EXECUTIVE INSIGHTS

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China's Industrial and Manufacturing Sectors: Opportunities and Challenges for Industrial MNCs

Introduction

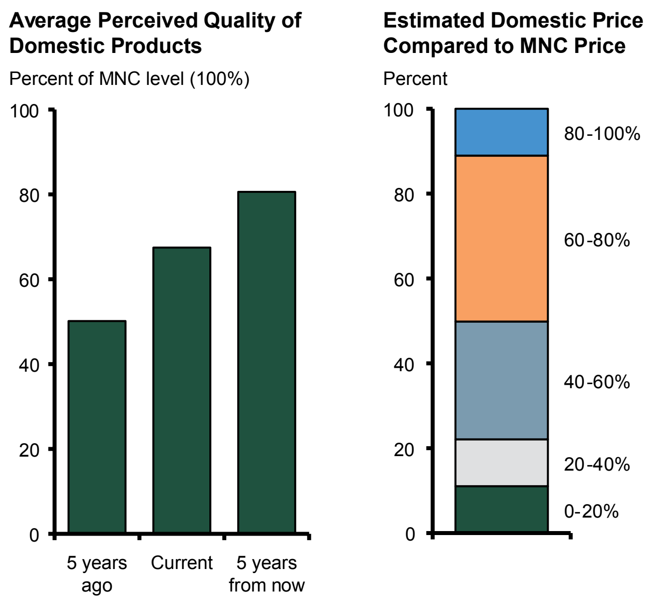
China has experienced dramatic growth over the last few decades, to become the global manufacturing powerhouse it is today. The market is again now changing and MNCs are grappling with how to best serve China's demand for products of all descriptions, in what will become the world's largest market. This opportunity will bring with it significant challenges and risks. MNCs are facing increasingly intense competition from domestic manufacturers, who are often adept at localizing foreign products for the Chinese market, and who are continually improving the quality of their products. The battle is taking place in an environment where it is also often difficult to protect intellectual property.

To succeed, MNCs must show agility and creativity in developing successful business strategies. To understand how MNCs are planning to cope with these competitive challenges, L.E.K. Consulting surveyed MNC business executives in China, including several from large industrial product supply companies. L.E.K. has analyzed these responses to detail the main strategies MNCs are developing to successfully grow their business in China.

Domestic Competition Getting Stronger

At a high level, the Chinese industrials market can typically be characterized by two generic segments; a quality segment with higher priced products which historically has been populated by MNCs and a value segment, which supplies cheaper products, usually made by the domestic companies. Previously, there may have been clear distinctions across these customer segments, but in China's dynamic environment of evolving customer needs and intense competition, the market segments of value and quality are converging in many of the industrial sectors in which we are working.

Figure 1



Source: L.E.K. survey and interviews

China's Industrial and Manufacturing Sectors: Opportunities and Challenges for Industrial MNCs was written by **Michel Brekelmans**, a Director and Co-Head of L.E.K.'s China practice; and **Eric Yan**, a Manager at L.E.K. Consulting's Shanghai office. Please contact us at LEKCHINA@LEK.COM for additional information.

Surveyed respondents recognize that the domestic manufacturers' quality is continuing to improve at a rapid pace. When asked to rate domestic competitors' product quality against the MNC's products, domestic players' quality levels were perceived to be only half of MNC manufacturers' quality five years ago. However the surveyed executives expected that in five years from now, domestic companies' product quality would likely reach up to c.80% of MNC quality levels. Furthermore, domestic manufacturers are likely to maintain their substantial price competitiveness against MNC manufacturers.

Strategic reponses to this situation are varied. Many MNCs do not yet view the domestic players to be a major threat in the premium segment that they compete in. For instance, a large MNC paint and coating manufacturer recognized that in the "middle and low end market, the tech gap is closing," but stressed that the MNCs and their domestic competitors were targeting distinct customer segments. A medical device manufacturer stated that that "MNCs and domestics are competing for different groups of customers."

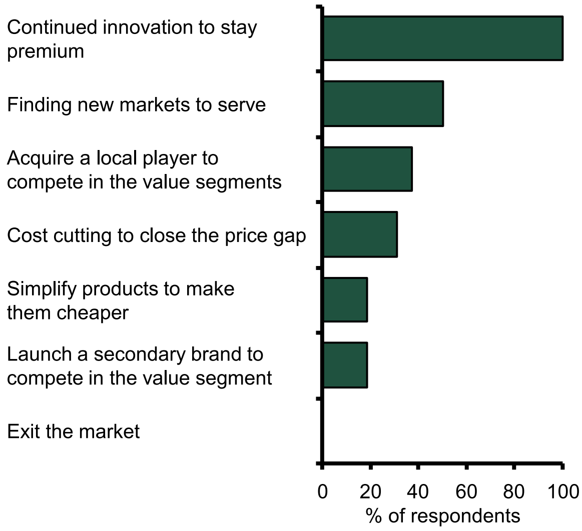
However, as the domestic companies' quality continues to improve, it is essential for MNCs to be well prepared and have the right strategies in place to effectively compete with domestic products.

