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Asian Issues Management Paper

China: Managing the pricing challenge for goods and services

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This **Asian Issues Management Paper** is based on discussions with fourteen Asia Program clients during April 2003, combined with secondary research on the macro-economic factors contributing to pricing pressure in China. To illustrate the issues from an industry perspective, Chris Nailer compiled a series of market sector reviews. The findings were presented and discussed with clients at IMA Asia's peer-group briefings on 28 April (Sydney) and 1 May 2003 (Melbourne).

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Material for the Session

Asian Issues Management Papers (AIM Papers) are produced by IMA Asia based on presentations by guest speakers and discussions at peer group briefings and quarterly Asia Strategic Forecast briefings. The AIM Papers and the slides from the briefing session are available in Adobe format to clients of the Asia Pacific Managers' Service in the members-only area of our web site (www.imaasia.com).

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OUTLINE

The sections of this paper are:

- Summary
- Our clients' experiences
- The macro-economic picture
- Five industry studies
- A framework for planning price and cost strategy
- China pricing checklist

SUMMARY

The China price is becoming the global price

… and China cost structures win

Richard Martin: Can foreign firms successfully meet China's pricing challenge? A majority of the firms with which we discussed this believe it is possible, but it often requires a complete rethink of their original China strategy, if not key elements of the parent company's strategy. In fact, for several of the firms, the solutions to China's pricing challenge are becoming the *de facto* solutions for the parent company's global pricing challenge. As a result, firms manufacturing and selling in China's domestic market are starting to adopt some of the cost and pricing strategies of the low cost exporters who use China as an export-manufacturing base. The bottom line for both groups is that the China cost structure has to be the lowest production cost structure that they have anywhere in the world. Moreover, for firms following this path, the China cost structure has to move as close as possible to that of China's emerging local competitors. In this process of driving China costs and prices down, the China price is becoming the global market price.

Niche strategies can work in premium segments

… for the moment

Niche strategies do enable a degree of premium pricing at present. Almost half of the firms that we spoke to have avoided cutthroat pricing by targeting - and sometimes creating - niches where customers are willing to pay premium prices. Many of these customers have tended to be other MNCs seeking high quality plant, equipment or materials, although some of the biggest buyers are now local firms. Premium pricing has also worked on consumer goods, from Honda's small volume of imported Accords in 2000 and 2001 (not to mention the Bentleys and Ferraris in China that now outsell both HK and Japan) to clothing and foods. However, there is a concern about the sustainability of some of these niches against competition from mass-market players who will eventually launch more sophisticated products. The solutions to this challenge include a constant focus on product development (including some original R&D), and, for some manufacturers, a much greater focus on the service component of their value proposition. Branding and advertising also play a role.

MNCs must leverage their global skills to set China prices

One minor theme of the interviews and review discussions was particularly striking. This is that some MNCs operating in China do not appear to be fully leveraging the skills that should be mobilised by a sophisticated international or global firm in setting prices. Some MNCs maintain highly regionalised global production with tied markets, internal prices that create artificial barriers, and minimal sourcing flexibility. Others fail to draw on their product and process development skills to rapidly tailor products and processes for the China market. Firms that do best in this regard tend to recast the China pricing challenge as a pricing challenge for the global business and thereby open up an array of tactical responses that can give them an edge over the highly competitive local firms emerging in China.

China's pricing challenge – our clients' experience

Richard Martin: In fourteen interviews (eight US firms, four European firms, two Australian firms; ten manufacturers and four service firms) we found only one example of a firm that had managed a price increase in the last four years. That increase was based on a rise in the price of steel in global markets. In all other cases companies have been evolving strategies to hold prices steady by increasing the value delivered to customers and constantly launching new products or by cutting costs as fast as prices fall. How successful were these strategies? At best, some of the clients we spoke with would say they were sufficiently successful but their implementation required significant changes in product and operating strategies. For other clients there is concern over steadily diminishing margins prompting concern over both strategic positioning and commitment to the market.

Comments from several of these interviews are set out below to give a flavour of the challenge and the strategies being adopted by firms:

FMCG LEADER

Incessant copycats

… leading to constant product and productivity improvements

"Every time we launch a new product with a good margin a copycat will quickly produce a similar product and grab market share with lower prices."

