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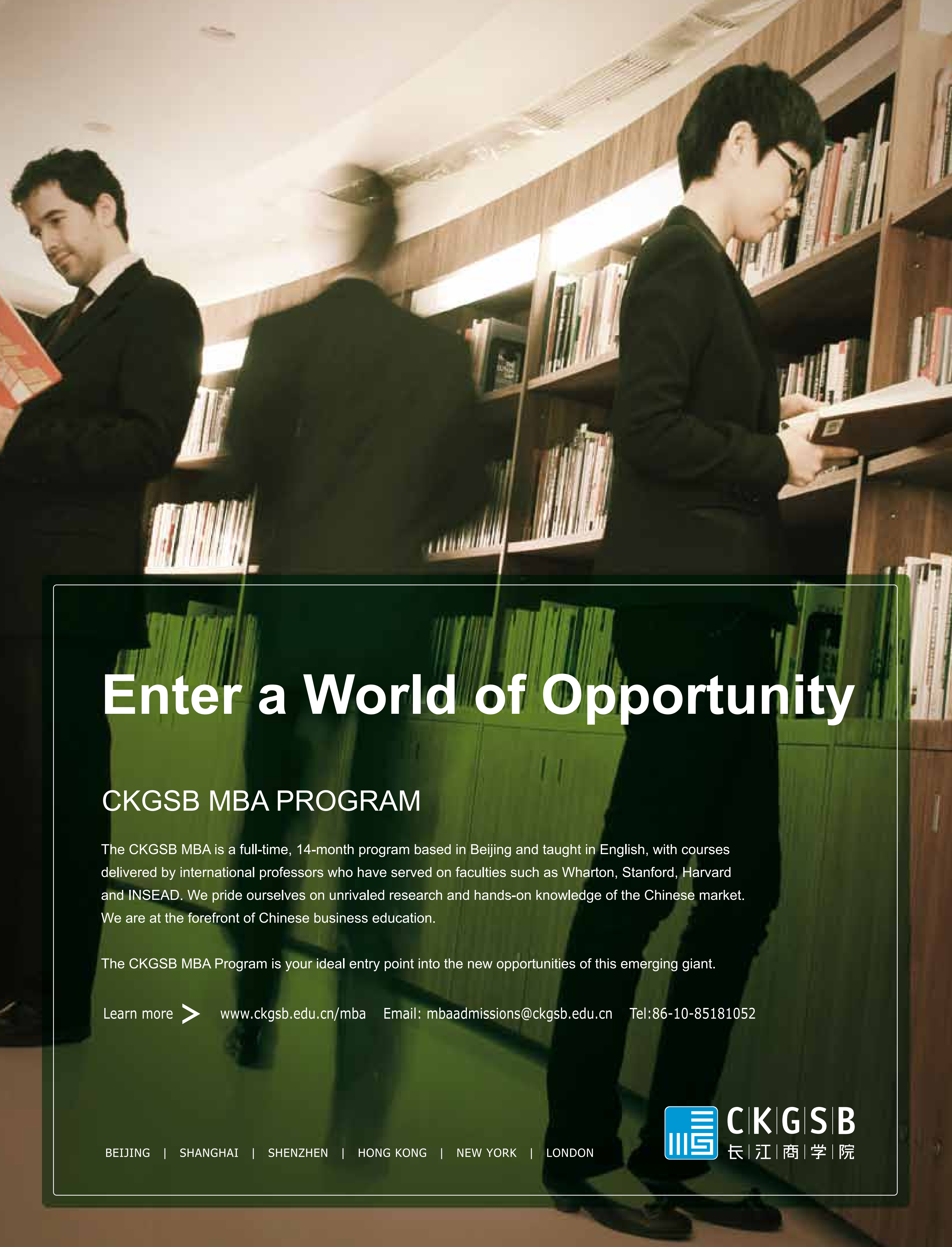
Future of Free Rides?

Can China's internet companies make money off free services?

- Lenovo future-proofs its strategy
- Lady de Rothschild on inclusive capitalism
- China gears up for 4G
- Jingdong's global play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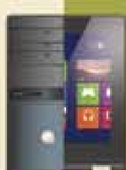


No More Free Lunches?

I have been working out of CKGSB's Hong Kong office for the past few weeks now whereas most of my team sits in Beijing. It's during times like these that I appreciate the value of services like Skype. Thanks to Skype it is possible for me to communicate with my colleagues in Beijing or those in our global offices in London and New York at virtually no cost at all.

A lot of us have gotten used to such free services in our everyday lives. The experts call this the 'freemium' business model, wherein the basic service is free and amasses a huge user base. The extras, which few users subscribe to, are paid for. Services like Skype, LinkedIn and Dropbox ascribe to the freemium model.

The freemium model is not new to China. Many internet-related businesses here, such as online classified sites Ganji.com and 58.com which we wrote about a few issues back, use this model.

Recent events in China have put the spotlight on the idea of 'freemium'. Those of you who live in China would have heard of the recent tangle between internet services company Tencent and China's telecom operators. The reason for this contentious battle was a seemingly harmless mobile phone app called WeChat (Weixin in Chinese), which is available for free. WeChat, thanks to features like voice messaging and text messaging, has started eating into the telecom operators' revenues, and the operators tried to pressurize Tencent into charging for WeChat.

While the Ministry of Industry and Information Technology (MIIT) finally weighed in and refused to force Tencent to charge for WeChat, this episode did raise quite a few intriguing questions. One, how many users would actually like to pay for the value-added services, and would that be enough to subsidize the costs of the users who don't pay. Two, would it be easy to migrate people used to getting a service for free, to a new model where you pay for the value-add? Three, would this be sustainable in the long run? Four, will WeChat continue to have a huge user base after changing its business model?

There's also the flipside: it is likely that adopting the freemium model might eventually help Tencent keep WeChat free for the majority of its users.

To understand more about the freemium business model from both the Chinese and global context, please turn to our cover story ('Future of Free', page 24).

While still on the subject of mobile apps and internet services, please read our story on the multitude of start-ups in mobile technology in China ('Upwardly Mobile', page 34). While this industry is a hotbed of innovation, it is also one that is hypercompetitive and lacks funding avenues.

Elsewhere in this issue, we have an interesting article on China's state-owned enterprises (SOEs) ('The Ascent', page 40). The common perception is that China's SOEs are lumbering giants, that are both inefficient and slow to change. Our story details how a conscious push to go global has been slowly changing the DNA of China's SOEs and making them more competitive and agile.

Talking of change, Lenovo, China's own computing giant, is engineering a change of its own. We tell you the fascinating story of how the personal computing giant is revving up for the era of smartphones and tablets with something it calls the 'PC-plus' strategy ('The Switch', page 46). In a sense, Lenovo is deviating from popular perception here and also holding its own against what Apple Founder Steve Jobs called 'the death of the PC'.

I would also like to draw your attention to our power-packed interviews section. This time we have Lady Lynn Forester de Rothschild, CEO, E.L. Rothschild, on her idea of reforming capitalism (page 62). In The Thinker Interview section, we bring you an in-depth conversation with Stuart Hart on his and C.K. Prahalad's idea of the Bottom of the Pyramid (page 55).

In the end I would like to draw your attention to the CKGSB Business Conditions Index on page 38. This will give you a sense of the business sentiment of executives about the macroeconomic environment in China. This research, conducted by Li Wei, Professor of Economics and Emerging Markets Finance, and his team, is one that I am personally very proud of. From now on, we will bring you his research findings in every issue.

As always, if you have any feedback or comments please email me at *ckgsb-magazine@ckgsb.edu.cn*

Yours Sincerely,

Zhou Li
Assistant Dean, CKGSB

For more insights on the Chinese economy and business, please log on to http://knowledge.ckgsb.edu.cn/

Internet giants Alibaba and Tencent lock horns after Alibaba teams up with Sina's Weibo, Hershey's capitalizes on China's chocolate cravings, and Warren Buffet advances into China's condiment market via America's favorite fry-topper.

Proud to BUY American

American brands are still all the rage in China, according to *USA Today's* list of top brands in China. General Motors is at the very top, followed by Apple and Nike. Starbucks, Microsoft Windows, KFC, Gillette, Coca-Cola and Intel followed respectively. While US brands do well in China, the US-China Business Council says nearly 100 sectors have tight restrictions that prevent foreign companies from competing fairly with their domestic counterparts.

Baidu ups the Stakes

Though expected by avid tech geeks, Baidu confirmed in May its purchase of online video service PPS for $370 million, *TechCrunch* reported. Baidu will reportedly integrate PPS into its own video service, iQiyi. Market leader Youku has Youtube-like dominance within China's online video sector, but PPS has a solid niche by focusing on streaming television and movies in a fashion similar to Netflix or Hulu.

Time is on China's Side

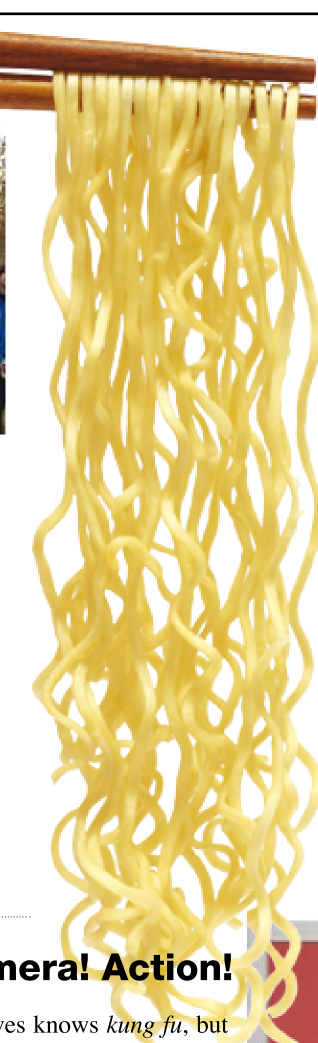
A Chinese holding company recently purchased Swiss watchmaker Corum for $90.6 million to satisfy China's demand for luxury goods, even amidst a slowing economy, Swiss Info reported. A Nielsen survey of Chinese consumers showed the Chinese consumer confidence index at 108 points, 15 points ahead of the global average or a quarter past time to sell sell sell!

Why Buy Wine...

...when you can buy a vineyard? Famed New York and London-based auction house Christie's is opening a Hong Kong consultancy to assist Chinese clients in buying vineyards around the world. According to a post on an industry blog, *The Drinks Business*, Christie's is opening the real estate office because of continued requests from clients at its Hong Kong wine auctions for advice on buying vineyards. Demand for fine wine in Hong Kong has exploded in recent years, with Christie's reporting a total of £24 million from nine wine sales in Hong Kong last year.

Ketchup Thicker than Water

Warren Buffett and 3G Capital's planned takeover of condiment maker Heinz got the green light from China's competition regulator, *South China Morning Post* reported. The Chinese Commerce Ministry's speedy approval of the deal may indicate a streamlining of regulatory bureaucracy in China.



China's Sweet Tooth

US candy maker Hershey wants a bigger bite of China's candy market, investing in a Shanghai-based development center as well as launching a domestic candy brand, *The Wall Street Journal* reported. Hershey's China rival Kraft Food Group, has had great success with Chinese flavored snack foods like green tea-flavored Oreos. If Hershey's does well, it may trigger a wave of foreign food companies producing China-centric snacks.

Noodle Nation

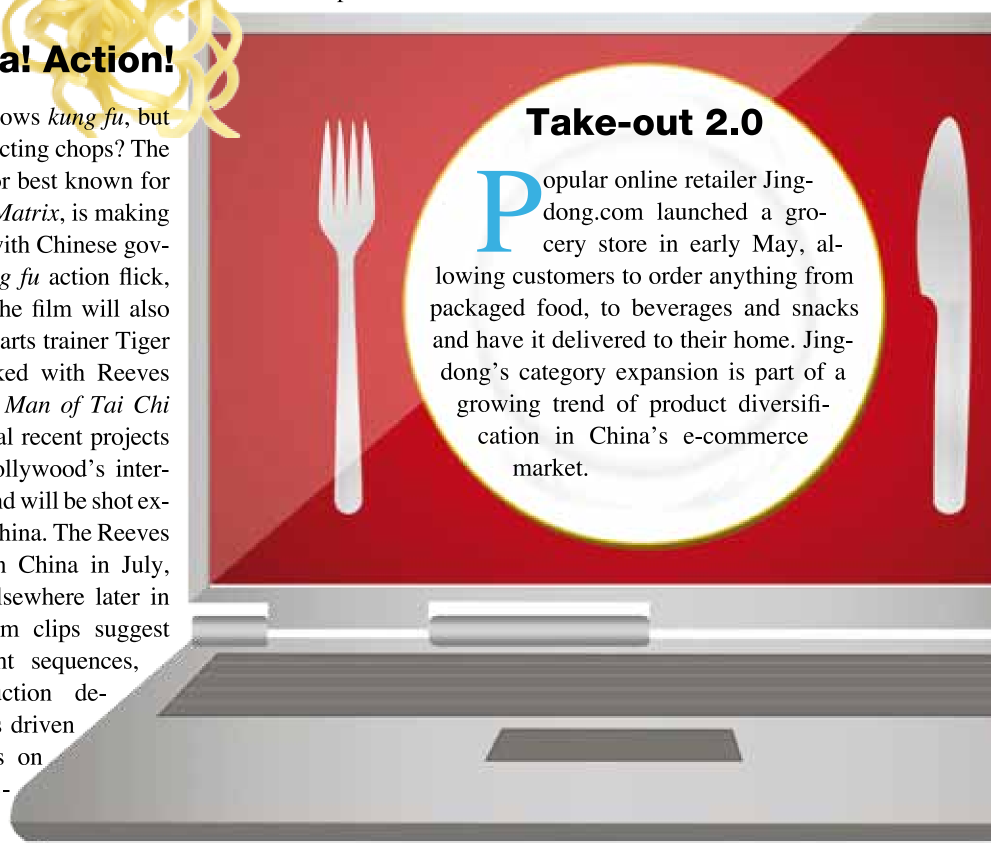
The Chinese have an insatiable demand for ramen instant noodles. Overall the nation consumed a whopping 44 billion packets of instant noodles in 2012, according to the World Ramen Association. Statistically speaking, 1,400 packets of instant noodles were eaten every second in China! Some appetite that is!

The Gloves are Off

In the battle for supremacy of China's internet sector, the two main players are Alibaba and Tencent, especially after Alibaba's $586 million investment in Sina's microblogging service, Weibo (amounting to an 18% stake). This could be Alibaba's latest move to check Tencent's feverish growth by investing in its most direct competition.

Lights! Camera! Action!

Keanu Reeves knows *kung fu*, but how are his directing chops? The Hollywood actor best known for his role as Neo in *The Matrix*, is making his directorial debut with Chinese government-backed *kung fu* action flick, *Man of Tai Chi*. The film will also star noted martial arts trainer Tiger Chen, who worked with Reeves on *The Matrix*. *Man of Tai Chi* is one of several recent projects that reflect Hollywood's interest in China and will be shot extensively in China. The Reeves film opens in China in July, premiering elsewhere later in the year. Film clips suggest intricate fight sequences, sleek production design and cars driven at top speeds on China's freeways.



Take-out 2.0

Popular online retailer Jingdong.com launched a grocery store in early May, allowing customers to order anything from packaged food, to beverages and snacks and have it delivered to their home. Jingdong's category expansion is part of a growing trend of product diversification in China's e-commerce market.

What's in a brand?

China's top 10 brands and the companies behind the logos

1 China Mobile

BRAND VALUE: $50.6 billion
YEAR ON YEAR CHANGE: -6%
SOCIAL MEDIA RANK: 1

To expand the brand abroad, subsidiary China Mobile International initiated a major Hong Kong facility as a cloud computing center, a submarine cable landing and other functions. China Mobile also partnered with US-based Clearwire, to develop 4G roaming between China and the US.

8 Bank of China

BRAND VALUE: $13.6 billion
YEAR ON YEAR CHANGE: -27%
SOCIAL MEDIA RANK: 13

Bank of China opened its first branches in Poland and Sweden in 2012, making it the first Chinese bank to enter these countries. The bank also received a license to open a branch in Kenya. This expansion reflects the globalization of Chinese banking generally and the international leadership of Bank of China, which is now present in 36 countries.

10 Sinopec Oil and Gas

BRAND VALUE: $12.5 billion
YEAR ON YEAR CHANGE: -9%
SOCIAL MEDIA RANK: 12

The cap on fuel prices hit Sinopec hard because refining generates much of the company's revenue. It also operates China's largest network of service stations, which sell gasoline and other petroleum products. Sinopec plans to double its oil and gas generation from overseas projects by 2015.

6 Agricultural Bank of China

BRAND VALUE: $17.3 billion
YEAR ON YEAR CHANGE: 0%
SOCIAL MEDIA RANK: Below Top 20

Agricultural Bank of China expanded its overseas presence while rolling out new technology to improve its contact with domestic customers. It recently established video contact centers in some branches to increase interaction between customers and bank employees. It also has plans to roll out video-enabled ATMs in the future.

9 Moutai Liquor

BRAND VALUE: $13.0 billion
YEAR ON YEAR CHANGE: 42%
SOCIAL MEDIA RANK: Below Top 20

To update its image as the brand favored by business and government leaders, as well as appeal to a younger audience, Moutai created a new label called Jackie Chan Moutai, associating the brand with the action film star. They're also sponsoring scholarships for 20,000 university students.

Footnote: All portals, social networking sites and e-commerce sites were removed from the social media ranking, since consumers use them to engage with brands in the digital space

7 China Life Insurance

BRAND VALUE: $14.4 billion
YEAR ON YEAR CHANGE: -6%
SOCIAL MEDIA RANK: Below Top 20

The rise of a middle class that views life insurance as a good investment and also seeks asset management products and property insurance to protect accumulated wealth, has benefited the company. To drive growth in a slowed economy, they have introduced new products like medical insurance for rural cooperatives and developed new distribution channels such as telemarketing and online sales.

5 Tencent

BRAND VALUE: $20.2 billion
YEAR ON YEAR CHANGE: 60%
SOCIAL MEDIA RANK: NA, see footnote

Weixin, aka WeChat, is an important part of Tencent's strategy to diversify and expand internationally. QQ, Tencent's well-known instant messaging service, has over 700 million active users, making its China user base comparable in size to Facebook's globally.

3 China Construction Bank

BRAND VALUE: $24.0 billion
YEAR ON YEAR CHANGE: 9%
SOCIAL MEDIA RANK: 4

One of China's largest banks, China Construction Bank traditionally has differentiated itself by focusing on providing loans to Chinese industrial corporations in oil and gas, power, telecommunications and infrastructure.

4 Baidu

BRAND VALUE: $22.7 billion
YEAR ON YEAR CHANGE: 40%
SOCIAL MEDIA RANK: NA, see footnote

Baidu expanded its mobile presence During 2012, with the launch of a low-cost smartphone using its own Baidu Cloud operating system. It also launched its own mobile browser for Android phones. As a result, the company's mobile sales tripled during 2012, affirming its determination to expand its brand into mobile territory.

2 ICBC

BRAND VALUE: $40.4 billion
YEAR ON YEAR CHANGE: -8%
SOCIAL MEDIA RANK: 19

ICBC's overseas activities driven partly by a desire to become a global financial institution not dependent exclusively on the Chinese market. Especially in the investment banking business, ICBC emphasizes its Chinese roots to differentiate from recent failures associated with Western financial institutions.