Industrial MNC Strategies

Respondents to the survey were asked to choose from seven different strategies to deal with the challenge presented by domestic competitors. The results revealed that despite the forecasted competition, none of the companies were currently considering leaving the market. This suggests that management teams believe that with the right strategies, China still offers attractive opportunities for MNCs. The survey also indicated that executives believe continuing innovation to keep their companies' products premium is the key to success in the China market. The executives' responses can be aggregated into three high level strategies: focusing on innovation, finding new markets to serve, and competing directly with local manufacturers.

Figure 2

Strategies Implemented by MNCs to Overcome Challenges From Domestic Companies



Source: L.E.K. survey and interviews

1. Continuing innovation to stay premium

The most frequently cited strategy in the survey is to continue with vigorous innovation in an effort to retain control over the high-end segment. A large European-based engineering and electronics company replied that "domestic players do not innovate now; they just imitate MNC products, so MNCs need to maintain their R&D capabilities to build competitive advantage."

As many MNC strategies in China rely on continuing innovation, deciding on the method to foster innovation is likely to be one of the most important strategic decisions facing MNCs. Options can include:

- Setting up local R&D centers or moving R&D from western countries to China
- Retaining R&D overseas but bringing more innovative products to market in China
- Integrating Chinese engineers as a key part in global R&D programs

FANUC, a Japanese company, is the world's leading supplier of computer numerical control (CNC) systems, which are used with modern machine tools to enable highly automated operations. FANUC entered China by establishing a Beijing joint venture in 1992, and its China CNC business has become the company's biggest contributor of overseas revenue. Since its founding, FANUC has focused heavily on research and development;

globally 30% of its employees are engineers dedicated to R&D, and the company has more than 1,000 researchers working in 11 laboratories worldwide. While the company does not have a CNC R&D center located in China, FANUC China has stated that it intends to introduce new products to the local market. Continuous innovation has allowed FANUC to secure a leading position with a reported c. 50% market share in China. Domestic suppliers of CNC systems are primarily focused on the lower-end sectors and so far have been unable to close the quality and technology gap to FANUC.

2. Finding new markets to serve

Finding new markets to serve is also a commonly cited strategy. A laminate manufacturer, headquartered in the U.S., stated that "we are currently trying to expand our product range to also serve the flooring and roofing markets." Expanding the potential customer base is often a key strategic initiative for MNCs to compete effectively in China, with potential options including:

- Target applications in new industries with existing products or services
- Explore new geographic markets in China with existing products or services
- Target new customers or segments in China with existing products or services
- Produce new products to serve adjacent markets based on existing similar products, technology and facilities

Dow Chemical is the second largest global chemical company with a diversified product portfolio. It entered China in the 1930's, and the China market has now become Dow's second largest. Approximately 75% of mainland China sales came from coastal areas. However, Dow is now looking to take its products into new geographies; the company is entering Northern and Western China by setting up new offices in Chengdu and Harbin. It is also planning to build a paint factory in Sichuan. Dow has stated that it aims to double its sales by 2015 in China by serving the new markets in inland areas.

3. Competing directly with local players

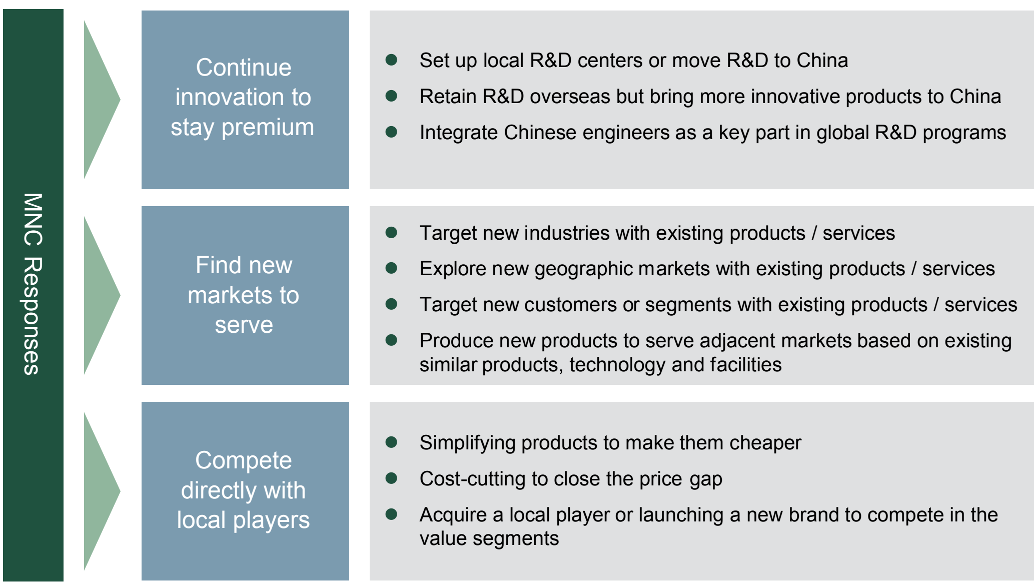
The third category of responses from executives is to seek ways to compete directly with local players, which typically involves expanding the MNC's presence beyond the high-end premium markets. Strategies can involve making simpler (and cheaper) products, renewing a focus on cost, or acquiring / launching a budget brand into the market.

