions, yet much of this so-called data is incomplete or outdated by the time it is gathered and presented in a formal manner. By eschewing the all-important in-person field work, these executives generally don't have the judgment to make the right decisions when the market information is incomplete or ambiguous. This is the crux of the challenge for many foreign executives in China.

Strategic Anticipation and Business Flexibility

At the best-run companies in China, systematically capturing market knowledge helps to develop a capability for “strategic anticipation,” which a company can use to gauge when and where discontinuities may occur and to position themselves to take advantage as they materialize.

Critical to this positioning is building as much flexibility as possible into every business venture. The challenge is not to fixate on a single scenario, but rather to envision several scenarios and bet on a few of them. Sometimes buying into a market will make sense, sometimes building is the right alternative, and often teaming up is the best way to hedge against a downturn while still being able to capture the upside. No matter what the choice, it is vital to implement flexible business plans that can react to different scenarios.

The tire industry is a good example of how companies missed a huge opportunity because of their inability to react quickly enough. Earlier this decade, most industry experts believed automobile purchases would grow at a healthy 17 percent. Much to everyone’s surprise, growth has been at least twice this on average, and as high as 75 percent in one year. The problem was that 17 percent was just an educated guess. The fact was the Koreans, Japanese, French, Americans—everyone making investments—did not know for certain how fast it would grow, and suddenly many foreign tire manufacturers were caught by surprise and missed a huge opportunity for growth and share gains. Now many of these same companies are overcompensating, rushing in and likely to creating significant short-term overcapacity and perhaps long-term structural overcapacity should demand growth slow.

The kind of flexibility that can respond to 17 percent growth or 75 percent growth is tough to achieve, to be sure, but there are a growing number of foreign success stories in China. KFC, for example, has been in China since the late 1980s, when it started with a small number of stores. KFC was careful in getting its business formula right before rolling out across China with major investments. Today, China is the second-largest source of revenue and profits for the company worldwide. Yet contrast KFC’s approach to some of its major international competitors who, until recently, were still in the process of assessing whether there was a market for them in China. Starbucks built similar flexibility into its entry and growth model in China by choosing to do joint ventures in a couple of key entry cities—the only market

in the world where it took this route—as a way to hedge against potential losses while buying an option on the upside through an agreement that allowed it to buy out its partners.

Building up market knowledge over time eventually puts a company in a position to make a big bet. General Motors, for example, entered the market in 1997 with the Buick and today, without China, would be in far greater financial peril than it already is. In China, GM has carefully built a series of successful partnerships that are now paying off. GM’s sales in China grew 35.2 percent in 2005, boosting its market share to an estimated 11.2 percent, second only to Volkswagen at that time. Shanghai GM, the company’s flagship joint venture with Shanghai Automotive Industry Corporation Group (SAIC), sold 28.7 percent more cars than in 2004. SAIC-GM-Wuling, GM China’s small car joint venture with SAIC and Wuling Automotive Co., also had a record year, with sales growing 43.4 percent from 2004. Pending Chinese government approval, GM plans to invest more than \$3 billion over the course of the next three years and expects sales in 2006 to set another record.

Conclusion

Many foreign companies are looking to China to provide a future boost to sales and profits—and many companies that aren’t, should be. However, succeeding in China requires that companies navigate markets that are highly diverse, complex, and fast-changing. They need the right organizational DNA—the right mindset—coupled with strong leaders who have their noses on the ground, and thus can use market discontinuities to exploit opportunities. To succeed, China executives also need to communicate effectively with headquarters in order to align expectations and strategy.

Finally, spotting and managing the discontinuities within market segments through smart triangulation of available data is paramount if companies are to capture the S-curve while avoiding, or at least mitigating, downturns. To this end, strategies and business models in China should be flexible and adaptive.

There’s no doubt the challenges to success in China are significant, but the payoff potential is greater still and the repercussions of failure can be severe. With China’s continued economic growth, numerous business opportunities will present themselves. Company executives who miss the opportunity today may be creating a permanent competitive disadvantage for their companies.

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