Their strategy for dealing with this has four main components:

- Regulatory controls / IP protection. However, they have found that efforts to protect intellectual property achieve little.
- Advertising for brand awareness and consumer education.
- Constant productivity improvements to enable a lower price.
- Constant R&D to release new products.

As a result, they have usually managed to win back market share at lower prices and thinner margins.

IT EQUIPMENT SUPPLIER

… getting closer to the customer with novel solutions

"We sell IT equipment to the premium or "solutions" market and try to avoid competition in the low-priced "transactions" market. However, copycats quickly emerge with identical goods to ours and supply to our resellers who then demand lower prices for our genuine products."

Their strategy for dealing with this includes three steps:

- Constant efforts to enforce some form of IP protection.
- Constant R&D to produce a new stream of products. This is more effective as they can get a three to six month lead over the copycats.
- They have changed their business model with the aim of getting much closer to customers with novel solutions. This is a step that the copycats find hard to replicate.

As a result, they have achieved good sales growth.

EQUIPMENT SUPPLIER TO F&B, MEDICAL & INDUSTRIAL MARKETS

… confronting a PRC entrepreneur running a privatised SOE

"We face an apparently very wealthy PRC entrepreneur who has bought the main SOE in our field and now produces an adequate product at half our price. His son, educated in Germany, has launched European sales and is winning market share in Europe."

Their strategy for dealing with this is still evolving, but includes the following:

- Initially, they attempted to rely on their parent's global supply contracts (& pricing) for sales to the China subsidiaries of their major Western customers. Unfortunately, the managers at the China subsidiaries - themselves under extreme pricing pressure - often ignore global supply contracts.
- They are now looking at a range of local sourcing and production opportunities to cut costs. They may even consider sourcing from their new PRC competitor.
- They are also exploring niches where they can deliver a higher value-added service proposition.

They continue to have good sales in China but are still at the early stage of confronting this challenge.

ENGINEERING FIRM

Started buying from the new China factories of their Western suppliers

"Our market is almost wholly Western MNCs requiring high quality facilities. One PRC firm has emerged as a minor competitor for this segment offering lower prices. Downward pressure on prices is coming more from MNC customers who need to cut their capital costs."

Our client's strategy for dealing with price pressure has two steps:

- They are lowering their building costs while maintaining quality by sourcing from MNC suppliers who have moved to local production in China. For example, they can now obtain high quality doors from a German firm that has just set up a local factory. This is a significant cost saving over the imported materials they used to rely on.
- They maintain a highly flexible cost base, increasing engineering staff only when required by specific projects.

With the boom in foreign direct investment in China over the last five years, this client has had good sales and profit growth.

MATERIALS SUPPLIER TO FMCG FIRMS

"We supply premium products to P&G, J&J, etc in China. They are now moving from their strong position in the premium sector of the FMCG market into the volume market and are demanding much lower prices from us. There is the risk that they will simply cannibalise the premium segment as they do this."

… working with FMCG customers on differentiation of premium and mass products

Our client's strategy for dealing with the price pressure involves:

- Convincing their FMCG customers that they can deliver at a lower price based on older technology, provided the FMCG customer differentiates their volume brands from their premium brands in terms of features and quality. This takes a lot of education of staff and managers on both sides of the transaction.
- They also sell to the top PRC firms and note that they have great management without a Western MNC cost structure

So far this client has maintained strong growth with good margins.

The macro-economic picture

China's role in global deflation

Richard Martin: Downward pressure on prices - including the risk of deflation - has become a global phenomenon over the last few years. China is an important subset of this problem because of the global impact of its massive export industries and also because of its own unique pricing challenges that reflect China's gradual transition from a command to a market economy.

The pricing challenge is changing, not reducing

China's pricing challenge is changing – but not necessarily declining – as this transition takes place. The pricing challenge that foreign firms face in China can be thought of as moving through three overlaying phases:

- **Command economy phase** - during which the government dictated prices with little concern over production costs or demand levels. This phase is largely over, although some elements are still apparent in certain industries dominated by traditional SOEs.
- **Transition phase** - during which prices are affected by tariff cuts under the WTO, the privatisation of SOEs, and generally greater use of market signals in price setting. Two critical characteristics of this phase are: attempts to impose a domestic cost of capital (i.e. fix the banks), and a cost of technology (i.e. protect intellectual property), both pillars of a full-blown market economy. This phase started within the last five years and dominates in most industries. Elements of this phase are likely to be prominent for another five years at least, if not ten years in specific sectors.
- **Market phase** - during which prices are set by the intersection of demand and supply and firms that cannot reach that price point depart the market. Discussions with clients suggest that elements of this phase have been emerging in China over the last two years and in some segments it is rapidly becoming the most important arena for pricing competition.

