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CHINA BRANDS MUSCLE MNCS OUT OF HOME TURF

Summary

Chinese companies are now a force to be reckoned with on their home turf – a market which used to be dominated by foreign brands. This report looks at how the change has come about and where Chinese brands are headed.

Overview

The year was 1985.

The place, a factory warehouse.

Angered by the defects found in its refrigerators, the chief executive of appliance manufacturer Qingdao Home Appliance Company (now known as Haier), Mr Zhang Ruimin, raised a sledgehammer and landed it on a brand new machine, smashing home the message that quality was of paramount importance. A customer had brought a faulty refrigerator back for an exchange, but had difficulty picking a replacement as all of them had some form of defect. Mr Zhang then called for an inspection of the more than 400 machines in the warehouse and found that 76 of them had some form of imperfection such as scratches on their exterior. He assembled the factory workers who suggested that since the flaws were mostly superficial and did not affect the machines' functioning, they could sell the machines – priced at RMB 800 or equivalent to two years' salary then – at a discount to workers.

However, Mr Zhang would not settle for that, saying that allowing the 76 refrigerators to be sold meant acquiescing to the production of another 760 defective products. The brand concept that Haier came up with in 1985 was "strive to be the best". He was out to raise the bar on quality and drive home the point that any product with a flaw, however small, was a damaged good. He then told the workers responsible for each of the defective machines to smash them, which they did – some with tears in their eyes.

This story of Haier's early days might be dramatic but it personifies the emphasis on quality that has enabled Chinese players to climb up the value chain and move from being manufacturers of inferior products to the innovators that they are today.

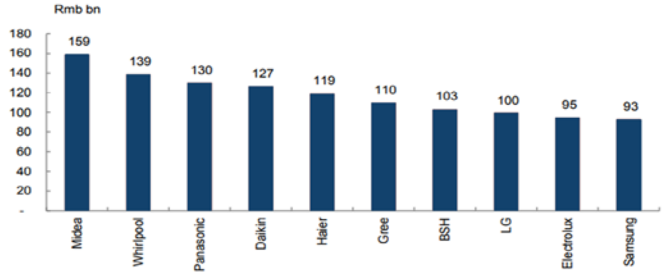
Playing second fiddle in the domestic market historically

In the past, Chinese companies had no brand to speak of and were seen as inferior cousins that merely modelled after foreign players entering a nascent market with a huge potential for consumption. Most of the local players were original equipment manufacturers (OEMs) creating white-label products designed by their foreign brand partners.
The Chinese players had no budget or the requisite know-how to market their products or create brand awareness. Neither did they possess the technology or invest in research and development. They lacked strong management and access to capital. On the other hand, foreign players, with substantial budgets, already had established brands and were ahead by a mile in marketing their products.

However, things are now changing.

In the home appliances market for instance, European or Japanese brands used to dominate the China market but now local players are catching up. In terms of sales value, Chinese company Midea is number one globally while Haier and Gree are fifth and sixth respectively. China brands are not only increasingly popular domestically, but are also gaining ground globally.

Chart 1: Global ranking of home appliance companies in 2016 by sales value



Source: Company data, CICC Research, January 2015

In the initial years when foreign players whose home markets were saturated headed to China for a new growth engine, Chinese players defended their turf with price wars, driving margins razor thin. In their next phase of growth, Chinese companies have evolved, paying more attention to customer feedback, paving the way for innovation and retooling products to better suit customer needs. For instance, Haier, after receiving complaints from a farmer that his washing machine was faulty, sent a technician to visit him. It turned out that the machine kept getting clogged up because the farmer was washing potatoes in his machine! This prompted Haier to develop a vegetable washing machine.

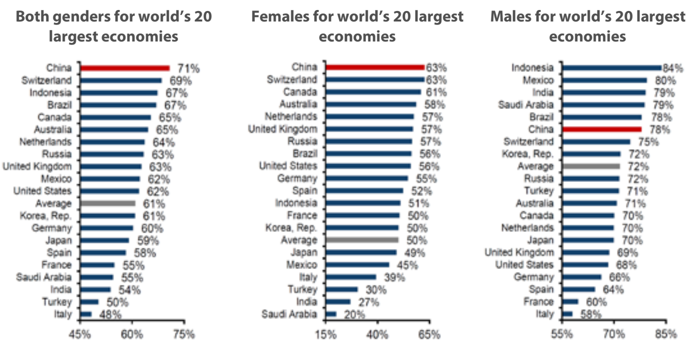
Demographic shift and more discerning consumers

The latent potential that multinational companies eyed when they ventured into the China market has become a reality with the world's most populous nation now also the largest consumer market globally. With changes in the demographic structure and increasing affluence, the Chinese are proving to be voracious consumers. On top of that, with continued urbanisation, farmers are migrating to cities and settling down as urban residents, creating a new engine for growth and an upgrade of consumption. These new city dwellers are estimated to number at least 300 million, which is equivalent to America's total population of 319 million and the total 320 million population of Germany, France, England, Italy and Spain combined[1].