Source: BrandZ Top 50 Most Valuable Chinese Brands, Methodology and Valuation by Millward Brown

MOBILE ENCOUNTERS OF THE 4TH KIND

China is charting its course for 4G, but did operators learn from their problems with 3G?

By Don Weinland

There is never a dull moment for Chinese smartphone users. More than 330 million users have access to the greatest volume of free internet content on the planet. Whether thumbing through news, watching a soccer match or simply buying clothes or groceries, Chinese are burning mobile internet data as fast as their third-generation (3G) connections allow. But that connection often isn't quite fast enough.

"I can't always stream video with my service. I use Wifi connections for that," says Yang Liwei, an unemployed 28-year-old from Harbin, Heilongjiang Province, who uses China Mobile's 3G plan. "Of course, I want to go faster."

But Yang isn't completely willing to double the price of his service plan, which runs about RMB 80 per month, and he doesn't want to buy a more expensive phone either. He would have to do both if he wants to jump from 3G to 4G, which could be commercially available by the end of the year.

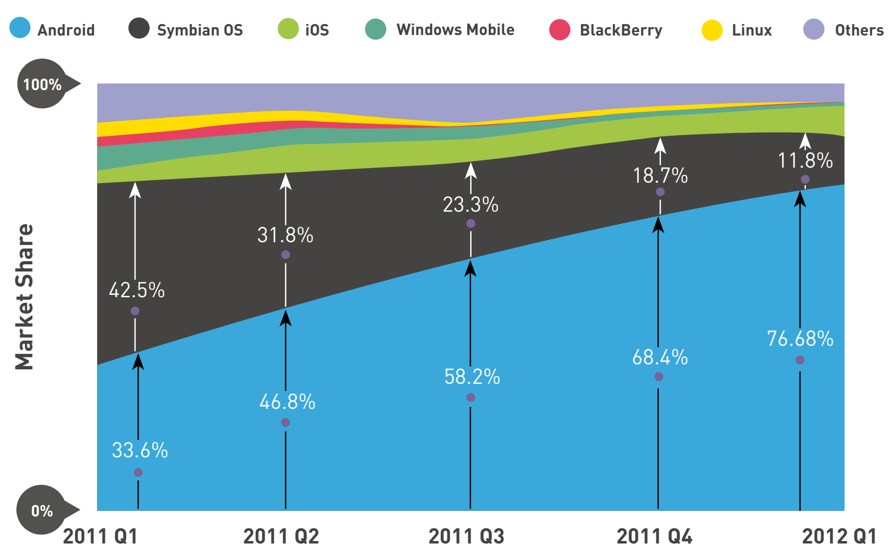
Since 2011, China Mobile has been erecting 4G towers in major cities across the country. These towers—an expected 200,000 of them by the end of 2013—pull large amounts of data from phones and other mobile devices at the same rate they feed the data into the phones. This allows users to not only watch uninterrupted videos in the palm of their hands, but also upload content to the web at the same pace. The technology is generally known as 4G or 4G LTE, which stands for "fourth-generation long-term evolution".

The government has given no official indication of when it will hand out licenses for 4G service. But as one of China's most centrally controlled state-owned enterprises, China Mobile's rollout of homegrown 4G technology is a strong indication of a soon-to-come commercial launch. The seemingly imminent approach of 4G begs the question: will it be an improvement over the torturous rollout of 3G in China?

China Mobile needs to get 4G right. The company, with 720 million subscribers, the biggest mobile provider in the world by that measure, botched its deployment of 3G by most accounts. The state's other two telecoms, China Unicom and China Telecom, with 246 million and 165 million subscribers respectively, are most certainly preparing to launch similar services. China Telecom wtih 165 million subscribers, has already pointed to a foreign-developed standard as its choice for 4G, which would allow for a deliberately speedy rollout.

Who Has the 3G Loot in China?

Android and Symbian are closing the gap on Apple for the number of 3G-capable handsets



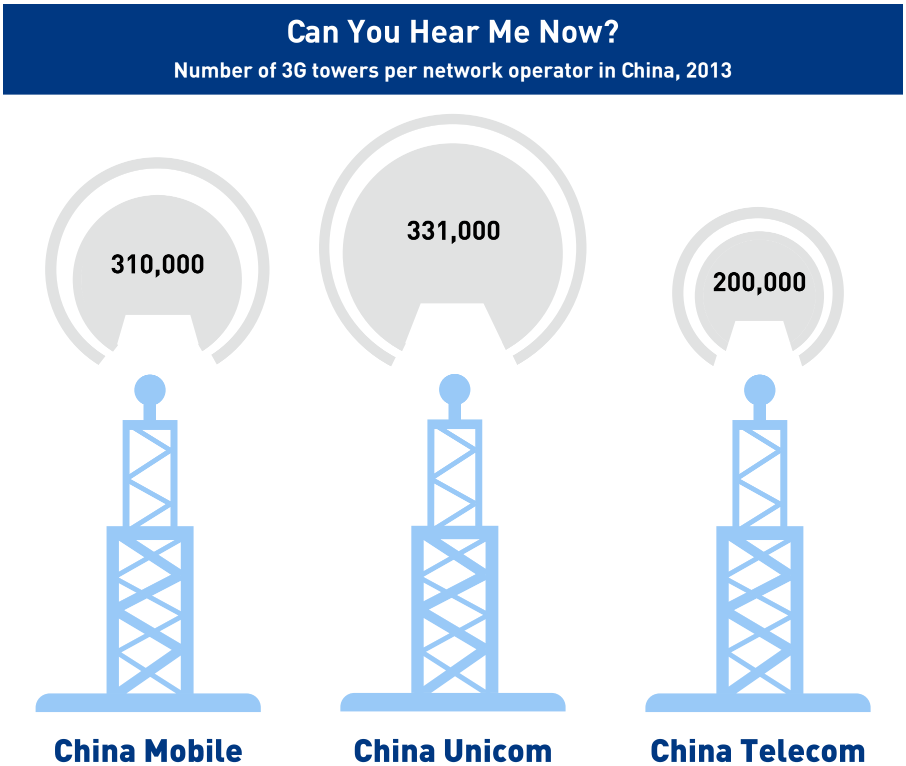
Source: Enfodesk© Analysis International

> TD-LTE is a global technology. It's not fully tested but basically the evolution is the same as FDD—meaning it works
>
> Elinor Leung
> Head of Telecom-Web Research
> CLSA investment bank

"They way that I look at it is that [China Mobile needs] the 4G technology because for them this is their 3G, this is their mobile data product which they can then use to compete against China Unicom and China Telecom," says Bertram Lai, head of China research for CIMB, a Malaysia-based investment bank.

Analysts told *CKGSB Magazine* that service plans for 4G will cost roughly double that of 3G. The networks are valuable in developed nations because of the volume of data that they sell. China Mobile will need to translate the costly deployment into profits if it wants to be the national champion of the 4G generation.

From a logistical standpoint, a 4G launch in China is already showing improvement over that of 3G. China Mobile struggled to provide devices for its 3G net-



Source: tech.hexun.com, tech.ifeng.com, tech.163.com

work four years ago, phone manufacturers look prepared this time around to meet at least most of the initial demand.

How many of China's approximately 1 billion mobile users will want to pay for 4G-capable handsets is a different question. Much of that market is still price sensitive even for 3G services, a trait that does not bode well for the more expensive 4G.

Adding to the complexity of the 4G rollout is competition between China's two smaller mobile operators and China Mobile. Depending on when the country's telecommunications regulator issues licenses, the fight for subscribers could range from China Mobile taking the entire market to all-out war with China Telecom and China Unicom. Analysts say they expect the Ministry of Industry and Internet Technology (MIIT) to wait until all parties are ready before issuing licenses for the service.

Technology Blues

The MIIT, the main telecom regulator, has been cagey on divulging details surrounding the licenses that will allow the operators to launch 4G, and with good reason.

China Mobile's 3G launch has been unsuccessful on a number of levels, leading the ministry to a more cautious approach to 4G.

China Mobile was expected to launch 3G services in 2006. However, it took three more years for the company to put its homegrown technology in working order. The other mobile operators waited patiently for the mega-carrier to prepare the service network, namely erecting towers and ironing out service coverage issues, and only then did MIIT issue licenses.

Since then, all three companies have done poorly at making money off of 3G. Average revenue per user, a baseline metric for calculating the success of mobile products, is actually falling at all three operators, according to a note from Barclays. In March, per-user revenues were more than 20% lower than they were a year earlier. In this sense, the 3G market in China is still in infancy.

MIIT doesn't want a repeat of 3G. The ministry will most likely hold onto licenses until it's sure that the operators can turn a profit on 4G.

Another technology problem added to a long list of 3G ailments for China Mobile was the supply and selection of phones. Users needed to buy phones made specifically for China Mobile's 3G and couldn't choose from the wide variety of brands and models that are compatible with global 3G standards.

China Mobile 4.0

China Mobile and its technology are on a more positive trajectory for the 4G rollout. The standard for 4G will look much more similar to those already deployed globally, a factor that should make the domestic launch easier.

The number of global 4G users is expected to more than double between 2013 and 2014, according to a recent report from technology intelligence firm Juniper Research. Next year, there could be as many as 220 million people using the service, up from 105 million this year.

The first 4G networks were launched in Norway and Sweden in late 2009, according to OpenSignal, an organization that compiles information on mobile networks. Since then, 62 countries have brought the technology online in some form, although it is often limited to urban areas or even specific districts within cities.

In December 2010, Japan was the first East Asian market to launch 4G, but Korea, which launched the following year, has one of the world's highest 4G penetration rates at about 17%.

A notable characteristic of the global launch is that most operators use FDD-LTE, a globally developed technology for 4G services. Although several other standards exist, FDD-LTE thus far has been the clear winner in the global rollout.

With an estimated 440 million 4G users by 2017, according to tech intelligence firm IHS iSuppli, China Mobile's launch will greatly offset the dominance of FDD-LTE.

TD-LTE, a standard developed primarily by China, should perform somewhat similarly to FDD-LTE, analysts say. However, China holds the intellectual property rights to many of the patents on the technology, meaning Chinese companies such as Huawei and ZTE will earn royalties on it should other countries and regions choose to adopt it.

The equipment used in TD-LTE is 70% the same as FDD-LTE, according to Elinor Leung, Head of Telecom and Internet Research at CLSA investment bank.

In contrast to the poor performing TD-SCDMA, on which China Mobile launched its 3G services, TD-LTE was developed by several global players with China leading the way. The 3G standard was more an exclusively domestic effort.

"TD-LTE is a global technology. It's not fully tested but basically the evolution is the same as FDD—meaning it works," Leung says. "But it still needs to be tested to see if it can handle so many people using the network at the same time."

The network will need that capacity because demand for the product is "humongous", Leung says, even with the product priced at a premium. Contrary to pricing trends in other markets, where new products start at a high price and gradually fall, Chinese companies will price 4G low in order to pick up initial subscribers, Leung said. From there the service cost will climb.

As with Yang Liwei, the Harbin resident, it's unclear how many Chinese will buy into services at double the cost of what they already have. Chinese want more mobile data, yet not all are willing to pay for it or the new phones they'll need to use 4G. The market will be relevant only to city dwellers at first, according to Leung.

Strong Signal

On the device side, China's switch to 4G should be a vast improvement over 3G. The 4G system will be much more flexible with phones due to its more global nature, Leung at CLSA says. All 4G phones will be usable on the TD-LTE standard, she says.

The government's momentous push for the new technology, far outshining its support for 3G, will also mean more incentives for phone makers to produce compatible phones, says James Yan, a Senior Market Analyst at US-based global market intelligence firm IDC.

> "
> Because [the government] will support this, there are benefits for phone vendors. They'll be willing to take part in China Mobile's TD-LTE
>
> James Yan
> Senior Market Analyst
> IDC

"Because [the government] will support this, there are benefits for phone vendors. They'll be willing to take part in China Mobile's TD-LTE," Yan says. "I'm pretty optimistic about this."

One phone maker held high hopes for a possible 4G launch this year and its impact on the smartphone market. In January, Jeffery Yang, Huawei's Vice-President and Chief Marketing Officer for the China region told *CKGSB Magazine* that the issuing of 4G licenses would be the biggest driver for China's smartphone market this year.

Analysts have predicted phone sales to be dominated by lower-priced products in smaller cities as a new generation of Chinese enters the market. But a 4G launch could bring that attention back to the cities, where the vast majority of the high-speed data market is thought to exist.

Political Network

Considerable political intrigue is tied into the 4G launch. Since a major overhaul to China's telecom sector in 2008, the then-newly formed MIIT has maintained a pro-consumer mantra that has sought to reduce monopoly in the industry, according to CIMB's Lai.

Issuing licenses sooner rather than later would only serve to give China Mobile a significant head start, and thus a hold onto the vast majority of subscribers.

The National Development and Reform Commission, a ministry-level body under China's State Council, has been pushing for the quickest 4G rollout possible, Lai says, as has China Mobile. The company is composed of the top managers from an earlier rendition of the MIIT, which broke off to form the mobile company in the late 1990s. Its political sway is considerable.

It's also the carrier of the homegrown technologies TD-SCDMA and TD-LTE, which the ministry instructed it to use. The success of these domestic technologies—which are seen as representations of China's technical prowess—is a top priority of the ministry's.

China Telecom is a similar concoction of regulators-turned-businesspeople, only at a less influential level, according to Lai. China Unicom has little political influence. The two smaller companies are hard at work trying to convince the regulator to delay 4G so they can continue monetizing an immature 3G market.

All three mobile companies' agendas considered, the MIIT will likely begin issuing licenses toward the end of the year when the smaller companies are better prepared.

Mobile Cold War

China Telecom Chief Executive Wang Xiaochu polarized China's mobile industry in late March when he hinted that the company would deploy its 4G services on a Western-developed standard instead of the China-developed standard. The announcement shouldn't come as much of a surprise. Both China Telecom and China Unicom have used foreign standards to launch 3G over the past four years with relative ease.

The two smaller operators have essentially caught up with China Mobile despite the latter having a years-long head start in preparing the network. In March, China Mobile had about 104 million 3G users. China Unicom and China Telecom had about 83 million and 74 million, respectively.

At the earnings meeting where Wang disclosed the tentative plans, media sources also reported that he attempted to quell worries that the company, by far the smallest of the three giants, would lag behind China Mobile. Investors have worried that China Mobile could scoop up the majority of the early 4G market because it is far ahead in installing service towers.

Wang told investors and reporters that the rollout on the foreign-developed standard FDD would be quick and cheap. The claim is legitimate. FDD-LTE is a tested and largely proven standard. Rollouts in markets such as the US, Japan and Korea will add to the efficiency but reduce the price of a rollout in China.

Following the Money

Just as important as which standard will be used is where it will be used. Wang at China Telecom specified that his company would target only customers in urban centers, not across the eastern seaboard like China Mobile. The more focused launch could pick up customers where they exist and cut back on unnecessary infrastructure in places where people are unlikely to pay for pricey data services, analysts said.

This caveat could be the big difference between China Mobile and China Telecom in the cost of 4G. In fact, China Mobile's political status as a national champion, and the correlating government directives to reach as many people as possible, could hurt it.

"The way China Telecom will lower their 4G capital expenditure is by lowering the number of base stations and just by focusing on where they think the customers are, instead of having this mandate to launch it nationwide," says CIMB's Lai, referring to the political pressure on China Mobile to reach as many potential customers as possible.

Capital expenditure on 4G has been a major worry for investors in the two firms early this year. A report from Citibank said the companies will struggle to get returns on the investments in the short and medium terms.

China Unicom, which has most successfully monetized 3G deployment in China, has stated its preference for the more globally common FDD standard. In a report, Barclays toned down investor concerns over an expensive 4G network for China Unicom.

The firm, like China Telecom, will focus on 'hot spots', namely cities, for the service, while only allocating one-eighth of its capital expenditure on 4G in 2013, a far lower ratio than at the other two carriers.

Going Global

Although China's mobile market is the biggest and one of the fastest growing in the world, TD-LTE, developers like Huawei and ZTE, China's biggest telecommunication equipment makers, are looking beyond the Middle Kingdom. As mobile services develop beyond 4G, the country's leadership certainly hopes to position China's economy as a net exporter of telecommunications technology—an ambition that may be within grasp.

The FDD frequency spectrum is increasingly crowded, and as more countries and carriers launch 4G, space at the FDD wavelength will be limited, leading to what many say would be a greater adoption of TD-LTE, which uses lower frequencies.

Some international operators have already deployed the Chinese technology. In the Indian state of Kerala, Airtel launched TD-LTE in partnership with ZTE. According to reports from Digimedia, there is yet more interest in the standard in India.

> "Absolutely there is interest in [TD-LTE] outside of China
>
> Daryl Schoolar
> Principal Analyst
> Ovum

In addition, some 59 other operators have already shown interest in the Chinese technology this year, according to an Ovum market research report. This could mean a buy up of the Chinese-developed version.

"Absolutely there is interest in [TD-LTE] outside of China," says Daryl Schoolar, Principal Analyst at Ovum. Sweden-based Ericsson, one of the world's biggest telecommunications companies, has expressed interest in buying more networks that use both TD and FDD as space on the FDD frequency grows scarce, he says.

There's more to China's 4G rollout than success at home. The world's telecom players are no doubt waiting to see how a TD-LTE network performs in China. If China Mobile can make the standard work, the country can expect a greater global interest in the technology.

It may be late in the game for China and TD-LTE to become dominant players in the global 4G rollout. But if Samsung's hopes of going live with '5G' by 2020 are realized, as South Korea's state media reports, China may be able to perfect its positioning as one of the most influential actors on the global telecom stage in time for the fifth-generation.

No Love Lost

Can foreign carmakers in China continue to dominate the market while appeasing their Chinese counterparts?

By Engen Tham

CCTV, China's powerful state-run television broadcaster, unleashed a torrent of faulty vehicle claims against foreign automakers in March. First, the network targeted Volkswagen, alleging transmission issues with some of its cars, which led to the recall of more than 380,000 vehicles at an estimated cost of $618 million. The broadcaster then attacked BMW and Daimler, who were accused of selling cars that produced harmful fumes.

The media's indictment of foreign carmakers dovetails with China's policy to nurture indigenous players. From removing financial incentives for foreign carmakers to requiring they launch Chinese brands, Beijing has tried to curtail the seemingly endless popularity of non-local autos as domestic brands continue to cede ground to their foreign counterparts. Foreign auto manufacturers first set foot in the Chinese market 30 years ago, fully aware that the state allowed their entry into the market on the condition that they enter into joint ventures (JVs) with domestic firms, who were expected to benefit from their technical expertise. Despite a lack of complete freedom, they've flourished ever since, but the latest round of government-sanctioned media criticisms may force foreign companies to change tack.

Slow Start

The Chinese auto industry has grown rapidly since the nation opened its doors in 1972, shouldering past the US in 2009 to become the word's largest. Domestic players have profited from this expansion, but their market share is receding compared to foreign car makers: the 30% portion held by Chinese brands at the end of 2009 fell to 26% in 2012 according to financial research firm Sanford C. Bernstein.