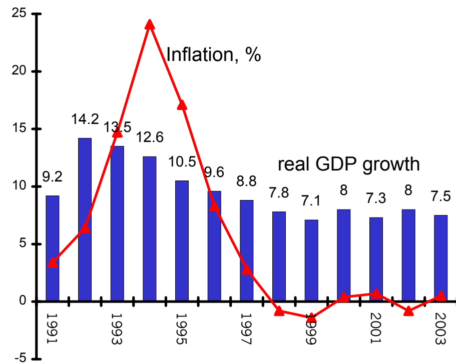
The price challenge may only ease

The government has attempted to end deflation by boosting demand, both its own through a massive investment program and that of households via higher public sector salaries, bigger pensions, and longer holidays to encourage shopping. The investment side has been particularly strong, with some analysts now warning of the dangers of over investment (similar to the Asean markets prior to the 1997 crash). By contrast, household demand growth has been modest at best in urban areas and non-existent in rural areas.

… when capital is priced correctly by both foreign and local firms

Relatively little has been done to address the supply side problems, largely because of concern about triggering higher unemployment if factories cut production or are closed. However, one supply side aspect of the pricing challenge may ameliorate when players – both foreign and local – decide they want an adequate return on capital. For the PRC firms this may occur when bank reform stops PRC banks handing our essentially free capital to well-connected PRC players. For foreign firms it will occur when companies require the same return on capital from China that is required in other markets.

Deflation in China
Source: AMAP by IMA Asia

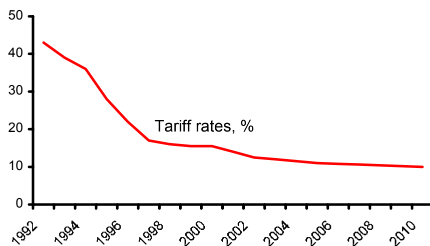


Falling inflation - China's annual inflation rate, as measured by its consumer price index, peaked at close to 25% in 1994 before rapidly falling to -0.8% in 1998; since then China has had marginal inflation (around 0.5% pa) for only two years, 2000 and 2001. With the onset of SARS, China is unlikely to return to positive price movements until 2004 at the earliest. This rapid transition is a result of two factors:

1. **An anti-inflation policy.** In 1993, the government adopted an explicit anti-inflation policy to stabiles an overheated economy.

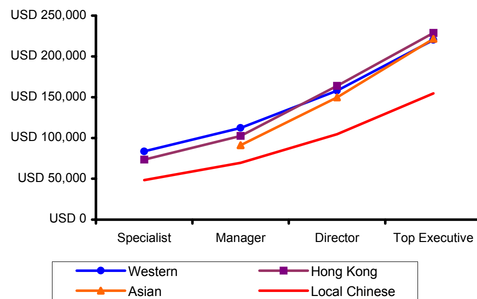
2. **Production exceeds demand.** Production has surged in China over the last six years as FDI has poured in (often based on inaccurate demand assumptions) and restructured SOEs and privatised firms have lifted production to meet foreign competition. Meanwhile, demand growth has been modest in most areas.

Lower tariffs have cut import prices



WTO accession - China entered the WTO in December 2001. In order to meet WTO entry requirements, China had embarked on a major program to reduce tariff rates and remove tariff barriers several years prior to accession. Following entry, further major cuts were implemented in January 2002 and in January 2003. As a result, the price for many imported products have fallen dramatically over the last three years and are set to continue declining over the next two years under WTO commitments.

Cutting salary costs



MNCs cut their local costs - Foreign firms in China have also been able to trim their local cost structures over the last five years. One major step has been to reduce the labour cost by moving away from expatriates to locally hired staff. Some companies have also reduced the number of functions carried out in China by allocating some management and support roles for the China operation to staff on the pay roll of other operations (typically HK and Singapore). Office rentals have also been falling in Beijing, Shanghai and Guangzhou since the mid 1990s as a result of a spate of office construction. This has enabled firms to negotiate lower rents.