Real average household disposable income per capita has doubled in the eight years from the 2008 global financial crisis to 2016, with household consumption now contributing 39 per cent to China's GDP or 57 per cent of GDP growth. This rise in the middle-income group is driving a rapid rise in purchasing power, premiumisation and pushing consumption upgrade.

Changes in the demographic structure is creating new consumption growth drivers with each segment of the population having unique needs and preferences. For example, the baby boomers of the 1980s are now settling down and furnishing their homes while those born in the 1990s – the product of China's one-child policy – are relatively affluent and would not mind splurging on a cup of tea in a trendy café. Interestingly, female consumers are also coming into their own with increased spending power as China has the highest labour force participation rate for females among the world's top 20 economies.

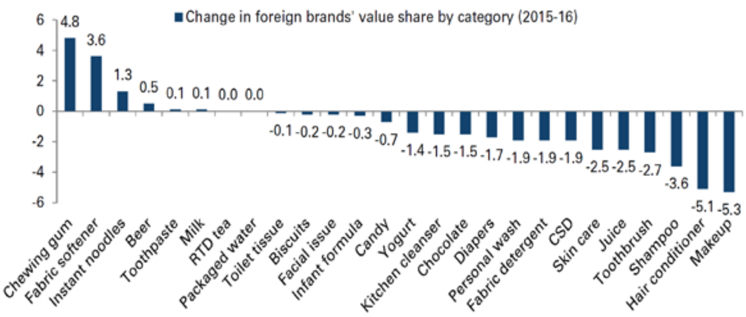
Chart 2: Labour force participation rate



Note: Data is based on International Labour Organization's estimates.
Source: World Bank, Nomura research, December 2017

All these have led to an evolution of consumers' preference. They are now more discerning and no longer chase brands blindly, increasingly favouring local brands over foreign ones. The Chinese players have started to invest in research and development and are more attuned to the local culture with a deeper understanding of consumers' psychology and behaviour. Their intimate knowledge means they are better able to tailor products to suit the needs of Chinese consumers, such as in food products like instant noodles and yoghurt, as well as skincare products. In fact, foreign brands have been losing out with their value share in most categories declining in recent years.

Chart 3: Change in foreign brands' value share



Source: Kantar.com, Goldman Sachs Equity Research: 'The Asian Consumer – A New Taste of China', 18 September 2017

In the case of Haier for example, a realisation that Chinese customers do not like washing their clothes with their innerwear prompted the company to develop its Duo washing machines that can wash two loads at the same time with a self-cleaning function. Such a focus on understanding customers' needs coupled with a move up into the premium market has propelled the brand to be the number one major household electrical appliance company globally for the ninth year in a row, with 14.2 per cent of global market share in 2017, according to market research firm Euromonitor.

From manufacturers to innovators

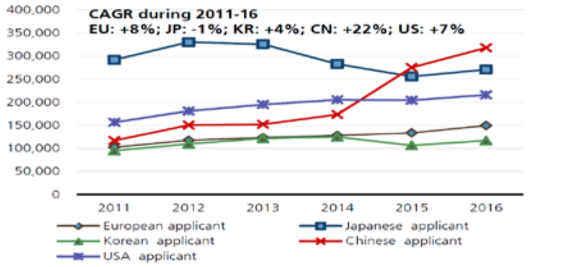
From OEMs, Chinese companies are now becoming innovators, shaping their products to suit the unique local palate, creating and investing to build brands – and gaining recognition, stature and market share in the process. In fact, China now has the most number of patents filed globally, with new applications exceeding the combined total of the US, Japan, Korea and Europe in 2016[2]. On a company specific level, baby stroller manufacturer Goodbaby boasts a portfolio of 9200 patents across its range of international durable juvenile products, according to its FY2017 annual report.

China's large consumer market serves as a viable testbed for new products and Chinese companies are leveraging on this to refine their product offerings.