This is not the turn of events China hoped for when it granted foreign auto manufacturers market access in 1984. Beijing knew its carmakers were behind the curve on precision manufacturing, so it encouraged JVs with foreign firms to bolster domestic tech-expertise, hopefully leading to a globally recognized national champion.

"The joint venture policy towards the auto businesses in China has always been one of 'you're a guest, you're invited and we will tell you the rules by which you must play,'" says William Russo, Senior Advisor at consulting company Booz & Co.

In 1984, Zhao Ziyang, China's then premier, said JVs would facilitate the consolidation of the auto market into three large and three small producers, with high levels of local content. Zhao's vision has not come to pass. Different outlets give different estimates—*The Wall Street Journal* said there were 170 Chinese automakers as of April this year, while the *International Business Times* cited only 115 companies as of 2012, neither news outlet divulging the source of their information—the China Association of Automobile Manufacturers declined to confirm any specific figure. Either way, even the ballpark is well off from Zhao's prescription.

Not only has consolidation not occurred, but local carmakers also remain umbilically dependent on their foreign JVs for profits. Shanghai Automotive Industry Corporation (SAIC), China's largest car manufacturer, owes 90% of its sales to its foreign JVs, according to a research paper from January this year called "Case Study: SAIC Motor Corporation" published by the US think tank Center for Strategic and International Studies (CSIS). And no Chinese carmaker has managed to design and produce a single car that has won global acclaim.

In stark contrast, foreign carmarkers have thrived. "The Chinese market is very orientated towards foreign brands. Three out of every four cars sold in China carry a foreign brand," says Russo.

> "The challenge that Chinese car companies have is convincing their own consumers that Chinese companies in fact can make good cars
>
> William Russo
> Senior Advisor
> Booz & Co.

The China market, now General Motor's (GM) largest, was the US company's savior during the financial crisis, as sales in the nation helped it heave itself out of bankruptcy proceedings in 2009. Since the firm tied itself to SAIC nine years ago, it has amassed 14.7% of China's market share, earning a profit of $1.5 billion in 2011 from its joint venture, according to GM China reports. Still confident of its position in China, GM aims to increase sales by 75% in two years to 5 million cars.

China is also Audi's most lucrative market. The German manufacturer's sales increased by 14.2% in the first quarter of 2013, to almost 103,000 vehicles and it is planning to open a new plant in Foshan, Guangdong province, which will have a manufacturing capacity of 150,000 cars annually when it opens for production at the end of this year according to state-run *China Daily*.

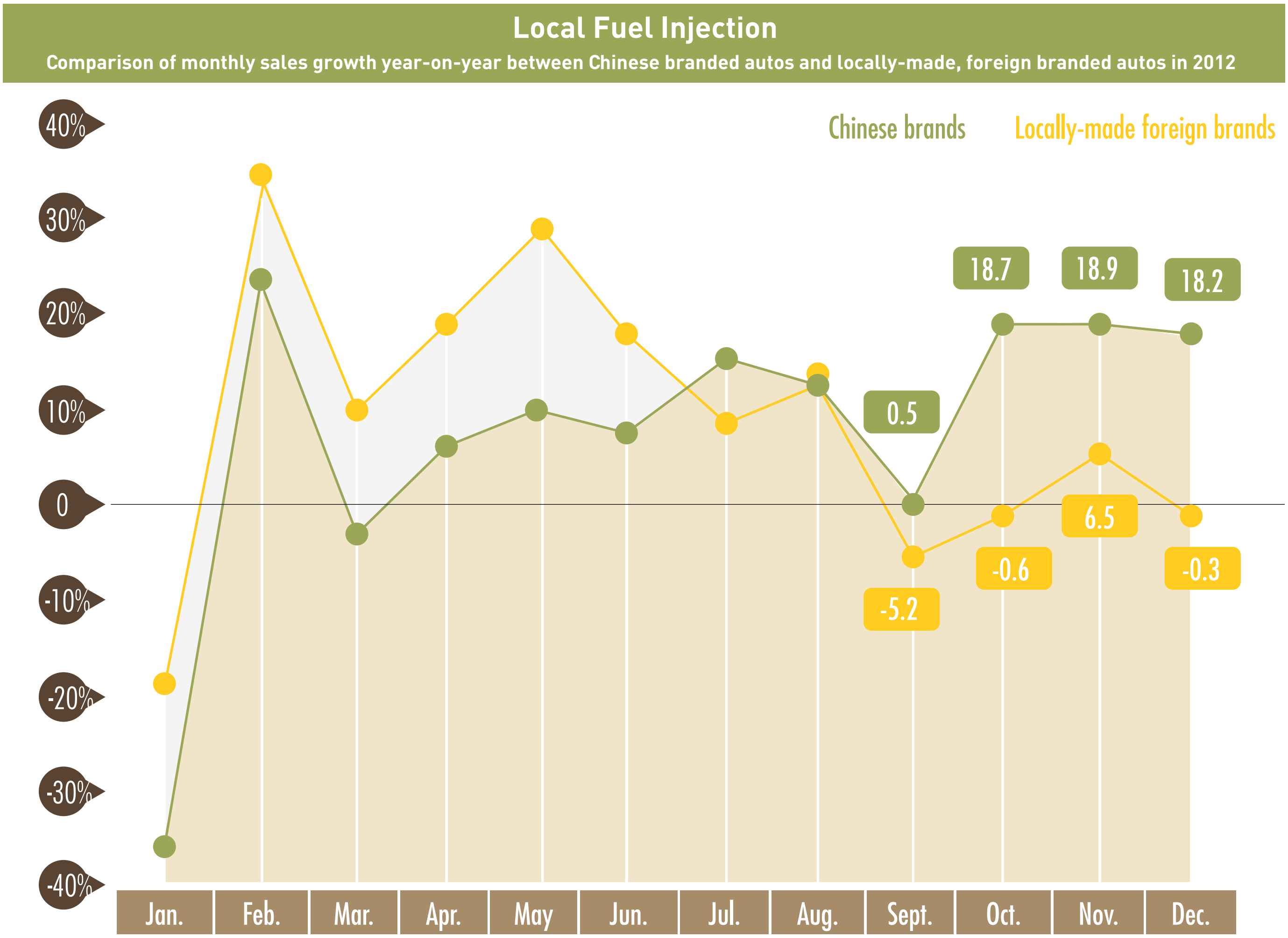
Still Second Choice

Chinese consumers are buying foreign brands over local ones, because domestic makers are finding it hard to shake off poor repute. "The challenge that Chinese car companies have is convincing their own consumers that Chinese companies in fact can make good cars," says Russo.

A number of Chinese brand cars have failed foreign safety standards, sullying the reputation of Chinese carmakers and making it difficult for indigenous brands to market themselves at home and abroad. Brilliance China Automotive, a firm tied to both Bayerische and Toyota, tried to sell its BS6 sedan in Europe in 2007, but earned only one out of five stars for safety from a German car association, which said the driver would have little chance of surviving a side collision.

Chinese car companies find it tough to ratchet up the quality, in part because they lag on research and development spending. "Most Chinese companies are thinking five to six years out with their R&D spending and trying to compete with international companies that are already thinking 20 to 25 years out," says Nat Ahrens, Deputy Director and Fellow of the Hills Program on Governance at CSIS.

This thrifty approach means Chinese companies have less to spend on nurturing innovative engineering and design. In-



Source: auto.sina.com.cn

stead of creating a car from scratch, which would allow them to claim half the patent rights, Chinese JV partners take existing foreign vehicle blueprints, make a few changes and call it a new JV auto: GM and SAIC's first JV car, Baojun 630, is built on the old Buick Excelle, while Dongfeng and Nissan's first Venucia vehicle is fashioned after Tiida. By taking the path of least resistance, Chinese JV companies demonstrate to the consumer their reliance on foreign tech for quality, which does little to raise confidence in their own brands.

Driven to Distraction

The relative success of Western brands against languid domestic ones has sparked indignation and embarrassment among Chinese commentators. In January, Communist Party mouthpiece *The People's Daily* blamed foreign companies for the sluggish performance of domestic players, writing, "Most Chinese car companies involved with JVs have not received the technology they were promised." In September last year, former machinery and industry minister He Guangyuan said JVs are "like opium" and likened China's JV policy to a negative addiction. "So many years have passed and we don't even have one brand that can be competitive in the auto word," He said.

But some feel that China's expectations of tech transfer were too high. "I don't think any promises were broken, these contracts are laid out very clearly on what was going to be transferred and what wasn't… I don't think that there was any deception on the part of the foreign partners," says Ahrens. "You can't force technology transfer."

Market Remodel

As the strength of Western brands has grown, China has pushed back by trimming the incentives and freedoms of foreign automakers. In January last year, China said it would no longer promote investments from foreign carmakers through preferential tax treatment and streamlined approval processes, increasing costs for foreign manufacturers.

The month after, Beijing excluded foreign carmakes from a newly released list of approved vehicles for government use. While this measure will have little impact on the profits of foreign carmakers such as Audi and Mercedes (brands that were included on previous lists), it signaled Beijing's determination to freeze out non-local competition. In April of the same year, Maxime Picat, the Director General of Peugeot-Citroen's Chinese joint venture, said Beijing was threatening to restrict the firm's manufacturing expansion plans unless it launched local brands.

The squeeze on foreign auto manufacturers is likely to put a strain on existing JV relationships, making the negotiation process for new deals increasingly delicate. The conflict inherent in a joint venture between two would-be competitors is clear. "A foreign company's interest is not to nurture a local company so that it is as successful or more successful than itself. It will undoubtedly withhold some of its crucial technology," says Teng Bingsheng, Associate Professor of Strategic Management at the Cheung Kong Graduate School of Business. At the same time, domestic firms are bartering with access to the largest auto market in the world at a time when foreign firms, whose own markets are drying up, can ill afford to be choosy. Under government pressure, the biggest challenge for an existing foreign JV partner will be how to relinquish enough intellectual property to placate Beijing, while at the same time, invest sufficient amounts in R&D to maintain its lead over local and other international players.

But China's actions are not likely to wean consumers off foreign brands as the central issue is one of demand not supply. "Government policy cannot change the nature of demand. Chinese consumers will spend their money on the brands they prefer and there is very little that can be done to force Chinese consumers to buy Chinese brands," says Russo.

This Chinese consumer preference is likely why state media reports went after foreign carmakers to begin with, to damage their brand equity in hopes of restoring balance between foreign and domestic brand preference. But it will take more than a few quality-control reports to undo the brand resonance of foreign cars. Chinese brands will have to spend a significant amount of time garnering consumer confidence before they become as popular as well known international carmakers.

The Chinese government's distortion of the market may also have unintended consequences. The launch of new domestic brands by foreign JVs will add another level of competition to an already fragmented market and take business away from Chinese companies who are already struggling to build their market share. By ramping up competition, China in fact weakens the position of wholly-domestic brands like Chery and BYD, thus stifling their own plans for a national champion.

> "A foreign company's interest is not to nurture a local company
>
> Teng Bingsheng
> Associate Professor of Strategic Management
> CKGSB

"For example, if GM launches a domestic brand, customers that would otherwise be buying a Chery or BYD car will see a car coming from Shanghai General Motors [the GM joint venture with SAIC] and will buy that instead," says Russo. "So they [the State] are going to eat their own young."

Just a Fender Bender

Despite Beijing's cooling approach to foreign carmakers, the country's leaders are unlikely to stifle them completely. "At the end of the day, the government wants to see the domestic car industry succeed, but many of the Chinese companies depend on successful foreign joint ventures to contribute to their profitability and they won't do anything to harm those companies, because that would ultimately harm the whole industry," says Russo.

In spite of the complications, foreign carmakers are finding their tie-ups beneficial in some ways. GM is using SAIC's low-cost vehicle technology to vault into emerging Asian markets. SAIC's technology for producing cars priced as low as $4,800 is central to GM's plans to plug middle-class needs in India and Indonesia. Also it has been reported that BMW and Chinese Brilliance brand Zhi Nuo—which roughly translates as "The Promise"—may start exporting their vehicles to Europe.

The government's latest measures to suckle a national auto champion are unlikely to seriously dent foreign makers' prospects in the short-term. Ultimately, consumer choice determines the winners and losers and the Chinese are increasingly buying foreign brand vehicles. Also, the structure of the market is so dependent on symbiotic JVs that separation in the near-term would damage both parties.

The biggest long-term threat to foreign carmakers in China is competition from increasingly sophisticated Chinese brands, whose manufacturing skills are developing steadily. Nissan and Honda, two Japanese brands known for their attention to detail, stated publicly that they now outsource heavily to local Chinese suppliers. Quintessentially precise Mercedes-Benz-manufacturer Daimler opened a trial engine production plant in China in May. A decade ago, this would have been unthinkable given the quality of production in China.

Experts draw comparisons between the fledgling Chinese car market and the early Japanese one. In the 1970s, consumers largely thought of Japanese cars as cheap machines. Now, Japanese manufacturers produce premium lines. Hyundai was originally well known for its affordably priced cars, and now makes very innovative, high-quality products. "Great Wall, Geely and Shanghai Auto are capable of making good, quality cars and give an indication that the Chinese car industry will be able to produce a globally competitive car company," says Russo. "It's a question of time."

SMEARED!

How smear campaigns are hurting businesses in China

By Angela Doland

In China, the benevolent cartoon of Master Kong—pudgy, cheerful, topped with a white chef's toque—is the face of instant noodles, the ubiquitous logo that grins out from supermarket shelves. The brand has the largest market share in China's instant noodle business, with flavors to tempt taste buds from Shanghai to Kashgar, as well as assorted other beverages and snacks. Tubs of dry, uncooked Master Kong noodles, sold for roughly 4 yuan, are a staple in Chinese dormitories and train stations. There's even a Master Kong noodle-making museum in Tianjin, where the company was founded by brothers from Taiwan in 1992.

Understandably Chinese consumers were taken aback when accusations appeared on microblogs late last year claiming that the Hong Kong-listed maker of Master Kong, Tingyi (Cayman Islands) Holding Corp., was actually a Japanese company in disguise. The rumor broke out during China's territorial dispute with Japan over the Diaoyu/Senkaku islands in the East China Sea, when mainland rioters were smashing Japanese cars and demolishing sushi shops. Some microbloggers claimed that Master Kong, China's noodle king, had donated JPY 300 million (RMB 19.2 million) to Japan to purchase the disputed islands. They incited followers to "spread the message, and let all our countrymen know!"

University students organized boycotts. Photos of Master Kong products appeared on banners at anti-Japanese demonstrations. An unnamed Tingyi executive quoted in the *China Times* blamed rival company Uni-President for the rumors, a charge the competitor denied. Throughout the crisis, Tingyi released statements refuting the allegations.

And yet the ridiculous-sounding rumor proved disastrous: Tingyi's share price slid from about HK$24 (RMB 19) to about HK$20 (RMB 16) from mid-September to early January, as documented by Chinese media blog Danwei. The company's net profit plummeted 75% in the last quarter of the year, dropping to $14.9 million (RMB 91.4 million). What happened?

> "China prevents free flow of information, creating an environment where rumor and gossip flourish
>
> Steven M. Dickinson
> Attorney
> Harris & Moure

Gossip, Rumors and Lies

Rumors, always potent in an age of social networking, are especially dangerous for companies operating in China, public relations specialists say. In one case, the share price of leading search engine Baidu dropped late last year amid rumors that co-founder Robin Li was divorcing his wife. Li was forced to broach the subject—awkwardly—while accepting a business award in December, denying the rumor and blaming unnamed competitors. In January, rumors spread on the internet in China that Coca-Cola Co.'s Minute Maid orange juice contained a harmful pesticide. The company swiftly issued a denial, said it had filed a police report about the rumors and reassured consumers that Chinese health officials had tested the juice and pronounced it clean. In such cases, it's often difficult to pinpoint where the gossip originated, though there's a tendency to blame competitors.

There are a host of reasons why rumors proliferate in China: in a country where information is tightly controlled, many here are skeptical of official news outlets and sources of authority. "[The government argues that] the web must be actively policed to prevent the spread of harmful rumors… The reality, of course, is that China prevents free flow of information, creating an environment where rumor and gossip flourish," says Steven M. Dickinson, a lawyer with Harris & Moure and co-author of the *China Law Blog*.

While the State Internet Information Office cracks down on some rumors—as seen in a recent wave of arrests of users spreading panic online about the H7N9 bird flu virus—it focuses only on those deemed especially sensitive. Most business-oriented rumors go unchecked.

Companies themselves often aren't transparent with investors and media. Though Tingyi issued public denials throughout the Master Kong crisis, it hasn't always been forthcoming. In 2011, a blog for *The Wall Street Journal* recounted how Master Kong annoyed shareholders and reporters by barring them from an analysts' briefing on a strategic alliance with PepsiCo Inc.

In China, "many companies are extraordinarily non-transparent, even to the point that basic information you would expect as an investor is not disclosed," says David Wolf, Managing Director of the Global China practice of Allison+Partners, a San Francisco-based PR firm. "It's a perfect breeding ground for mistrust. It's a petri dish for rumors."

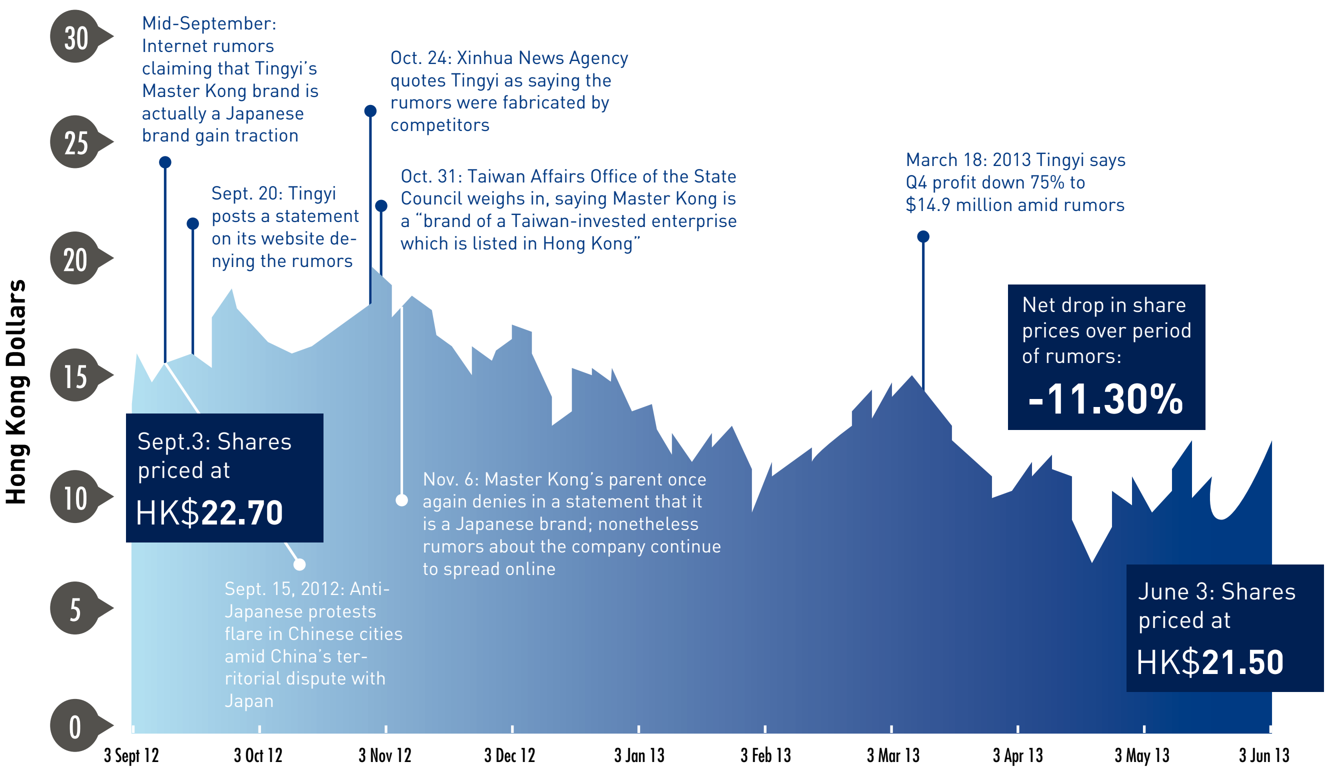
In the case of Master Kong, hidden amid the rumors was a grain of truth. Though Taiwan's Ting Hsin International Group owns the largest stake in Master Kong, 33.27%, Japan's Sanyo Foods Co. Ltd. has the second-largest stake, with 33.18%. Some consumers might not have been aware of that, and the over-the-top rumors drew their attention to it.