How low are China prices?

With all this price-cutting, how low are China prices compared to elsewhere?

… the scope for higher China prices is small and narrowing

Higher China prices. There are some instances where prices of some products in China have been significantly higher than elsewhere in the world. In 2000, Honda's imported Accord was selling for around US$32,000 against US$20,000 for the same model in the US, reflecting China's high car tariffs at that time and better margins for Honda ($3,000 in China versus $1,000 in the US according to McKinsey). However, car firms are now slashing their prices in China as tariffs come down. The number of products with significantly higher China prices must be small and falling.

… growing comparability with SE Asia prices

Comparable China prices. A number of firms we interviewed indicated that prices in China were comparable with those in Southeast Asia. This could apply to a significant range of goods, as region-wide tariff reductions reduce the potential for country price differences. This works both ways for China, as one interviewee noted in the case of premium bottled beers where China's tariff cuts raises the prospect of parallel imports competing against higher priced locally bottled beers of the same brand.

… sacrificing margins to create demand volume and win market share

Lower China prices. As a rough guide to China's very low pricing on some goods we have turned to *The Economist* magazine's light hearted Big Mac index. The index is actually the local price of a MacDonald's Big Mac hamburger converted at current exchange rates into US dollars and one of its main uses is assessing whether currencies are under or overvalued (it is surprisingly accurate at this). In January this year a Big Mac in China cost US$1.20, less than half of the US price of US$2.65 and also considerably less than Australia's US$1.76 (the lowest price for a developed country). The only country with a lower price in the January survey of 42 countries is Argentina, who, in addition to having low cost beef, had just suffered a currency collapse. Why is the big Mac so cheap in China, as we can assume that materials costs are much higher (including import duties on some components) and economies of scale are much lower? Lower labour costs would be one factor but we can also assume that pricing decisions around creating demand volume and winning market share – both at the expense of profit margin – are at work.

China pricing – industry studies

Chris Nailer: I will review five brief industry studies – PCs, automobiles, mobiles phones, digital cameras, and microwave ovens – before drawing some conclusions about the patterns. The studies have been compiled from news reports and journal articles (see the footnotes on the slides at the back of these notes). What is striking is that although foreign firms established all these markets (with the exception of cars) in the last five to twenty years, they are fighting today to hold their position in these markets.

PCs

Chinese firms now control 80% of the market

China in now one of the world's top three PC markets, with close to 11 million in annual unit sales in 2002, up over 100% in volume in just three years. Yet the foreign firms who dominate this industry elsewhere in the world have been pushed back to a 20% market share with three tiers now apparent in the market:

Global: IBM, Dell, HP-Compaq, Toshiba (12-13% share, declining)

Taiwan: Acer, ASUS, Compower (7-8% share, stable)

Local: Legend (37%), Founder (8.3%), Tongfang, Haier, TCL, Qixi, Hengshan, Boan, others (80% share, growing)

… and are entering the premium segment while driving prices down

Three developments stand out in the competition over the last year:

- **Escalating premium sector competition** – Legend is now challenging IBM and HP in servers and laptops.
- **Extreme price competition** – Legend is driving the laptop price down to US$850.
- **PRC competitors go global** – Legend and white goods maker Haier are now producing in the US.

AUTOMOBILES

The battle has started

China would now be in the top eight world car markets and is the fastest growing market:

	2001 sales	% change over 2000
Cars	756,610	21.1%
Trucks	818,430	5.6%
Buses	788,620	14.5%

… with 20% price cuts as tariffs drop

At present the market is highly fragmented, with over 100 makers and 3000 component suppliers. There is little economy of scale and locally produced cars cost more than imports. With the WTO slashing tariffs from 2002, a wave of price-cutting has started, led by Tianjin Auto, which cut prices 20% but was quickly followed by the local producers and importers.

… and massive new foreign investment

Foreign cars makers see China as a key geography in the global market and are ramping up investment, production, imports and marketing. Yet the question remains as to whether they can capture (or hold onto in Shanghai VW's case) the volume market. Many locally made foreign models are priced above Rmb200,000 (US$24,000) in the top 10% of the market. Imports, which have

dominated the over Rmb300,000 segment will now move down into the Rmb200,000 to Rmb300,000 segment. By contrast, the strongest growth is expected in the Rmb100,000 to 200,000 range.