3.1. Simplifying products to make them cheaper

MNCs have discovered that many of their original products are

Figure 3

Three Strategic Thrusts for Success in China



Source: L.E.K. survey and interviews

over-specified for several applications within China, and so have successfully increased sales by addressing the demands of the local market and simplifying their products. Options for doing so include:

- Redesigning the appearance, replacing non-core materials without changing the core function
- Removing additional features and functions of the product, and focusing on meeting the customer's basic needs
- Changing the volume and size of a product, making it more suitable for users with minimal demand

Gravograph is a maker of engraving and permanent marking equipment based in France. Gravograph entered the China market in 1994 and has served a variety of MNC and local customers such as educational institutions, hotels as well as high-end luxury jewelers. In order to strengthen its leading position and attract more local customers, Gravograph implemented a number of strategies including offering simplified products by deactivating some function modules of the software used in the engraving process, then charging customers to activate the additional function modules at a later time when required. Gravograph also launched a smaller, new CO_2 laser engraving system, which is suitable for the first-time user and easy to operate.

3.2. Cost-cutting to close the price gap

All companies must seek to control costs; however a need to produce a low-cost product can refocus attention on reducing production costs to remain competitive. A low-cost product strategy must be implemented cautiously to avoid erosion of valuable brand image associated with high quality. Options to be considered include:

- Move manufacturing sites to places with lower labor costs. Some players are relocating capacities both within China (from coastal areas to inland areas), and also to other countries such as Vietnam where there may be lower (typically labor) costs
- Source local suppliers to control cost of raw materials and reduce shipping fees
- Explore new distribution channels, e.g. online stores

Nissan is a leading Japanese automobile manufacturer in the world, which entered China in the 1980s. In the first half of 2013, Nissan accounted for c. 36% of Japanese passenger cars sold in China. In recent years, young Chinese car buyers have increasingly preferred cheaper, no-frill cars, and the segment has become a focus for competition. In response to tough competition from local brands such as Geely, Nissan, along with other Japanese car makers in China, has been prompting their suppliers to localize production in China. Currently Nissan is using many locally produced components for their cars to be sold in China. Nissan is also turning to Chinese suppliers to manufacture some of their parts. For instance, Nissan was able to achieve cost savings of c.40% on taillights by switching to a local supplier for its local brand, Venucia.

3.3. Acquire a local player or launching a new brand to compete in the value segments

Some companies have suggested they intend to address the value segment directly, either by acquiring local players or launching new low-cost brands. A U.S.-based filtration and purification equipment maker stated that they were considering acquiring a local company to compete in the value segment. Such a strategy is intended to allow MNC manufacturers to enter the middle-to-low-end market segments without tarnishing their original brand's image. Acquiring local players also allows the possibility to leverage domestic brands' position and often low-cost infrastructure. Options include:

- Acquiring a local competitor to serve the middle-to-low-end market in China
- Acquiring a local competitor to take advantage of cost synergies, and better understand the China market
- Acquiring a local player in another position of the value chain to gain additional competitive advantage

Michelin, one of the largest tire manufacturers in the world, entered China by establishing an office in Beijing in 1989. Today, Michelin's headquarters are located in Shanghai. Coverage of all market segments with multi-brands has long been a key composition of Michelin's strategy in China. Michelin established a joint venture with the Chinese manufacturer Double Coin Holdings in 2001, acquiring the mid-to-low-end 'Warrior' brand. Michelin finally acquired a 100% share of the JV in 2009. This enabled Michelin to retain its own brand to focus solely on the high-end market and avoid cannibalization.

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L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns. L.E.K.'s comprehensive range of services can assist MNCs facing challenges with operations or strategy in China.

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• Market assessment, segmentation and positioning • Evaluation of growth and investment opportunities • Competitor benchmarking and costs effectiveness programs • Business plan development • Sales and distribution strategy • Portfolio optimization	• Evaluation of manufacturing options and locations • Supply chain strategy • Performance measurement and improvement • Business process redesign • Sales force effectiveness • Organization structure • Capability development	• Identification and screening of partners/acquisition targets • Commercial due diligence on partners/acquisitions • Negotiation strategy and advisory services • Post-Merger Integration and 100-day planning • Distributor evaluation and assessment	• Organizational capability development • Embed strategy into organization • Translate strategy into actionable projects • Implementation planning and execution • Progress tracking

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