The World of "Dark PR"

In a cutthroat business environment, there's an entire industry devoted to business misinformation. So-called "black PR" firms sometimes recruit people to

Words Hurt

Charting Tingyi's daily stock prices and the impact of the anti-Japanese smear campaign



Source: Yahoo! Finance (stock price data)

write phony product reviews—a Taiwanese subsidiary of Samsung recently faced allegations that it hired people to write fake reviews bashing a competing cell phone, the HTC One.

Sometimes, all it takes is a well-placed comment from an opinion leader with a few thousand followers on Weibo, and a rumor might go viral.

Sam Flemming, Founder and CEO of China's CIC, a social business intelligence provider, pores over online chatter for his clients, mostly multinationals operating in China.

"We have worked on cases with clients where there is no absolute proof, but it's pretty convincing that something is being manufactured [online to purposely harm a company]," says Flemming. A slew of negative comments from newly registered accounts is one suspicious sign, he says.

In Master Kong's case, media reports suggested at the time that Tingyi, who controls more than half of China's competitive instant noodle market, had gathered material for a complaint against a competitor, but the company didn't respond to follow-up questions on the case.

"If it was a competitor, and if it's true that Japanese investors control a significant portion of the company, that's a pretty clever way to make a point," Flemming says. "I'm not saying it's right, but touching on nationalism is always good for the retweet."

Pride, Pocketbooks and Poison

Tapping into patriotism is one way to make rumors go viral. Consumers tend to get upset if they believe they receive lower-quality products or services than customers elsewhere. Case in point, when CCTV reported in March that iPhone warranty policies were unfair to China's consumers, Apple Inc.'s Chief Executive Tim Cook was forced to apologize and pledge improved customer service. Pocketbook issues also come up—amid recent reports that Tencent's WeChat would start charging customers, users voiced anger at potentially paying for something they had been getting for free.

Consumer safety is likely the biggest concern. That's where most rumors tend to swirl, especially after the 2008 milk powder crisis when at least six children died and thousands fell ill after drinking tainted formula. With customers in a panic, rumors about milk products are constantly popping up, some of them outrageous. In 2010, rumors alleged that China's Synutra baby formula had caused three infant girls to develop breasts prematurely. After testing, the government determined the milk was safe, as the company had insisted. Where did the rumors start? With a competitor, some media reported.

Whatever the cause, the damage was vast: in the year ending March 2011, Synutra International's sales dropped 15% from the previous year, and it logged a $40.1 million loss. That's how even a preposterous tale of babies growing breasts can cost a company tens of millions of dollars.

Rumor-Fighting Checklist

Experts tell *CKGSB Magazine* how companies can navigate the rumor mill

Let the sunshine in

If there's a lack of readily available information about your company, rumors will fill the void. "If you're not going to bring sunshine in, expect fungus to grow… If there's no disclosure, there's no trust, and it leaves companies highly susceptible to lasting damage to their business," says David Wolf of Allison+Partners. Having a wide social media imprint is important, as is having good relationships with journalists and opinion leaders online.

Prepare for the worst

Rumor-fighting is a crucial part of your company's crisis response preparation and media training. Companies should practice how to respond to rumor scenarios, experts say. A complete response might include a statement, a reaction on social media and a list of FAQs to clearly state why the rumor is wrong. "You get through half a dozen of those [practice scenarios], and you find going through that process has created a set of corporate muscles that didn't exist before—it's those muscles that enable a response," Wolf says.

Time it right

All experts agree on one thing: Fight rumors fast.

Sam Flemming, the founder of CIC, adds nuance to that advice. While companies must keep close track of budding rumors, he says, there's such a thing as reacting too quickly.

"If something's just on social media, if you react on it, comment on it, you can make it bigger than it is," he says. "You want to get out there either just before or just after traditional media picks up on it."

Don't play dirty

In China, a multitude of "dark PR" firms will offer to scrub the web clean of negative press and gossip about your company, usually by bribing website employees to erase them. Don't be tempted. Such practices are illegal, and police have raided PR firms that offered them, as detailed in February by *Caixin* magazine.

Darren Burns, Weber Shandwick's Managing Director for China, says his PR company was recently kept out of a digital pitch because it refused to erase negative online postings about the company in question within 24 hours.

Though some multinational firms occasionally resort to the practice, it's more common among Chinese firms. Burns says paying a dark PR firm to erase posts "is the most ridiculous thing you can do. You risk damaging your reputation, which leads to lower sales for sure." Thankfully, he says, the practice seems to be dissipating.

Know the law

Foreigners often misunderstand Chinese law on these issues, says lawyer Steven M. Dickinson. "Unlike the US, in China the ISP is liable for false statements posted on the web," Dickinson says. "So the strategy in China is to immediately go after the ISP to get the stuff removed."

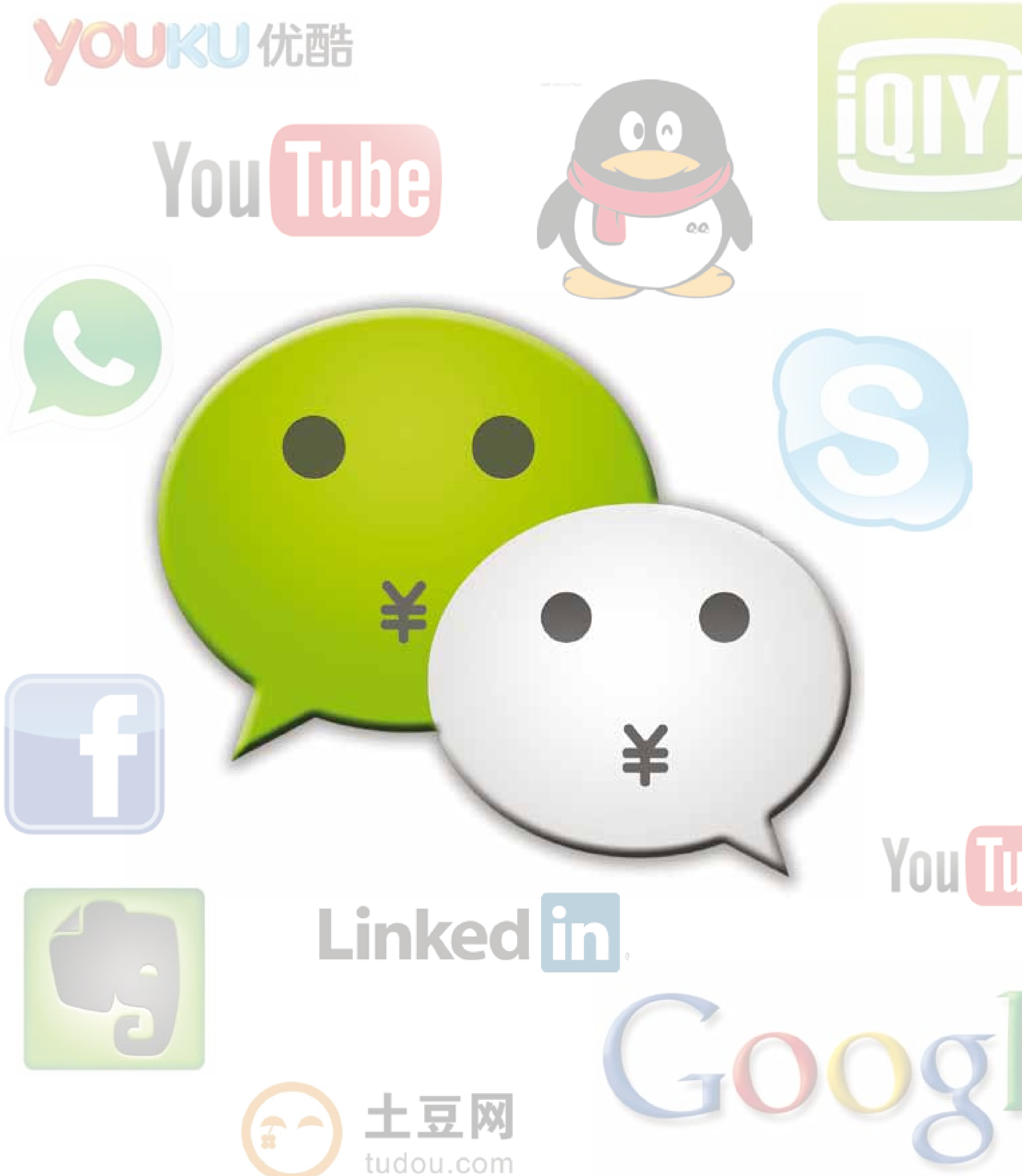
A tort law passed in China 2010 allows people to sue when their reputations are harmed online.

Take the pulse

Companies need to track the brand to "know at any given time where they stand with consumers. If they know they're slipping, if they know these things are coming up, if they see discourse on line, they need to find that out as soon as possible, and take some measures to deal with it," says Denise Sabet, Vice General Manager of China-based brand consultancy Labbrand. Typically, brand tracking services in China cost RMB 1 million-1.5 million for the first year, and slightly less in subsequent years.

Seek balance

Brand equity rests on four pillars: relevance to consumers, differentiation from existing products, knowledge about your brand and esteem for it. In China, a young market, many brands put the emphasis on differentiation and relevance. "I think most brands are still very focused on that sort of initial market entry mindset—there aren't a lot of brands thinking long-term enough to get into the esteem and knowledge element," Labbrand's Sabet says. But if consumers have deep knowledge of a brand and respect for it, they will shrug off rumors and crises when they hit.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Future of Free

How companies like Tencent are finding ways to keep their services free

By Ana Swanson

China is in love with Tencent's mobile chatting application, WeChat (Weixin in Chinese). The service—a close copy of the US application WhatsApp but with novel features like a 'shake' function to add new friends and walkie-talkie-like voice chatting—had more than 260 million users in China as of April 2013, according to company figures, after only a little more than two years of operation.

But like many who fall in love, WeChat's users can be a fickle bunch. "My opinion is that if they start to charge, most people will stop using it," Chaoping Zhu, a 36-year-old IT worker in Shanghai, says of the Tencent application. "Currently it's very cheap, very convenient, but it's also very easy to be duplicated by others." If he had to pay, Chaoping says, he would switch from WeChat to a similar free program, such as Momo, a location-based social networking and dating application, or Tencent's old chatting standby, QQ.

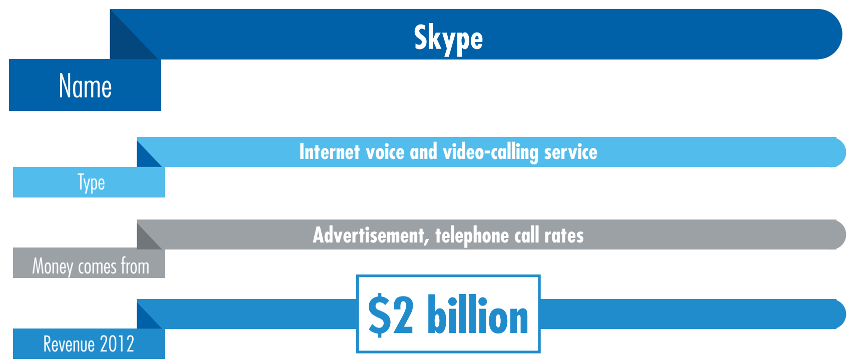
Most young Chinese agree with him. An online poll by the official Xinhua News Agency found that around 90% of WeChat users said they would drop the service if it began to charge. The question became a hot topic in March, when technology minister Miao Wei said that China's telecom operators might put pressure on Tencent to start charging for the application because of its heavy use of bandwidth. (*See Shifting Sands.*)

Tencent clarified at the beginning of April that it was unlikely to charge for using WeChat. However, analysts have said the company would likely generate fees from the product in other ways, for example introducing games with paid-for virtual bonus items, such as armor, weapons or medicine. Tencent officially announced their plans to add games to WeChat in mid-May. In doing so, Tencent will adopt what the technology industry terms a 'freemium' business model, in which a basic service is provided for free, with the goal of getting some users to upgrade and pay additional fees for premium features and functionality. "It's very much a 'build it and they will come' mentality," says Michael Clendenin, Managing Director of RedTech Advisors, a Shanghai-based research firm that specializes in the technology industry.

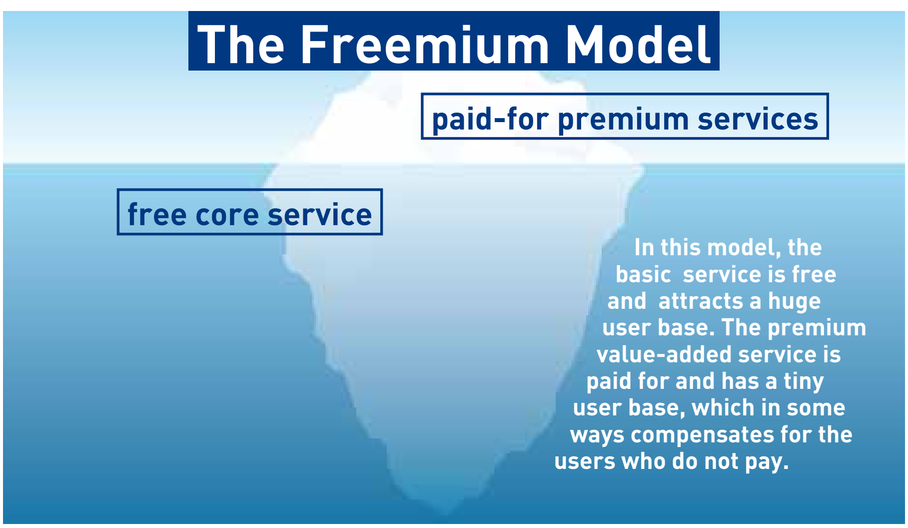
Freemium has become a widely adopted business model in the tech world, supporting such success stories as file-sharing service Dropbox, note-taking software Evernote and internet calling service Skype (See Flavors of Freemium). But for countless other companies, providing a unique and useful service for free while still covering costs has been a tricky prospect. Many freemium services and applications, including several Chinese Craigslist clones, have gone out of business, and high-profile tech executives like Alibaba Group's Jack Ma have commented that free is no longer a sustainable business model.

Analysts say Tencent has the experience and cash reserves necessary to generate substantial returns from the freemium model. But for the scores of smaller Chinese tech companies that Tencent is driving out of business, the future of freemium looks far less certain.

Flavors of Freemium-1



Source: Company reports



The Rise of Freemium

The basic business model of freemium has been around since the 1980s when software companies began offering trials of their products for a limited time or with limited features in an effort to gain more users. In the last decade, the model has proliferated, appearing everywhere from free-to-play games to the 'soft' paywall of *The New York Times*, which allows readers to view a set number of articles for free each month before asking them to pay.

The decision to offer digital goods for free was not motivated by a newfound generosity towards consumers, but simple economics.

He Chuan, Associate Professor of Marketing at the Leeds School of Business at the University of Colorado at Boulder and Visiting Professor at Cheung Kong Graduate School of Business, says that the freemium business model stems from a much older concept—offering a low-priced basic service and a high-priced premium service. In the internet age, however, the marginal cost of producing a digital good has dropped to almost zero, making the freemium model possible, says He.

In the old days, a music company would incur a significant cost for producing and selling a CD. Today, duplicating and distributing an MP3 file on the web costs almost nothing, so competition pushes companies to offer free products.

The business model can also be seen as a kind of "unbundling", or selling certain digital services separate from others in order to serve customers of all demand levels, He says. This allows a company to tap value from all its users and maximize revenue, while also removing an initial barrier between many potential customers and product trials.

Mark Natkin, Managing Director of Marbridge Consulting in Beijing, says online game companies in particular have benefited from unbundling their services. Most companies used to offer their games on a subscription basis, where a consumer would pay for their game time upfront. But that derailed many potential users.

When companies began letting people play for free and purchase items in the game as they liked, they not only attracted larger user bases, but also earned more. "The idea is you don't leave anything on the table. You basically get all the revenue you can from every user," says Natkin.

The proclivity for maximizing revenue has pushed freemium to become the dominant model for mobile applications in recent years. Analytics firm IHS iSuppli estimates that in-app purchases will account for 64% of global application revenue by 2015, up from 39% in 2012 and less than 20% in 2010.

The model is also particularly suited to China. First, consumers have less disposable income on average, and therefore are more likely to be discouraged by an upfront payment for a digital product.

> "The idea is you don't leave anything on the table
>
> Mark Natkin
> Managing Director
> Marbridge Consulting

"I think China is a much tougher market, because average incomes are much lower than the West," says David Zhu, the CTO and Co-Founder of Hong Kong-based Enterproid, which is developing a free-to-use mobile application called Divide. Divide creates a separate and secure workspace on a worker's personal phone, protecting the worker's privacy and eliminating the need to carry around a separate BlackBerry for work. "Chinese businesses have to be a lot more creative in getting users to 'impulse buy' or really pay for services. They need to take revenue where they can get it."

Second, the freemium model can help to protect online services and applications from China's rampant piracy. Most game companies in the West generate revenue by selling discs or CDs with their games; in China, however, these can be duplicated by pirates within weeks. With the free-to-play model, gamers log on to the operators' servers to play the game, and operators generate most of their revenue from in-game advertising and micropayments, rather than a one-time fee.

Tencent in particular has built one of the world's biggest gaming empires off of the free-to-play business model. The company generated RMB 43.89 billion ($7.1 billion) in revenue in 2012, up a stunning 54% year-on-year. Its profits for the year were RMB 12.78 billion ($2 billion), up 25% annually.