[1] CICC Equity Research '300 million new consumers coming to town', 9 May 2017
[2] Source: Worldwide Intellectual Property Organisation (WIPO) 'China tops patent, trademark, design filings in 2016' Geneva, 6 Dec 2017

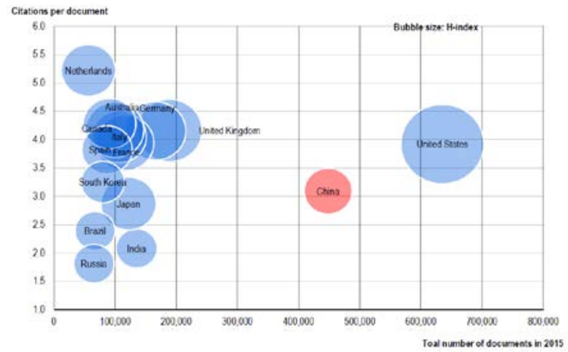
Chart 4: China has the largest number of patents globally

China has been granted the largest number of patents globally since 2015



Note: Includes only IPS Offices granted patent data. Source: IPS Offices

China is the world's second-largest research publisher, comparable with Japan and Korea in quality



Source: SCImago, Scopus, UBS, December 2017

Capital is now readily available to entrepreneurs, who are ploughing it into research and development, as well as in marketing and advertising. Whether it is through venture capital (VC) investments – the country attracted USD31 billion or 25 per cent of global VC raising in 2016 – or public fund raising, Chinese firms now have plenty of avenues to access capital.

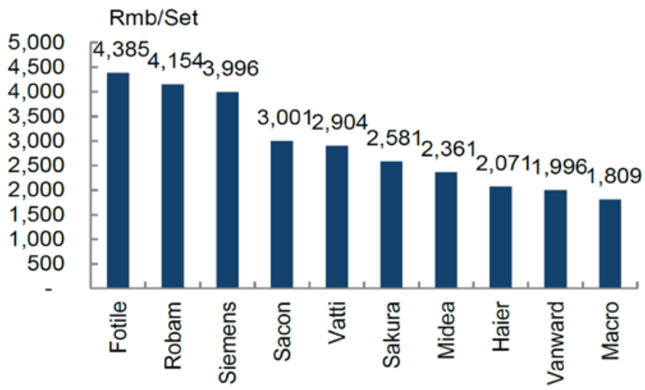
The local brands are now equipped to compete head-on with their foreign competitors, with big-budget advertising on primetime TV programmes such as popular variety show I Am a Singer. The prominent product placements slowly chip away at the 'West is best' mentality among Chinese consumers. MNCs have to work harder, with an urgent need to localise and adapt their products to suit the local tastes in order to retain market share. Gone are the days when they could simply bring products developed for their home markets and distribute them to the local market. In fact, as a testament to local brands' increasing strength, domestic brands have chalked up cumulative growth of 43 per cent compared to 9 per cent for MNC brands in the China market from 2012 to 2016[3].

Take the example of Hangzhou Robam Appliances, a Chinese company manufacturing small kitchen appliances such as range hoods, gas stoves and induction cookers. While the market for such appliances used to be dominated by foreign brands, they have since lost favour with consumers due to not having localised their products. Chinese brands now dominate the range hood space, especially in the high-end market where Robam has 30 per cent of the market.

Chinese cooking methods are different from western and other cultures as they tend to be oilier and greasier, involving a lot of frying. Hence range hoods need to have very strong suction to be able to get rid of fumes and keep the place well ventilated. This understanding of local culture and continuous research and development enabled Robam to develop products catering to consumers' needs.

In the high-end market, Fotile (another Chinese company), Robam and Siemens dominate, with the latter managing to buck the trend of MNC's declining sales by investing in local R&D and manufacturing capabilities.

Chart 5: Average retail price of range hoods in 2016



Source: Company data, CICC Research, January 2015

Robam is also innovating in other ways, such as launching new retail formats where in place of staid sales showrooms, there are experience stores for prospective customers to join cooking classes to witness first-hand the suction power of its range hoods. An online app which can be used to control and monitor the cooking process remotely, as well as cooker hoods and stoves linked to recipes on users' phones that can automatically adjust cooking temperature, are ways in which the company is harnessing technology to attract younger users.

Competing head-on with global incumbents

Riding the wave of a demographic shift and urbanisation where new migrants are furnishing their dwellings, home appliance companies have been innovating and making strides in upping their product offerings to take on global incumbents. In some cases, they are even surpassing foreign competitors and vaulting ahead in the game.