… but who will win the mass market?

To an extent the government may be limiting the ability of foreign car markers to target the low priced mass market, unless they pair up with local firms as Toyota is doing with Tianjin Auto. It is also apparent that local firms are getting ready to quickly add features to their cars that are normally reserved for the premium segment. A joint venture between Haier and Sanyo has already started work in China on a car navigation system.

MOBILE PHONES

A giant market with little room left for foreign firms

China is the world's largest mobile phone market with some 65mn phone sales expected in 2003. It can also claim to be the most competitive on price and the trends in China are determining pricing and product strategies in the global market. The market has a three tier structure similar to the PC market, although in this case the Korean firms, rather than the Taiwanese, hold the middle section:

Global: Motorola, Nokia, Siemens, Ericsson, Panasonic

Taiwan: Samsung, LG, Telson, Sewon, Pantech

Local: 37 domestic producers: Ningbo Bird (10m in '02), TCL (6m) Konka (1.6m)

… as prices tumble and over-capacity looms

Around 70% of subscribers use mid to low-end phones priced below Rmb2,500 (US$302). Ningbo Bird cut its price by Rmb1,000 in April and Konka plans to cut prices to regain market share. With new sales slowing, the industry faces overcapacity, which should force out some local and foreign players.

… forcing foreign firms to reposition

Foreign mobile firms have adopted a number of strategies to stay in the market:

- **Globalising China operations** – the foreign firms are making China the primary site for their global production.
- **New technology** – foreign firms are moving in R&D and fighting over China's TD-SCDMA standard for 3G
- **Exit the phone business.** At IMA Asia's *Strategy Roundtable* last November in Singapore, Motorola outlined its strategy for dominating the supply of chips to all mobile phone makers while exiting the phone market itself (the notes from this session are available from the members-only page of IMA Asia's web site, www.imaasia.com).

DIGITAL CAMERAS

Local offerings will drive market growth

This market was only created in China in 1999 and the volumes are still very small (under 200,000 units in 2002). Yet in the last month (April) it has become clear that the Japanese firms that launched the market will lose it to the Chinese firms who will drive volume growth with low prices.

1999 – Japanese imports start. Volume 40,000

2002 – Volume jumps to around 185,000

2003 – Price war breaks out led by Chinese firms:
January – Sony pricing at US$1,100 (DSC-F717)
April – Legend launches at US$130
April – Sony cuts price to US$800
April – Founder brand launches under US$100

… based on extreme simplicity and POS support for first time buyers

The digital cameras made by Legend and Founder are extremely basic with minimal features compared to the Sony. Yet this is exactly why they will do well. China is still very much a first time buyers market where the average consumer is unlikely to have ever owned a car, a PC, a mobile phone, and certainly not a digital camera. The key in these sales is simplicity of operation and a higher degree of point of sale support.

… while the Japanese now face a new global competitor

The challenge for Sony will be managing the speed with which Legend and Founder upgrade the technology and features on their cameras and the speed with which they move into international markets. Within the next 12 months we can expect them to dramatically lower the global price.

MICROWAVE OVENS

Matsushita stages a comeback by localising

In the first four industry examples we've mostly examined the impact of the first wave of local competition based on price cutting in the mass market. Foreign firms can, in some situations, respond to this as this final case study indicates.

1999: Matsushita established production for both exports to the US and the local market in Shanghai. But market share in China steadily declined.

1999: Matsushita realised that its failure in China would lead to its failure in the global market as its cheapest local brand was US$70 versus US$36 for Guangdong Galanz.

2000: Matsushita launched an aggressive localisation strategy to cut its costs and prices, involving:

- Local materials and components sourcing
- Local designs better suited to local needs and production
- A new US$48 price level – as a premium product

2002: China unit sales (430,000) are now 2.5 times higher than 1999 while exports have grown to 2.4m units.