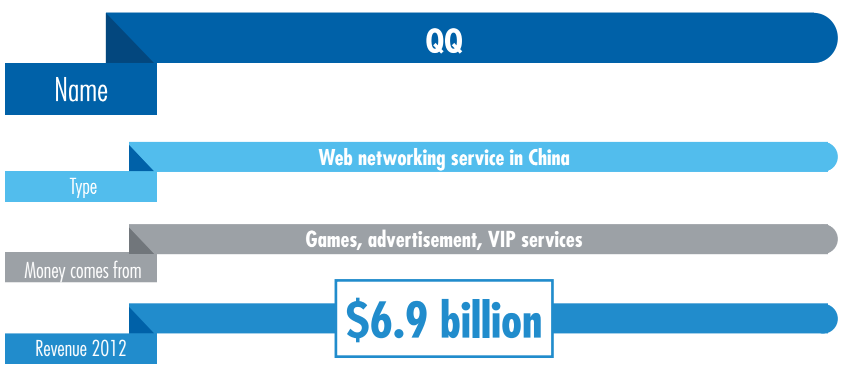
"Tencent is famous for developing this model in which, instead of charging a sizable monthly user fee, you let everyone use your products for free and introduce a variety of value-added services or virtual items. If you have an enormous user base, this adds up to fairly significant revenues," says Natkin.

No Such Thing as Free

The freemium model has generated big profits for some companies, but it also presents significant challenges.

Companies that adopt a freemium model must recruit large user bases to succeed, since typically only 2-5% of users choose to pay for premium services. But whether a company can amass the necessary users is a big gamble, especially for a

Flavors of Freemium-2



Source: Company reports

Let Freemium Ring

US businesses have learned that freemium is not a one-size-fits-all solution

"Six point five million unique users is not all that it's cracked up to be," Matt Wensing, CEO/founder of online weather service Stormpulse, said in a recent interview. "I don't want hits. I want revenue. I want a real business."

Comments such as these have caused some American observers to predict the end of the freemium business model, in which a company offers a service for free in hopes of getting some of its users to upgrade to a paid service. Some entrepreneurs in the West have begun turning away from the model, disillusioned with the high risks and slim profits.

It's true that many American technology companies saw the freemium model as the only key to success in recent years. The result has been a US freemium boom, with freemium overtaking the paid model as the biggest revenue source for the top 200 applications in the Apple App Store in 2011, according to app analytics company Distimo.

Some American companies caught up in the frenzy over the freemium model ultimately learned better. Since the model hinges on attracting a very large user base—a difficult proposition for many companies—it is essentially a high-risk, high-return strategy, by no means a guarantee of success.

But while freemium is far from a one-size-fits-all solution, it is likely to remain a very viable model in the US technology industry. The cost of computing power and storage space continues to fall for companies, making the freemium business model even more viable for online businesses such as Dropbox, LinkedIn and SurveyMonkey. Problems with intellectual property protection have made the model less viable in China, where small start-ups have difficulty reaching the necessary scale to make money before bigger competitors pirate their products. But the US, with its strong IP protection, does not experience these same problems.

Businesses that are likely to gain popularity and scale up quickly, that offer their users increasing value over time, and that have low marginal costs should be drawn to the freemium model. However, companies that provide personalized services, target a specialized audience or require significant sales and marketing outlays should probably avoid it. For these companies, paid downloads may very well remain a more attractive option.

Companies in the US are learning that the freemium model can be a valuable resource, but it's all in how they wield it. As Rob Walling noted in an article for *the Wall Street Journal*, freemium is like a Samurai sword—"unless you're a master at using it, you can cut your arm off."

start-up. With so many applications available free online, there's no guarantee that even a great product will reach consumers.

After receiving digital services and products for free for so long, consumers have also become tight-fisted. The tech industry describes this phenomenon as "the penny gap", meaning that the demand for a free service can be many, many times more than the demand for one at the price of one cent. In China, video site Youku faces such a gap: the site's high-definition video service, which charges roughly $1 a month, has been relatively unsuccessful. The service has been running for several years, but it still generates less than 1% of revenue, says Clendenin.

Succeeding with a freemium model also requires striking a careful balance between providing an experience that is compelling enough to get someone hooked, but yet preserving enough value so premium users feel they're getting their money's worth, says Zhu of Enterproid.

Flavors of Freemium-3

Source: Company reports

Many companies—including China's rash of Groupon and Craigslist clones—have flopped after failing to discover that secret recipe. "If their costs are high to begin with, then all of a sudden their runway for innovation becomes very short. They can run out of money before they stumble across a viable business model," said Clendenin.

Succeeding with a freemium model is particularly challenging now that huge companies like Tencent, Alibaba and Baidu have come to dominate China's digital landscape. These companies have diversified business models and generous cash reserves, and can afford to run some services at a loss to augment their user traffic.

They have also taken advantage of China's lax intellectual property environment, employing teams to reverse engineer popular technologies from around the globe, as Tencent did with WhatsApp after it was released in 2009. China offers "a distinct advantage for large established companies that don't mind copying others. So that clearly is right up the alley of Ten-

Shifting Sands

China's mobile operators struggle to protect revenues against disruptive mobile technologies like Tencent's WeChat

In March, Miao Wei of the Ministry of Industry and Information Technology (MIIT) surprised We Chat fans everywhere when he said that China's big three telecom operators might put pressure on Tencent to start charging for WeChat because of its heavy use of bandwidth. China's three telecom companies were clearly behind the statement, trying to regain lost ground.

The telecom companies were flexing their muscles to protect their business, as the shift from mobile network-based text messaging to free internet-based messaging applications like WeChat takes a serious bite out of their revenues. Online chatting applications like WhatsApp, WeChat and Vox are making text messaging obsolete in the same way internet-calling application Skype led to a sharp decline in international calling volume. The MIIT announced that the number of point-to-point text messages fell 10.6% in the first two months of 2013 compared with the same period last year.

But WeChat users were outraged by the prospect of a payment. Consumers complained they already pay mobile companies for internet-based services in data fees. But mobile operators argue these revenues don't account for the strain on their signaling networks.

WeChat has a heavy location-based aspect, for example a shake function that lets one identify other WeChat users nearby, says Mark Natkin of Marbridge. Because the application is essentially always online, it has near-constant interaction between a phone and a base station. China Mobile asserts that WeChat accounts for only 10% of its mobile data traffic but uses roughly 60% of its signaling resources.

Even so, mandating WeChat and other apps pay set fees to mobile operators could weigh heavily on mobile start-ups, harming innovation. "It would send a very bad signal," says Michael Clendenin of RedTech Advisors. "It implies that a start-up cannot grow to scale without having to incur heavy cost. Obviously Tencent is no start-up, but there are a host of small companies out there that are trying and hoping to have a similar hit on their hands."

Recognizing the impact, the MIIT conceded that forcing fees could set a harmful precedent. In April, ministry spokesperson Zhang Feng said the market should decide whether WeChat has to pay. To support innovation in the industry, the ministry would not intervene in the conflict, Zhang said. Without MIIT on their side, China's telecom operators may just have to face the music.

cent, which is a large company known for copying others," says Clendenin.

Big players can copy faster, gain users faster and afford to offer free services for much longer than any small company, Jack Ma, the Founder of Alibaba, said in a speech on April 1. Although the free tech service model worked when Ma founded his e-commerce empire 10 years ago, it no longer works today, the Chinese entrepreneur told a conference in Shenzhen. "Ten years ago, Tencent, Baidu and Alibaba were very young. Today if you go free, Tencent, Baidu and Alibaba would help you die. You cannot survive with ideas that worked five or 10 years ago, or in last century," Ma said.

An Uncertain Future

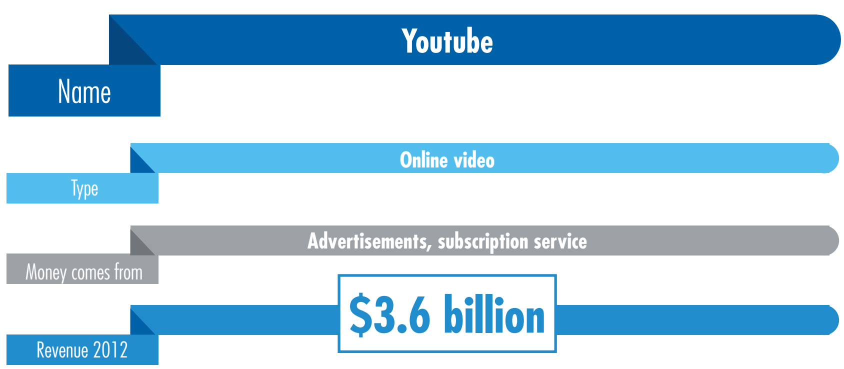
Tencent's innovative use of the freemium model helped it become one of the world's richest technology companies, and analysts say the company should have no problem in making WeChat another commercial hit. "WeChat is going to enable them to print more money than the central bank," says Clendenin of RedTech Advisors.

Tencent executives said in March that they would be testing a gaming platform for the service in the next few months. The company seems likely to use the same virtual micro-transaction model used in their desktop-based gaming systems, as well as sell items like special emoticons or videos that can be sent to other users.

But the freemium model will be far more difficult for China's smaller tech companies to pull off. To survive, small Chinese companies need to return to roots of marketing, analyzing consumer needs and pinpointing still-profitable sectors. "The trick is understanding the nature of [the freemium] model, unpacking the product to cater to different customer valuation," says CKGSB's He.

That will be difficult, but if applied intelligently, the freemium model has a bright future. "This is an old trick, new packaging," says He. "It will be there forever."

Flavors of Freemium-4



Source: Company reports

THE FREEZE

Regulators have suspended IPOs on China's stock markets. What's their strategy, and how will it affect Chinese companies?

By Christopher Beddor

To a casual observer, the recent behavior of China's financial supervisor might seem a bit odd. In June of last year a petition began circulating online that demanded the China Securities Regulatory Commission (CSRC) slow the pace of initial public offerings (IPOs) launching on Chinese stock markets. The rapid pace of new listings, it argued, was impoverishing existing shareholders. "Behind every retail investor stands a family that has been deeply hurt by unending IPOs and poor stock performance," the statement said.

The CSRC seemed unmoved by the plea. In an official online discussion with investors the agency dismissed calls to slow the flow of IPOs, instead emphasizing that it was committed to moving in a more market-oriented direction. That meant less interference in the IPO process, not more.

Yet just a few months later, the CSRC reversed course. Approvals for companies to list on China's three mainland stock exchanges—the Shanghai, Shenzhen and ChiNext boards—first slowed, then stopped. As *CKGSB Magazine* went to press, the last IPO to launch on a mainland bourse was in November 2012. Why did the CSRC suddenly have a change of heart?

The answer to that question could have profound implications for Chinese businesses. The immediate focus is on when the CSRC will allow IPOs to resume, and whether Chinese companies will turn to stock markets outside the Mainland—especially Hong Kong—in the meantime. But in the long term, the freeze illustrates the CSRC's efforts to change both its responsibilities and the process of going public in China—as well as its struggle against forces opposing those reforms.

"I clearly see a regulatory transition," says Chen Long, Professor of Finance at the Cheung Kong Graduate School of Business. "But it involves a lot of obstacles and a lot of political pressure."

In Search of Lost Returns

China's stock markets have experienced a dismal past two years. The benchmark Shanghai Composite Index fell 25% between April 2011 and April 2013, and the broader CSI 300 Index dropped 23%. These declines come even as China's economic growth has hovered around 7.5-8% and equity markets in other parts of the world have touched record highs.

Many investors chalk this performance up to the CSRC. By allowing the supply of IPOs to outpace investor demand, they claim, the regulator drained liquidity from existing shares and pushed down prices across the board. Hence the public pressure—from individual investors, investment funds, and others—to restrict IPO approvals in order to allow the market to recover.

Their petition may evoke a degree of sympathy, but skepticism is in order. Investors and listed companies are in effect asking the government to rig the market in their favor. Besides, the idea that new IPOs suppress the value of existing shareholders is "just plain wrong," says CKGSB's Chen. Studies of global markets have failed to demonstrate a link between more IPOs and lower stock prices, he adds. While mainland China is unique in the degree of control regulators exercise over IPO issuance, in general, research seems to indicate the opposite relationship: lots of companies launch IPOs during bull runs, and hold off when the market turns sour.

While the CSRC's reluctance to slow IPO approvals was well-grounded, many officials appeared to be swayed by investor pleas, along with a desire to address legitimate concerns about shoddy accounting and corporate governance. They may have more or less forced the organization to impose the freeze against its will. "The decision was probably a combination of the stock market not doing well and complaints about corporate governance and bad financial information," says Chen. "[The CSRC] was under a lot of pressure to do this."

> "[The CSRC] was under a lot of pressure to do this
>
> Chen Long
> Professor of Finance
> CKGSB

Making a List

In any event, the CSRC has taken the opportunity to clean up the listing process with an aim to revive investor confidence in the quality of future issues. In January it ordered underwriters—firms such as Citic Securities, Guosen Securities, Haitong Securities and many others—to review the financial year 2012 earnings of the almost 900 firms waiting in the queue to list, after which it would select 30 via lottery for an intensive audit. The unspoken expectation of companies was those that saw profits decline last year would withdraw their application.

By April 3, shortly after the deadline for self-reviews, 162 firms had voluntarily terminated their bids and another 107 requested deferrals. That left 612 firms still in the dock for listing. The deferred companies were granted until the end of May to produce results, after which another 10 would be chosen for inspection.

By all accounts, the CSRC means business. An anonymous investment banker uploaded a picture on Sina Weibo showing more than 25 boxes of company documents collected by regulators and warned of "sleepless nights" ahead. Peter Fuhrman, Chairman of the investment bank China First Capital, described on his blog rumors that the CSRC had begun videotaping interviews with company bosses and hired a team of facial analysis experts to spot lying executives.

Moreover, tales abound of companies that opted for deferral and are now locked in battle with their underwriters. Some of these firms had been due to list in late 2012 and did not anticipate they would have to post higher profits last year. They may be under pressure to cut corners on accounting in order to stay in the queue, gambling that they will not be selected for a CSRC audit, says a professor at Peking University who asked not to be named because he occasionally advises the regulator. Company underwriters, by contrast, are well aware that the CSRC could effectively shut them down if they are complicit with a falsified report.

"They are now applying significant pressure to [their clients] to remove themselves from [the CSRC IPO approval] list," the professor adds.

That tension may be precisely what the CSRC is looking to generate. Multiple sources say the regulator is using the self-review process in part to emphasize that underwriters are liable for the financial statements of the companies they handle, thereby shifting the burden of enforcing compliance away from the CSRC and investors and on to investment banks. That approach is similar to reforms the Hong Kong exchange pushed through in recent years, notes Philippe Espinasse, a Hong Kong-based former investment banker and author of *IPO: A Global Guide*. While Hong Kong has generally high disclosure rules, a handful of IPO stumbles spurred regulators to strengthen standards.

"The main way they decided to do that is to put the onus [of due diligence] on the banks," says Espinasse.

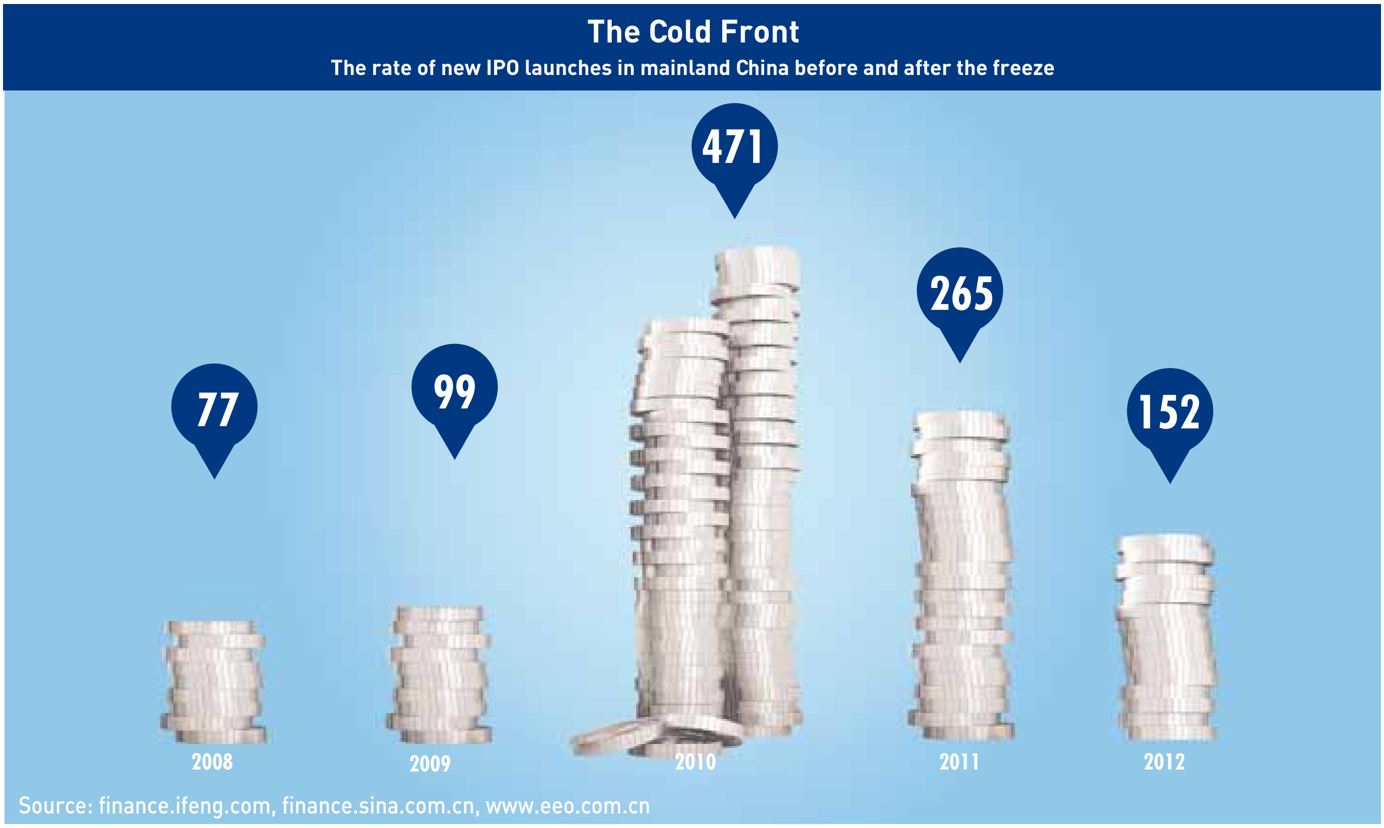
"The CSRC is also trying to create more financing options for the economy in general," says Anthony Skriba, Director at Z-Ben Advisors, a financial consultancy.

He notes that Chinese brokerages are much more reliant on IPO underwriting fees than international brokerages, and have been reluctant to invest heavily in alternative financing options. The freeze is forcing them to diversify their revenue streams, which should in turn lay the groundwork for the government's broader goal of developing a more diverse financing environment for Chinese firms seeking capital.

Looking for an Alternative

To that end, the CSRC has been actively encouraging Chinese companies frustrated by the freeze to explore options such as off-exchange equity markets, bond markets and equity markets abroad, reported *China Securities Journal*, a state-run news outfit with close links to the agency.

Some of these alternatives are not yet ready for prime time. Over-the-counter



(OTC) equity markets are still immature and lack the capacity to absorb a stream of new issues. Chinese firms will likely avoid the bond market as well, if only because they prefer to raise capital via equity than be saddled with debt.

Listing abroad, however, can be an attractive option. This is particularly true after the CSRC announced in late December that it would scrap minimum requirements on net assets, annual profits and fundraising targets for Chinese firms listing abroad.