Chinese technology company, Ecovacs, is one that has made a successful transformation from an OEM to a branded product company. Founded in 1998 in Jiangsu, the company started off as a manufacturer of vacuum cleaners for Panasonic and has since morphed into an independent manufacturer of

[3] Source: Kantar.com, Goldman Sachs Equity Research: 'The Asian Consumer – A New Taste of China', 18 September 2017

autonomous cleaning robots with a dream to put a robot in every household in the world.

When the company launched its first vacuum cleaner in 2002, American iRobot had a virtual monopoly of the market. Confident of the market potential, Ecovacs's management went ahead to compete head-on with iRobot, investing to develop its own products. It has since successfully extended its product line from robot vacuums to window cleaning robots, air purifier robots and robot butlers. The company is now no. 1 in China and has 47 per cent market share in Asia[4].

With an eye on innovation, Ecovacs, which has a team of more than 100 engineers and specialists, invests about 10 per cent of its revenue in R&D and launches 20 robotic products annually. According to its website, the company owns 345 trademarks and over 1,000 patents in China and overseas, boasting many firsts, such as launching the first talking and dancing robot cleaner in 2009 and in 2010, the first robot mobile air purifier. Its window robot vacuum cleaner, Winbot 930, won the red dot award in 2014. The company is looking to list on the 'A' share market this year, which will give it even more ammunition to compete on the global arena.

Stepping out into global markets

The next phase of growth for Chinese companies is to move out of their own backyard into global markets. This will not only open up new revenue streams but also allow them to exert dominance in their product markets.

In the auto market, Zhejiang Geely Holding Group is already making headways, having been on the Fortune 500 company list since 2012. While foreign car companies have largely replicated the models developed for their home markets when selling to China, Geely has been focusing on developing its own technology and models to suit the specific needs of the mass market Chinese consumers. For example, it launched Boyue, a Sports Utility Vehicle (SUV) model in 2016, which received good reception from Chinese consumers given its modern exterior design which incorporated Chinese cultural elements. Boyue became one of the top sellers in the China SUV market and Geely's sales grew 48.4 per cent year-on-year in unit terms[5].

Geely's speed at adapting its product offering to suit the evolving domestic auto trends, such as tripling its SUV offering – the fastest growth segment – within three years, shows its flexibility and responsiveness. Other foreign auto players pale in comparison. Hyundai Motor for instance has not been able to lift its SUV offering to more than a quarter of its portfolio, thus losing out in the race.

Foreign auto companies operate in China through a joint venture, hence the profit contribution is less significant than their home markets or the North American market. Thus they have historically focused on the US market and had less incentive to invest in R&D for the local Chinese market.

However, since 2010, China has become the largest auto market in the world and global auto players can ill afford to ignore it. Chinese auto makers used to command 21 per cent of the market with foreign players such as General Motors and Ford dominating the market; this has since doubled to 41 per cent in 2017 as Chinese products gain traction with consumers[6]. Geely has also moved from being a local player to a global one and from a single brand to a multi brand player with its acquisition of global brands such as Volvo, Proton and Lotus. Leveraging on the technology of its acquired brands, Geely has also developed and launched its own high-end brand, Lynk & Co where the presale of 6000 units was snapped up within 3 minutes![7]

Chinese companies have come a long way from the time they merely played second fiddle to their foreign counterparts in the domestic market. While foreign brands used to dominate the market historically, domestic brands are now trumping their competitors in many areas such as home appliances. With a shift in demographics and growing affluence among the middle class, Chinese consumers have also become more discerning, opting for products that are more tailored to their cultural tastes instead of blindly chasing brands. From white label manufacturers, Chinese companies have grown to become innovators. They are adapting and developing products to cater to local consumers' preferences, investing in research and development, as well as marketing and advertising to build recognised brands. In doing so, they are competing head-on with global incumbents, who have been mostly replicating their existing foreign products and trailing behind in adapting products to suit the unique China consumer. Chinese companies are also stepping out into global markets, acquiring global brands and building a portfolio of products that cater to customers beyond their shores.

With increased innovation, a large market as a test-bed and easy access to capital, it may not be long before a Chinese brand is the next most sought-after product by the well-heeled global citizen.

[4] Source: Forbes, 'Inside The Company Aiming To Put A Robot Into Every Home', 11 January 2018
[5&6] Source: Thinkercar, Credit Suisse, April 2018
[7] Source: Techcrunch, 'Lynk & Co. starts selling an SUV with a dedicated car share button in China', 29 November 2017

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