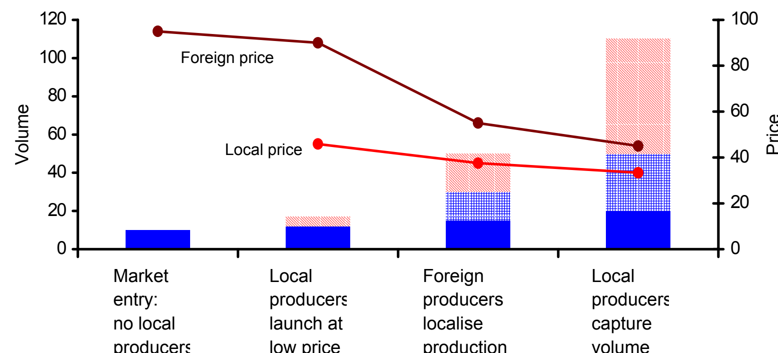
A framework for planning pricing (and cost) strategies in China

Chris Nailer: On the chart below I have set out a generic representation of the competition and pricing strategies that are apparent in all five of the industry case studies.

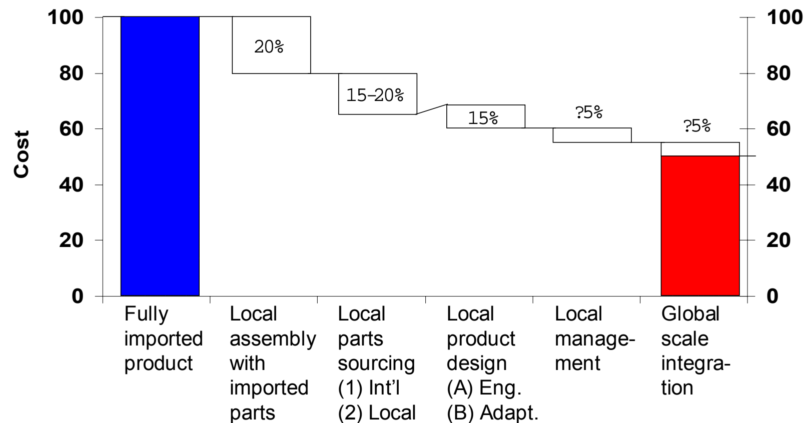
- Foreign firms launch the market at low volume and prices that may be modestly higher than their current global prices (the solid bar in blue).
- Local producers then launch a very basic product at about half the price of the foreign product (the diagonal red stripes).
- Foreign producers respond by driving their local production costs down by localising production and gain stronger growth (the blue cross hatched section).
- However, local producers continue to drive prices down and drive dramatic market volume growth, capturing 50% or more of the total market within a few years.

The chart below shows foreign firms holding onto a much reduced - but still significant - premium pricing position in the market. Foreign firms aim to justify this narrow price advantage on features, technology, and foreign brands. They also manage to hold onto – for the moment – a smaller premium segment of the market. However, holding onto this segment is already at question for the PC and mobile phone makers.

Domestic producers drive price, capturing volume



How to achieve a 50% cost reduction



The graph above provides an illustration of how foreign firms can bring their cost down by around 50% by progressively localising their operations. These estimates of savings are based on examples such as PCs, consumer electronics and microwave ovens.

- First, by **assembling imported parts locally**, tariff costs can be reduced by 20%.
- Second, a 15-20% cost saving can be achieved by **sourcing parts locally**. Perhaps half of these savings can come by sourcing components from MNCs suppliers that are based in China. A higher level of savings can be achieved by developing supply sources amongst local companies.
- Third, cost savings of around 15% can be gained by **localising product design and development**. There are two layers to this also. Local designers with knowledge of the domestic market are more capable at adapting an existing product to suit local tastes and budgets by designing-out unnecessary features that involve added cost. In addition, local engineers will have a greater working knowledge of domestic industry capabilities, allowing product designs to better utilise locally produced components.
- Fourth, employing **local Chinese management**, rather than expatiates, will lead to cost savings, perhaps by around 5%. While surveys by some global human resource consultancies estimate cost saving from localising management may be as high as 20%, such a figure is likely to be an overestimation. Anecdotal evidence suggests that most MNCs in China still find it difficult to find local managers with sufficient skills to adequately manage their China operations.
- Fifth, MNCs with global distribution networks are well positioned – in a way that domestic PRC companies are not – to utilise their China operations to **satisfy not only domestic demand but also global demand** for their product. Such large-scale production allows MNCs to achieve more favourable terms with suppliers for example, further helping to drive down average unit costs.