Of course, Chinese companies have already been exploring various foreign markets. US markets are effectively closed to Chinese firms after a series of short-seller attacks and downturn in investor sentiment, but Frankfurt on the other hand boasted seven Chinese listings last year. Other niche markets such as South Korea, Malaysia and Australia host the occasional Chinese IPO. At least one Chinese company is even considering listing on the Stockholm Stock Exchange, according to a Beijing-based financial consultant who asked not to be named because he is covering the deal.

Yet by far the best-placed exchange to capture spillover from the IPO freeze is Hong Kong. Some 80-90% of the market's IPOs hail from mainland China, and at least 10 large mainland firms have recently expressed interest in listing there by summer 2013, with combined fundraising targets of around RMB 50 billion ($8.1 billion). Chinese state media has claimed some of these decisions are directly attributable to the IPO freeze.

Hong Kong has plenty to offer Chinese firms, from liquidity and professional services to a general familiarity with the mainland. A few mainland IPOs have done well by listing in Hong Kong over the past few months. Perhaps the most notable example is People's Insurance Company of China (PICC), which launched a $3.1 billion IPO in December 2012. Share prices popped significantly on the first day of trading and remained high more than five months later.

Yet PICC's performance stands out as an exception, and those in the industry say Chinese companies will probably not turn there en masse.

"I'm really skeptical that we're going to see a wall of Chinese IPOs coming to Hong Kong [because of the freeze]," says Espinasse, the former investment banker.

Chinese regulatory hurdles to listing in Hong Kong are still a factor, market valuations are fairly low, and new listings have fallen dramatically over the past couple of years. As of mid-April, the exchange had raised just over $1 billion in new listings, putting it behind smaller bourses in Thailand and Singapore. Of those new issues, well over half were trading below their IPO price.

Part of the reason for the low valuations is that many mainland firms encourage underwriters in Hong Kong to compete based on the size of the cornerstone investment they are able to lock in, says Espinasse. That may sound like a good incentive in theory, but in practice some degree of coordination between banks is necessary to prevent key investors from

> The CSRC is also trying to create more financing options for the economy
>
> Anthony Skriba
> Director
> Z-Ben Advisors

being put off by multiple pitches for the same listing.

Moreover, many of the cornerstone investors for mainland Chinese IPOs are not traditional institutional investors but personal friends and family of the Chinese company.

"They place their orders and it means the IPO gets done—but these guys are not natural buyers in the market," says Espinasse. "You therefore end up with IPOs that fall in the aftermarket."

Still, he remains optimistic that deals can get done even in the current investor climate.

"There's a lot of cash moving around [the market] that is looking to be put to use, and when you have [Chinese] companies that need that cash, they'll meet at some point," says Espinasse. Then it comes down to pricing—Chinese companies may have to offer substantial discounts to lure Hong Kong investors, he adds.

Paradigm Shift

For that same reason, however, most Chinese companies will probably opt to stay at home. Valuations on mainland markets are substantially higher than other exchanges in large part because the CSRC has tightly controlled how companies are listed and de-listed, says CKGSB's Chen. Particularly before 2009, the agency not only vetted accounting records, but also company outlook and valuations. The upshot is that very few IPOs have failed in China. But tightly restricted supply also meant that listed firms were valued about 20% higher than their unlisted peers by the end of their first day of trading, says Chen.

"Even the shell of a [listed] company is worth something, because it's very hard to get listed and de-listed," he adds.

Chinese companies therefore have an incentive to simply wait for the freeze to end, which many traders reckon will be after CSRC audits are completed—likely sometime around June or July, reported Bloomberg. But they would do well to keep in mind that current market dynamics may not last forever. The CSRC's long-term goal, said Chen, is to move towards a system similar to Western stock markets, in which companies can easily list and be de-listed. Under such a system, the queue for IPOs would evaporate—along with the premium for listed firms.

"[The self-review process] signals the transition of authorities to convert from the current 'investigate everything about the business model' system to one that just verifies the quality of [company] information," said Chen. "That's the direction it's going in the long run."

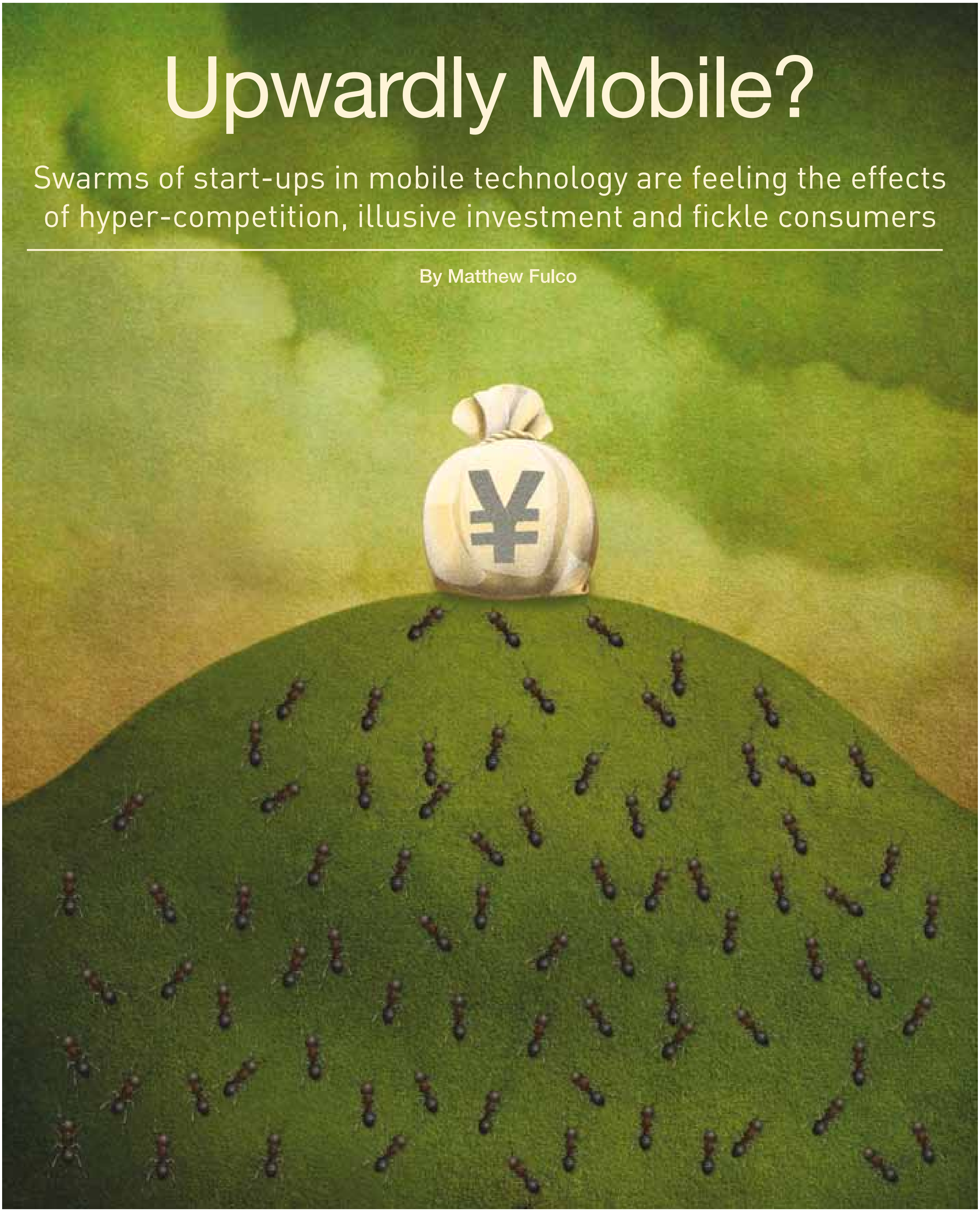
That might not please investors petitioning to rig the market, or listed companies that benefit from today's high valuations. But it would certainly be good news for future Chinese companies looking to raise capital and expand business.

(Log on to CKGSB Knowledge to read about the problems Chinese companies face when listing on global stock exchanges: http://knowledge.ckgsb.edu.cn/2013/03/01/finance-and-investment/chinese-companies-navigate-global-stock-exchanges/)

Upwardly Mobile?

Swarms of start-ups in mobile technology are feeling the effects of hyper-competition, illusive investment and fickle consumers

By Matthew Fulco



Fu Cong was a stubborn smartphone convert. For years, the 28-year-old Shanghainese communications consultant carried a bare-bones Philips mobile that he favored for its simplicity and immense battery power—it could easily go 72 hours without being charged. Fu used it for calls, text messages and not much else.

All that changed in February when he celebrated the Lunar New Year by buying himself an HTC handset powered by Google's Android. Fu loaded his new device with free applications designed for the burgeoning Chinese mobile market, like Dianping, China's top restaurant review site, a Baidu map for navigation and Tencent's wildly popular WeChat for voice and text messaging. "It has most of the functionality of an iPhone at half the price," he says. "If I had to use a phone without all these functions again, I would feel disconnected from the world."

Connectivity is a priority for the world's largest and fastest-growing mobile communications market, whose 1.1 billion subscribers include 200 million to 330 million smartphone users, analysts say. Last year, smartphone purchases by Chinese consumers rose by 112% from 2011, according to a report by the market research firm IDC.

China's hunger for mobile connectivity and preference for the Android iOS have sparked a boom in the production of free apps by start-up firms keen to quickly build a large user base, which they can later charge for products or services.

In 2012, 3,585 start-ups were founded in China, of which 25% were in the mobile communications sector, according to research by China tech-industry analyst Charles Custer.

"There is astounding growth in the industry," says Kai Lukoff, a Beijing-based product manager for the international division of Wandoujia, a content management app for Android phones. "We had predicted there would be 20 million Android smartphones at the end of last year and instead there are 200 million."

With Apple its only major competitor controlling just 10% of the Chinese market, Android will drive a highly competitive smartphone and app market for the foreseeable future, Lukoff says, prompting tech companies big and small to race for a share of the pie.

> "E-commerce was hot two years ago and then social was a huge deal. Now, mobile is *it*
>
> Kai Lukoff
> Product Manager-International
> Wandoujia

"To some extent, it is cyclical," he says. "E-commerce was hot two years ago and then social was a huge deal. Now, mobile is *it*."

The size of the target market remains captivating, especially as vast swaths of it have yet to be tapped, says Custer.

In Custer's view, China's mobile web is not only bigger than the broadband PC web, but also enjoys greater growth potential because hundreds of millions of its people access the internet mainly through their mobile phones, not computers. That phenomenon, coupled with the availability of cheap but powerful smartphones—Chinese brands like Xiaomi or Meizu can be purchased starting at RMB 1,000—will ensure an ever-greater share of the Chinese population goes online via mobile devices, translating into increased app downloads.

For example, photo-sharing app PaPa, which allows users to send voice recordings with their pictures, has attracted 10 million downloads from Android and iPhone users since its late-2012 launch, Consequently it has become one of the most successful Chinese start-ups of the past year. PaPa has attracted attention from the tech industry and beyond, with Innovation Works founder Kai-Fu Lee and actors Zhao Yuheng and Li Bingbing among its high-profile boosters.

Xu Chaojun created the PaPa app with a team of four in just one month in an office at a converted factory in Beijing's 798 Art District, where a number of start-ups have set up shop, although the majority remain based in the Zhongguancun technology hub in western Beijing.

"It helps that a killer smartphone app can be something that's very simple, cheap, and fast to develop. That's certainly not true of, say, a hardware start-up or a company trying to make PC games for hardcore gamers," Custer says.

Cheap but original is the key. John Tian, an analyst at 36 KR, a Beijing-based consultancy that helps start-ups increase their user numbers and find investors. "PaPa is original. It is the first mobile app in the world to integrate voice recording and photo sharing in a way that allows the user to create a spoken narrative to accompany a picture."

Get Out of Town

Apps that are genuinely original have more than just the China market to consider. Several ambitious firms have instead found success overseas with a B2B business model.

One start-up, named Cootek, signed a contract with overseas telecom companies to provide a language input app called TouchPad for Android phones which simplifies typing on a small mobile screen, says Gang Lu, a long-time Shanghai-based industry watcher and founder of the *TechNode* news site. TouchPad's learning based-predictions can foresee what users plan to type based on their previous typing input. It also has a 'blind typing' function that corrects typing errors based on the keys a person has pressed and the context of the words, allowing users to type without constantly looking at their touchscreens.

Thanks to those smart functions, 20% of Android phones outside of China have TouchPad installed, Gang says.

Mobile gaming is another area in which Chinese start-ups have found a niche overseas either selling the games outright in apps stores, or an in-app purchase, in which the game itself is free but the user must pay for virtual goods such as weapons or food, which can improve the user's prospects in a game considerably.

In Apple's app store, 70% of revenue goes to the game manufacturer and 30% to Apple.

According to Gang, a Hangzhou-based start-up called Droidhen has produced a number of games that have sold well internationally, notably a game called Defender in which players need to defend a castle against monster attacks. Such was the success of Droidhen's products overseas that the company's founders visited the US last year on a promotional tour, their first time to travel abroad, Gang adds.

Still, gaming has its limits for mobile start-ups, says Kevin Der Arslanian, an analyst at the Shanghai-based consultancy China Market Research Group. "Since the games tend to have a short shelf life, you need a real supply chain to launch one after another," he says.

Even with a well-developed supply chain, piracy and copy-catting present even more intrinsic challenges to mobile tech startups.

Weakness in Numbers

Despite the popularity of mobile apps in China, the longstanding habit of pirating internet products and an increasing availability of free services, few consumers value the products enough to pay for them. That leaves start-ups largely deprived of revenue streams.

"Ninety percent of mobile start-ups, maybe more, can't make money because of copycatting and piracy," says Gang. "After one good product comes out, there could be tens of copycats, or there could be hundreds."

Data from the Chinese-language 17Startup website shows that mobile firms also had the greatest rate of failure of any start-up sub-sector in 2012, with 26% folding.

In Gang's view, companies producing mobile apps tend to focus first on building a large user base, the way PaPa has. Founder Xu Chaojun believes his app could register 50 million users this year and 200 million by 2016, helped by its integration with the Sina Weibo microblogging service, which itself boasts 500 million users.

Start-ups believe attracting enough users, can eventually lead to money-making. A large user base helps start-ups to attract the attention of venture capitalists, says John Tian, a Beijing-based tech industry researcher. "The mobile internet in China has few business models at this point," he says. "Venture capitalists will often decide whether or not to invest in a start-up based on the number of users it has."

Indeed, PaPa's soaring numbers helped it secure $10 million in seed money from Innovation Works and California-based Sequoia Capital.

Zeroing In

Gang advises start-ups to target niche markets smartly, citing the success of the mobile app Edaijia for Android and the iPhone, a national 24-hour on-demand chauffeur service that relies on a team of freelance drivers to help intoxicated people get home safely from social functions. Founded in Beijing a year ago, the app has become increasingly popular over the past three months.

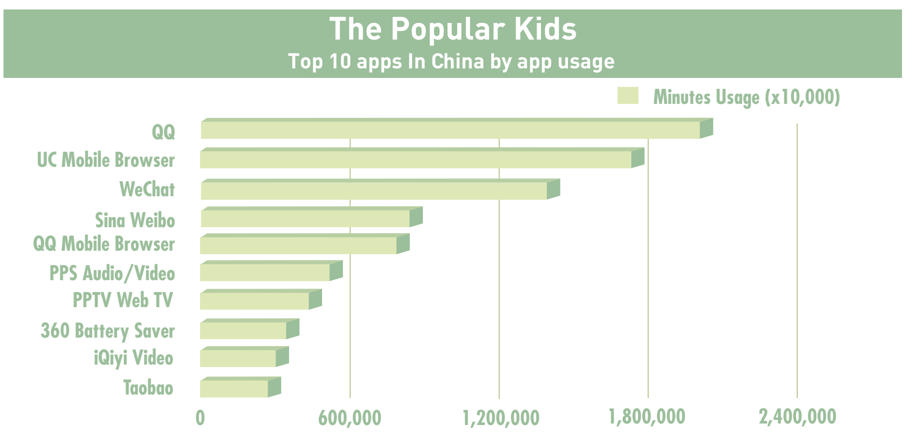
"In China, when you meet for business, it is usually over a huge meal followed by karaoke, and you have to drink a lot," Gang says. "Since businesspeople usually drive themselves to these functions, there is a need for this kind of service." The Edaijia app has a navigation function that is able to pinpoint the location of users and inform them of the drivers closest to them on duty along with their mobile numbers. Edaijia pays its drivers a fixed rate—which is higher after 10pm—to serve as stand-by chauffeurs who drive the intoxicated clients home in their own cars. For each client a driver brings home, the company takes a commission.

"They've really gotten bigger in the last three months," says Gang, without giving specific figures.

Another start-up app that has found a niche market is the virtual karaoke service, Changba, which starting in March, charges users to 'gift' singers they like with virtual flowers, but only if they want to gift more than three performers a day. The principle is identical to that used in mobile gaming: provide an entertaining initial experience for free, but require users to pay for continued stimulation.

No Exit?

For all the promise of China's mobile communications start-ups, a deeply ingrained copycat culture crimps their potential to grow, as companies see little rea-



Source: *TechInAsia*

son to pay for a good idea when they can simply copy it.

"It's cheaper to copy here," says Steven Millward, a Suzhou-based researcher for the *TechInAsia* site focused on start-ups. And it is not just big internet companies devouring their smaller competitors as with Tencent and WeChat—start-ups are both victims and perpetrators, he says.

But copycatting does not necessarily mean creating a carbon copy of an app, says Beijing-based analayst Tian. "In the mobile market, companies will often copy just the key functions from an app," he says. That phenomenon causes the start-up ecosystem to be full of apps with different names that perform the same tasks, reducing their competitiveness, making high user numbers all the more important, Tian says.

Millward says mobile communications start-ups face an additional hurdle because Chinese investors are reluctant to pay for something virtual. "E-commerce firms may attract investor money because they have a network of warehouses stocked with goods. You've got to have something physical," he says. Without investment capital, copying becomes a much more appealing option.

Those attitudes make IPO exits, an essential pathway to expansion for start-ups in the West, elusive in China. With the exception of the RenRen social media site, no Chinese internet company has gone public (See 'The Freeze', page 30).

China's restrictive stock exchange regulations, which require companies to demonstrate three years of profitability in order to go public, also prevent cash-starved start-ups from tapping the IPO exit option.

In this dog-eat-dog environment, start-ups need to be comprehensively strong to prevail, says Chen Hua, co-founder of Changba, which, despite its popularity in China, has yet to be duplicated.

"Your app needs more than smart technology and intelligent design," he says. "It needs to have strong selling power, to have a genuine brand identity."

Those attributes will help attract investor money, since the best products do not have trouble getting financing, Chen says.

Still, *TechNode* founder Gang Lu believes mainstream Chinese consumers lack loyalty for internet products, no matter how good they might be. "Most people just don't care," he says.

Such was the case with Hong Kong-based start-up TalkBox. TalkBox faced dozens of copycats from its release in the fall of 2011, but it was Miliao, the voice-messaging app created by serial entrepreneur Lei Jun for the Xiaomi phone, that emerged the most successful.

> "E-commerce firms may attract investor money because they have a network of warehouses stocked with goods. You've got to have something physical
>
> Steven Millward
> Researcher
> TechInAsia

But what goes around comes around, says Gang, as WeChat one-upped Miliao once Tencent realized the demand for voice-messaging apps in the China market.

Ironically, Lei Jun praised Tencent for WeChat's success at the Global Mobile Internet Conference held in Beijing in early May, but he also said he hoped China's smartphone users would give Miliao a chance. He declined to thank TalkBox for giving him the idea to create Miliao, however.

There is no way to stop copycats, says Changba's Chen. "You just have to create something stronger and more resilient than everyone else," he says.

Forget about Facebook

Looking ahead, China's mobile start-ups have cause for cautious optimism. Soaring smartphone usage means the number of potential users is growing fast. At the same time, the popularity of gaming will buoy the in-app purchasing model, says Lukoff of Wandoujia, offering mobile start-ups different ways to earn revenue and Chinese consumers more variety in gaming.

"As it becomes easier to buy good, authorized products, that's the direction in which mobile will move and it will be driven by gaming," says Lukoff.

Outside of gaming, the savviest firms will devise products not easily reproduced, making them resilient against potential copycats, says Millward of *TechInAsia*, citing the Jiayuan dating website. Jiayuan is China's largest online dating platform and a Nasdaq-listed company. It has an extensive network of resources, including access to some of China's wealthiest individuals. Jiayuan has resultingly launched specialized services difficult to replicate.

And for those who would replicate instead of innovate, tech industry analyst Custer offers sanguine counsel. "While copy-to-China still works, everyone knows that the chances of your being one of the winning copycats at the end of that race is extremely slim," he said. "I'd say start-ups are better off aiming smaller, even if that means not setting out to become the next Facebook."

A Blip in Confidence

China's entrepreneurs forecast modest figures for company growth in the coming years on concerns over a slowing economy

In June 2011, CKGSB's Case Center and Center for Economic Research initiated a project to gauge the sentiment of executives about the business environment in China—called an index of business conditions (BCI).

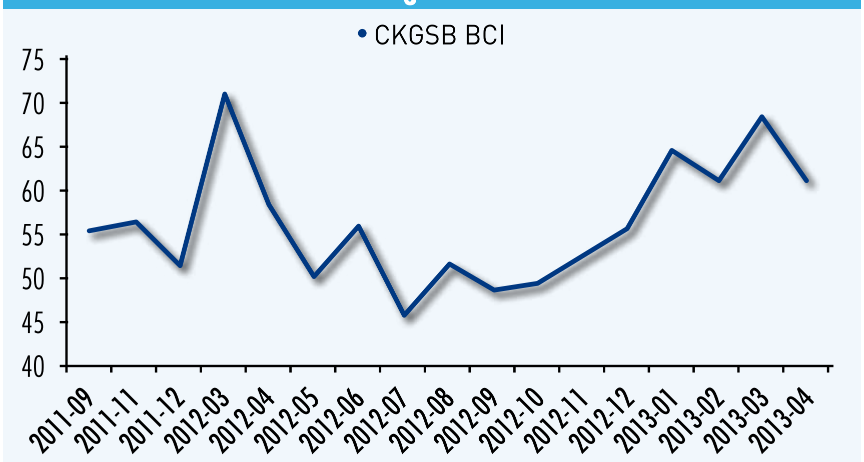
Under the direction of Li Wei, Professor of Economics and Emerging Markets Finance, in July 2011, the two research centers designed and tested the BCI survey. In September 2011, the first surveys were distributed and results computed. Since May 2012, the research team has published monthly BCI survey reports.

The CKGSB BCI Index

The CKGSB Business Conditions Index (CKGSB BCI) is a set of forward-looking, diffusion indices. The index takes 50 as its threshold, so an index value above 50 means that the variable that the index measures is expected to increase, while an index value below 50 means that the variable is expected to fall. The CKGSB BCI thus uses the same methodology as the Purchasing Managers Index (PMI).

The CKGSB BCI comprises four forward-looking sub-indices, forecasting future sales, profits, the corporate financing environment and inventory levels for sample firms in the survey. The sales index changed from 79.3 in March to 78.6 in April, and the profit index made a considerable drop from 77.9 to 48.1 (Figure 2). While corporate sales registered a small drop, the profits index was more remarkable, which cannot be easily explained by changes in general forecasts. Our hypothesis is that the observed inconsistency in the data may simply be a sampling issue, and we will continue to monitor our results in future months.

Figure 1



Expect Overcast Skies

In April, the CKGSB BCI dropped from its March value of 68.3 to 60.9 (see Figure 1). This indicates that the macroeconomic outlook for China is in a state of flux.

Corporate Conservatism

Corporate financing dropped from 58.1 to 51.9, but remained above the threshold of 50. Our sample consists predominantly of private firms, thus the index mainly reflects the private financing environment. Meanwhile, the inventory index shows a slight drop from 54.7 to 52.6, showing most companies don't anticipate increased inventory in the next six months compared with the same time last year (Figure 3).

Figure 2

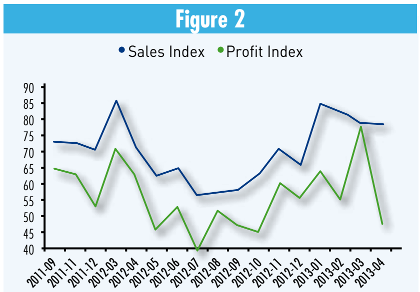
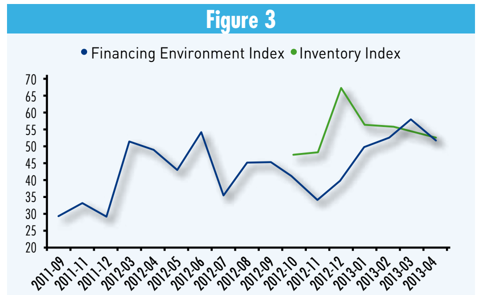


Figure 3



The Labor of Investment

The CKGSB BCI also collects information on operating costs and on sample firms' demands for labor and for investment. In April, the indices for operating costs displayed mixed messages. The index measuring labor costs rose from 87.3 to 87.9, while the overall business cost index fell from 78.3 to 76.8 (Figure 4). The index measuring business demand for labor weakened slightly from 68.7 to 68.3 (Figure 5). April's data also shows that corporate investment demand has weakened from 72.4 to 62.1 (Figure 6).

Figure 4

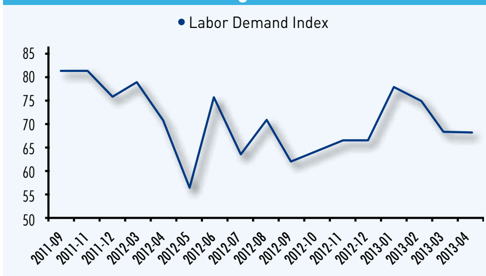


Figure 5

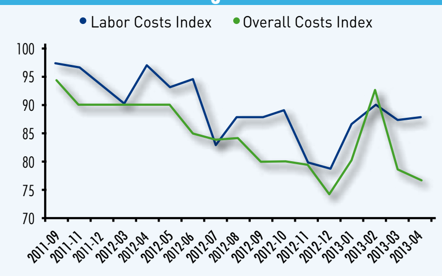
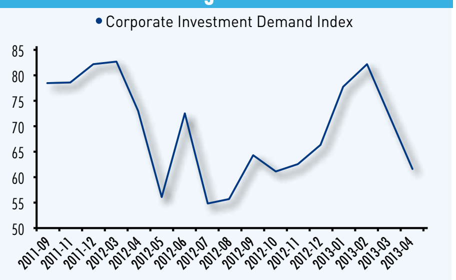


Figure 6



Agree to Disagree on Prices

In addition, the CKGSB BCI asks senior executives of companies whether their main products are for consumers or non-consumers, and then asks how they think product prices will change in the next six months. Based on survey responses, we have been able to report forwarding-looking changes in consumer and producer prices.

In April, price data from the survey showed both positive and negative shifts. The index measuring consumer prices dropped significantly from 62.7 to 44.4, while the producer price index rose slightly from 38.3 to 44.1 (Figure 7). The sharp fall in the consumer price index may be due to changes in sample composition from the previous month, a hypothesis that we may be able to test with a few more months of data.

Figure 7

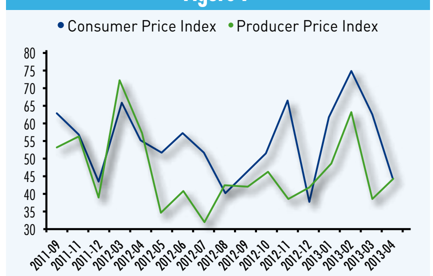


Figure 8

Taking Stock

Lastly, we ask companies for information pertaining to their relative competitive positions in their respective industries. Based on survey responses, we compute a competitiveness index for our sample. The higher the competitiveness index, the more competitive our sample firms are in their respective industries. Our data confirms that our sample firms are in a relatively strong competitive position in their respective industries (see Figure 8).

The Ascent

China's state-owned enterprises are making progress in honing competitiveness, despite political burdens

By Suzanne Edwards

In 2008, the seaport city of Duluth, Minnesota was catapulted to the gravitational center of US politics and foreign affairs. The state-owned Aviation Industry Corporation of China (AVIC) announced plans for one of its subsidiaries to acquire Duluth-based general aircraft manufacturer, Cirrus. There were calls in Congress for the deal to be blocked on concerns of national security. Duluth citizens were worried that the company would be dismantled resulting in massive job loss and the hijacking of US-born technology.

Three years later, US Congress approved the deal, the jobs have remained in Minnesota, and under its new ownership Cirrus is set to debut its first new aircraft in years. All thanks largely to one of China's central state-owned enterprises (SOEs) approaching the deal with a level of transparency and business acumen rarely displayed by Chinese SOEs in the international arena.

"A lot of the problem is that Chinese companies don't know how to really play the system in the US, so they alternate between being timid and ham-handed," says James Lewis, a Technology and Public Policy Fellow at the US-based Center for Strategic and International Studies who followed the AVIC-Cirrus deal. "But AVIC's a good example of a case going through."

The AVIC-Cirrus story exemplifies how international expansion is forcing China's SOEs to improve their managerial practices, corporate governance and transparency.

"The tension is between international best practices for corporations, which is what you need if you're going to be a global company, and the cozy relationship of the [Chinese] state-owned enterprise [and the government]," Lewis says. "They're bumping into this in the rest of the world and the reaction is interesting."

> "People want to know what the relationship is between you and the government
>
> James Lewis
> Technology and Public Policy Fellow
> CSIS

Joining the Big Leagues

Between 2004 and 2009, there were deals involving cross-border mergers and acquisitions (M&As) by Chinese companies totaling $50 million, with more than 81% of the transactions involving SOEs. Since 2009, the volume of outbound M&As has only intensified. In 2011 alone, the total value of outbound direct investment in the form of M&As totaled $27.2 billion according to China's Ministry of Commerce, with the favored sectors being mining, power generation and manufacturing.

According to data from Credit Suisse and Dealogic, the volume of cross-border M&A deals from China totaled $93.1 billion in 2012. With six of the top 10 outbound China M&A deals involving SOEs, with the other four involving Hong Kong-based companies. Clearly China's SOEs are serious about moving beyond 'national champion' status into global champion status.

The reasons for increased M&A are varied. Firstly, the economic collapse of 2008 left many companies all over the globe in dire need of a cash-rich investor to bail them out. For China's part, the government is eager to use M&A as a means of acquiring both the technical and managerial know-how of foreign companies.

Lewis points to a few areas where China's SOEs are a little raw in terms of management, particularly when handling an M&A project, and whether it's with regard to governance or accounting, the problem of transparency arises again and again as something difficult for Chinese SOEs, a flaw that can damage the prospects of closing deals.

"People want to know what the relationship is between you and the government," Lewis says. "Their normal tactic is to just stonewall, but it doesn't work with investors and it doesn't work with regulators."

Lewis also notes that there are inconsistencies between international accounting standards and the Chinese government's accounting standards, particularly with regard to transparency.

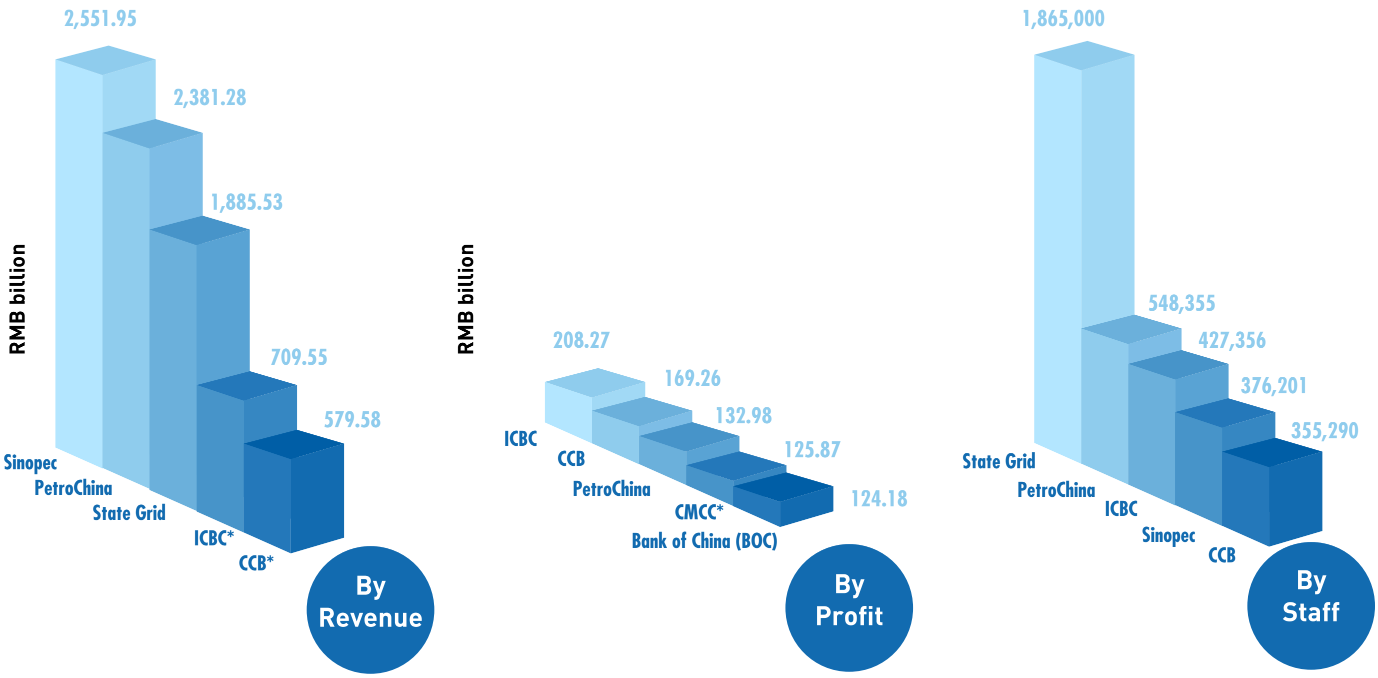
China's law, in fact, stipulates that companies, particularly SOEs, may not divulge any financial information that pertains to the vague term of 'security', thereby relegating some financial records to the category of 'state secret'. The impracticality of this law has been highlighted in the row between the US Securities and Exchange Commission and the China Securities Regulatory Commission over the withholding of accounting documents by the Chinese arms of five global accounting firms.

For brokerage firms that typically facilitate M&A deals between Chinese SOEs and target companies, they have to know all the accounting details from top to bottom. If a company is not acting in accordance with its World Trade Organization (WTO) agreements because of a political directive from the state of its home country, the broker will need to know that. This is not a practice that fits with the approach of Chinese SOEs. Lewis points to instances where SOEs assume that if they show up with a wad of cash, they'll automatically command respect, but that's unfortunately not the case.

"It's not just a cash transaction. You've got to meet with regulators, you've got to make people happy, you've got to make boards happy," Lewis says, explaining that one of the first things Chinese SOEs try and do in an international M&A deal is to recruit a figurehead Westerner to chair the target company board, and this doesn't work. "You've got to change the way you do business."

When Size Doesn't Equal Profit

China's top five largest SOEs by revenue, employment and profit



Source: Fortune China *Industrial and Commercial Bank of China, *China Construction Bank, *China Mobile Communications Corporation

Lewis points to CNOOC's 2005 attempt to acquire California-based Unocal for $18.5 billion as a perfect example of the "bungling" of an outward-bound M&A deal. It failed largely because of CNOOC's lack of adherence to international disclosure standards. When the company increased the transparency of its corporate governance, that is how much of the deal was politically controlled and how much of it was commercially oriented, CNOOC's second attempt at buying a North American energy company succeeded.

In 2005, Lewis says the hesitancy that CNOOC displayed in disclosing accounting details looked to some US lawmakers like the actions of a company with something to hide. That hesitancy might simply have been a cultural issue, but it sent the wrong message.

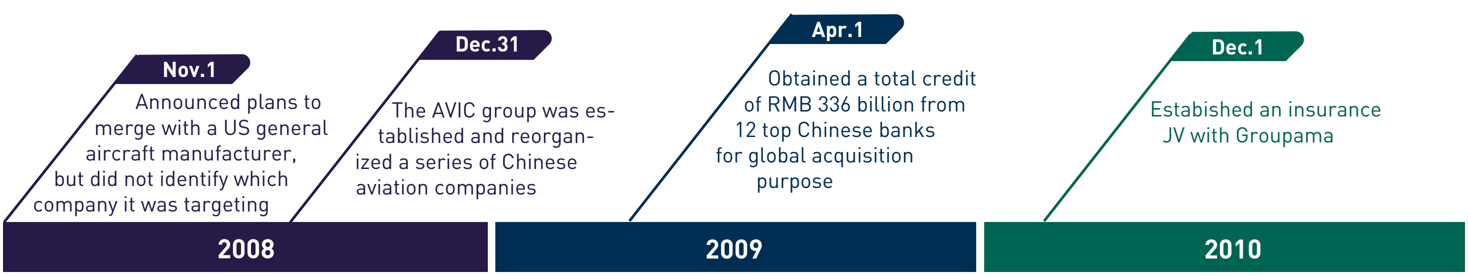
Fast forward to February 2013, and CNOOC closed the largest-ever Chinese takeover of a foreign company by acquiring Canadian oil company Nexen. The US Committee on Foreign Investment had to approve the deal because of Nexen's assets in the US, and according to Lewis the second time round, CNOOC was frank in its financial disclosures. Between 2005 and 2013, the company underwent recognizable changes with regard to transparency and corporate governance, however painstaking the changes were.

Best Foot Forward

Another change to take place in China's SOEs, begrudgingly or not, is the appointment of top executives who have real international management experience and education. The State Assets Supervisory and Administration Commission (SASAC), charged with overseeing China's SOEs' corporate governance, announced a global talent search in 2010 for key top-level appointments at 12 major state-owned enter-

A Takeoff Story

Tracking the most significant expansion moments of China's Aviation Industry Corporation (AVIC) over the past five years



Source: Company website

prises, some even considering foreigners for the positions. But the emphasis was clearly on Chinese managers who had experience in the corporate world outside of China.

The most outstanding example is Fu Chengyu, former CEO of China Oilfield Services and now Chairman of Sinopec Group. He used to serve as the Vice-President of USA Phillips International Petroleum Company (Asia) in the mid 1990s. He's also an alumnus of the University of Southern California (and incidentally of CKGSB as well).

In AVIC's case, the chairman of the the subsidiary that acquired Cirrus Aircraft, China Aviation Industry General Aircraft (CAIGA), is Meng Xiangkai. He has a degree from Northwestern Polytechnic University in California, in addition to his degree from Beijing University of Aeronautics and Astronautics. Over the past 10 years, such international credentials have become more common in the upper echelons of China's SOEs.

James McGregor, Senior Counselor at consultancy APCO Worldwide and author of two books on China's political and economic environment, describes a historical distrust between the Communist Party cadres and party members with international experience.

"Once you get a foreign education or work at a foreign company, you're not trusted by the Party, and they're going to have to develop trust with these people," said McGregor at a Foreign Correspondents Club talk in Shanghai in February.

To McGregor's point, the more traditional SOE executive is modeled in AVIC's chairman, Lin Zuoming. When examining his Party-approved online curriculum vitae and investor profile on various media websites, the company leader has no detectable international experience, and has the proto-typical SOE-head career history: engineer, party member, little to no outside-China influence.

> Some SOEs are really trying hard to become more efficient
>
> James McGregor
> Senior Counselor
> APCO Worldwide

Another more traditional example is CNOOC's chairman and non-executive director Wang Yilin, appointed in 2011. Wang graduated from China University of Petroleum and has been working in the industry in China ever since.

But then you have CNOOC subsidiary, China Oilfield Services being led by CEO and Executive Director Li Yong, who holds a master's degree from Scuola E. Mattei in Italy, according to his investing profile for *Forbes* and Reuters.

The Party's warming to internationally groomed managers in certain places is an acknowledgement that China's SOEs fall short in international M&As where multinational corporations of comparable size excel.

To rectify the knowledge gap, SASAC has initiated a collaboration with Duke University's Corporate Education Senior Leadership program in the US. According to the school's website, SASAC wanted to introduce senior executives from 18 of China's 117 SOEs to some international best practices.

"They have big training budgets, and some SOEs are really trying hard to become more efficient," says APCO's McGregor. "Some of these companies are requiring that their managers learn English and that's one way that management is measured."

Curtis Milhaupt, Parker Professor of Comparative Law at Columbia Law School in New York, says that SOE managerial performance measures are increasingly being tied to the company's international footprint.

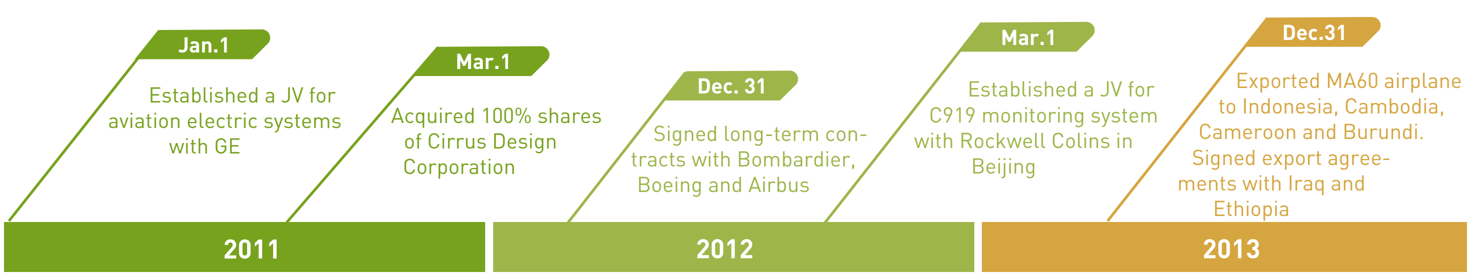
"I think global competitiveness of the SOEs is a true policy goal of the Chinese leadership," he says.

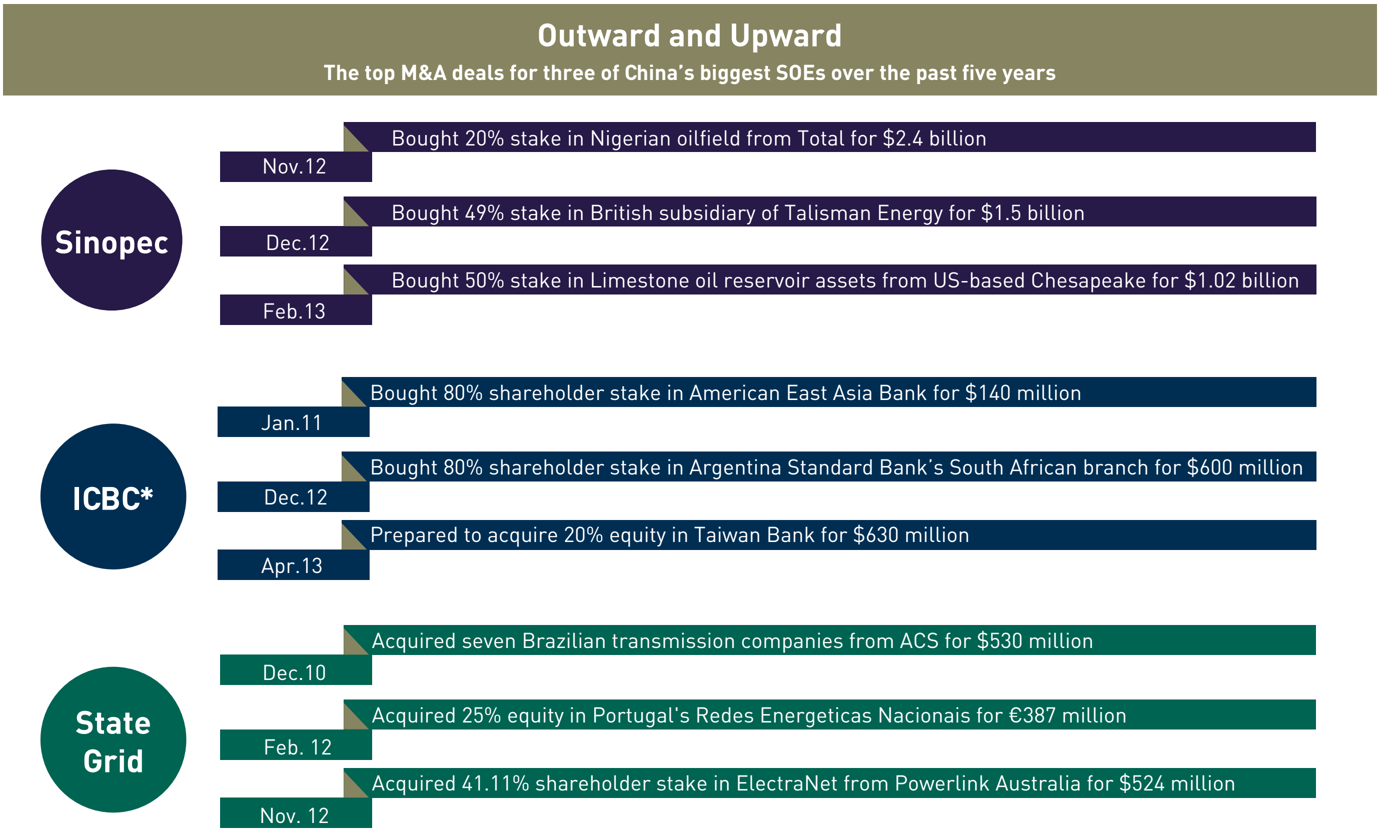
Still in the Nest

McGregor and Lewis both say that these company heads want to be regarded with the same seriousness and respect as MNC CEOs.

"For some of them it's embarrassing because globally they're such large companies, and they themselves know that they're not efficient, they're not global leaders, they're just big," McGregor says.

Columbia's Milhaupt concurs. "Many of them suffer from the monopoly curse," he says, referring to the tendency for a





Source: Company annual reports

*Industrial and Commercial Bank of China

company that has an unassailable position in a market to have no need for innovation.

Chinese economic think-tank Unirule published a report in 2010 on the nature and performance of China's SOEs that highlighted the effect that preferential financial policies have on SOEs' ability to make profits solely on their own merits.

The Unirule report notes that in 2009, the total net profits of all centrally administered SOEs in China amounted to RMB 4.05 trillion, 4.37 times higher than 2001 net profits. Superficially it seems that SOEs are doing better, but what the report details is that when factoring in the huge subsidies that these organizations receive from the central government, the performance is actually lackluster.

Between 2001 and 2009 the average return on equity for SOEs was 8.16%, whereas the average return on equity for private enterprises was 12.9%, even while at a disadvantage in land purchases and commercial bank loans.

For example, the report states that on average, SOEs pay a real interest of 1.6% on loans, while the market interest rate is 4.68%. The report goes on to calculate that the difference between the interest rates that SOEs should have paid according to market rates and the total interest actually paid amounts to RMB 2.3 trillion from 2001 to 2008, accounting for 47% of the total nominal profits from SOEs. It's little wonder that efficiency remains illusive.

State Leading the State?

Corporate governance at home has also been a key area of reform for SOEs in China. A huge number of China's SOEs were liquidated and sold off under the economic reforms of Zhu Rongji, China's premier from 1998 to 2003, and it became clear at the time that there was a need to consolidate the various agencies overlooking industry-specific SOEs. The Party also recognized the international norm of a large company having an independent board to which their senior managers were accountable.

Enter SASAC. Founded in 2003, SASAC was billed as a public/private hybrid charged with improving the corporate governance of SOEs and offering a sense of accountability to the senior management. The conflict inherent in a government-controlled organ acting as an 'independent' board is something most experts agree is not entirely effective.

"SASAC is a government entity, and if you look at the government organizational chart, many of the SOEs that it ostensibly controls as a shareholder rank equal to SASAC, and many of the CEOs of these massive, very powerful SOEs are at least as influential as the head of SASAC," says Milhaupt. "There's no way it can really perform its role as a shareholder without having its decisions being clouded by many other considerations and influences."

That's not to say that SASAC is a mere shell of an agency. Milhaupt specifies the consolidation of assets and reduction of employment numbers as initiatives from SASAC that have contributed to the increased profitability of these organizations, various subsidies not withstanding.

"It has restructured these enterprises, and that is certainly one thing you can point to as something that SASAC has accomplished, and that has resulted in higher profitability," he says. "It is checking, it is paying attention, it is trying to professionalize the board of directors, it's evaluating management and setting their compensation in formal terms, but its in such a conflicted position that I don't think it can really carry out that role in the way that its public face suggests."

SASAC aside, substantive change is difficult to achieve in the face of preferential financial policies that serve as the real basis for profits.

"There's nothing like real competition to make companies more efficient," McGregor notes.

There are companies that have bested their addiction to government support. Milhaupt and Lewis note that large conglomerates in other countries have transformed from dinosaurs into profit makers.

Model Neighbors

In Japan, the dissolution of large family-owned conglomerates known as *zaibatsus* was enforced by the US after World War II, and from their dismemberment came the *keiratsu*. Where as government support propped up pre-war *zaibatsus*, now under a *keiratsu* system, there is cooperation and cross dealings between Japanese companies across sectors to battle foreign competition.

The evolution of the South Korean *chaebols*, large family-owned monopolies that received massive government support from the 1960s onwards, have over the past decade embarked on a journey of separation from the state while gaining prominence in foreign markets.

The currency crisis of 1997, or the IMF crisis, was a wake-up call to the shakiness of a Korean economy built on *chaebols*. After the crisis, government ownership of *chaebol* stocks plummeted. Today, examples like Samsung, the top mobile handset maker in the US and Canada according to tech research firm ComScore, and Hyundai, who's European market share has doubled since 2008 according to company reports, are both competitive companies independent of the government.

> "There's a relationship between efficiency and quality
>
> James Lewis
> Technology and Public Policy Fellow
> CSIS

Not so for China's SOEs, where executives can be swapped like poker cards at the state's whim. "The degree of Party involvement in the appointment of corporate leaders is unprecedented for a market economy," Lewis says.

Case in point, Chang Xiaobing, the current Chairman and Chief Executive Officer of China Unicom, served as the Vice-President of China Telecom before hopping across company lines in 2004 to run the supposed competitor. These intra-sector swaps among China SOE executives emphasize to all that the primary allegiance of the managers is political rather than corporate.

"The biggest bosses in private companies are the owners who are responsible for the business, while CEOs in SOEs are actually officials who don't really care about operations. Their goals are different," says Mao Yushi, a prominent Chinese economist and one of the founders of Unirule. "The profits of enterprises need to be maximized, but that will only happen when the business is relevant to the CEOs' interest."

In Samsung's case, the degree of attachment between Chairman Lee Kun-hee and the company is almost spiritual. Anecdotes of the Lee-saturated culture at Samsung's headquarters have surfaced in various local and international media over the years.

Without such a bond, motivation for China's SOEs to become more efficient must come from someone other than the leader. Lewis of CSIS says the real incentive for SOEs to become more efficient is the quest for technical expertise.

If you can't Beat 'em, Join 'em

Technical expertise may be the biggest incentive for SOEs to become efficient, Lewis says. "There's a relationship between efficiency and quality, so if you're going to build a good airplane, that imposes a certain efficiency requirement on you, and that's where the driver of efficiency comes from." Lewis cites AVIC's co-production ventures with Airbus and Embraer.

"Twenty years ago Chinese airplanes were terrible, now they're okay and that's because of the skills they learned in how to build airplanes from these co-pro deals," says Lewis.

AVIC's recent history is telling for the future of SOEs' internal operations. Efficiency through the pursuit of quality technology, adaptation to international M&A practices, and adherence to transparency norms for deals outside of China, these are the changes AVIC has pioneered that will likely be mirrored throughout China's state sector.

The Party can fight it, as when well connected Huawei Technologies declared it was "no longer interested in the US market" in May after the US blocked its market entrance on national security concerns, or it can roll with it as when SASAC reached out to US-based Duke University for help in training. Either way, as great late singer Sam Cooke said, "change is gonna come."

The Switch

PC-manufacturer Lenovo is gearing up for the era of tablets and smartphones

By Jonathan Calkins

When the iPad 2 was launched in 2011, late Apple CEO Steve Jobs declared the years to follow as the “post-PC era”. Thanks to abysmal PC shipment numbers since, an army of tech bloggers have followed in suit declaring: “PCs are dead!”

True, according to the most recent global PC tracker data from the International Data Corporation (IDC), traditional PCs are at least in terminal condition. In the first quarter of 2013, global PC sales totaled 76.3 million units, a decrease of 13.9% compared to the same quarter in 2012. The year-on-year contraction stands as the worst quarter since IDC began tracking the PC market in 1994. IDC Research Director David Daoud characterized the scale of the contraction as “surprising and worrisome”. Two months later, in May, IDC revised its forecast of global PC shipments and now predicts the market will contract by -7.8% in 2013, darker than its March estimate of -1.3%. Similarly bleak figures from Hewlett-Packard (HP) and Dell indicate the two ailing PC makers would concur.

But one PC maker is robust despite the doom and gloom.

China’s Lenovo Group is gearing up for what it refers to as the ‘PC plus’ era, a period where consumers use non-traditional personal computing devices such as tablet computers and smartphones to meet their day-to-day computing needs. Major PC manufacturers HP and Dell are struggling to cope with these changes as tablet sales eat into their PC-related product lines. By comparison, rather than refocusing its attention away to solely support new product categories like tablet computers and smartphones, Lenovo has continued to support and innovate its traditional line of PC computers.

“Lenovo, until quite recently, has been very focused on the PC era. Lenovo approaches its PC business group and mobile business group as two separate businesses, and I think this has allowed them to grab more market share,” says Professor Teng Bingsheng, Associate Professor of Strategic Management and Associate Dean of CKGSB’s European Campus.

> “Major industry players are beginning to transition away from their traditional PC lines
>
> Ting Yang
> Senior Research Manager
> IDC China

This line of thinking holds true, and Lenovo CEO Yang Yuanqing went on the record saying, “We don’t live in a post-PC world,” in an interview with Reuters in January. “We are entering the PC plus era,” he added. Yang said it is a post-PC world for one group: companies that do not innovate in PCs. “In our industry many players think PCs have become a commodity product,” he said. “We have never thought this way.”

Yang’s accusal of other players have so far proven accurate, underlining how his company is embracing the ‘PC plus era’, which can be described as an era where PC makers should innovate in their PC lines, in additiong to recognizing the computer market’s seismic shift toward tablets and smartphones.

Shipments of tablet PCs—ultra-portable devices that utilize touchscreen input or a pen-enabled interface—are expected to reach more than 240 million units worldwide in 2013, easily exceeding the 207 million notebook PCs that are projected to ship, according to NPD DisplaySearch Quarterly Mobile PC Shipment and Forecast Report. Tablet PC shipments will for the first time ever secure more than 50% of the annual market share. PC companies that have come late to the game are paying the price.

HP and Dell are far and away the two biggest losers in PC sales, whose global shipments dropped 23.7% and 10.9% from the first quarter last year respectively, according to IDC figures. Corporate issues at both companies may have contributed to the decline: HP’s attempts at internal restructuring are negatively impacting commercial sales, and Dell is in the process of buying the company back from shareholders while simultaneously transitioning its business model away from a consumer hardware company to a software and services provider, similar to what IBM went through almost a decade ago. Both companies currently offer their own branded tablet devices, but have failed to secure a loyal customer base. Neither company currently offers smartphones.

“Major industry players are beginning to transition away from their traditional PC lines, and prefer to focus on their enterprise business units that promise higher profit margins,” says Ting Yang, Senior Research Manager for the Services and Telecommunication Research Group in IDC China. “Lenovo is without a doubt going to soon dominate the PC market.”

Lenovo, the world’s second-largest PC supplier in global shipments according to IDC, is so far the exception to the rule. Lenovo hasn’t shifted its attention away from the PC market and shipments stayed level worldwide at 11.7 million. The company maintained profit growth by expanding its market share. Lenovo sales actually increased by 13% (1.1 million) in the US compared to the market’s double-digit contraction, and the Chinese PC manufacturer is close on the heels of HP to becoming the world’s number one PC supplier by volume.

In fact, Gartner, another information technology market research consultancy, places Lenovo ahead of HP as the world's largest PC supplier, with a 15.7% market share to HP's 15.5%.

Lenovo's strategy is unique among the world's leading PC manufacturers, and is not easily copied.

Protect...

Since it acquired International Business Machine's (IBM) PC unit in 2005, Lenovo has grown into a force to be reckoned with through overseas acquisitions, aggressive pricing and by protecting its dominance in the China market.

According to Lenovo's 2012 third quarter reports, PC sales grew 16 points faster than the market with a record market share of 15.9% (IDC figures) and record earnings of $205 million.

Lenovo credits its 'protect and attack' strategy for their healthy results: they protect their two profit pools, global commercial PCs and China, while attacking high growth opportunities like emerging markets and 'PC Plus' products such as smartphones, tablets and smart TVs.

"'Protect and attack' is not just a geographical strategy, it also applies to our products and guides our investments. We protect our core business in PCs and attack new opportunities that exist in smartphones and tablets," says Chris Millward, Global Communications Director for the Lenovo Business Group. "In the past year we have begun to focus on what IDC refers to as 'smart connected devices.' This term refers to connected PCs, tablets and smartphones. That's what 'PC plus' is really all about: smart connected devices."

> We are really good at protecting our core businesses
>
> Chris Millward
> Global Communications Director
> Lenovo Business Group

So far 'protect and attack' has proven a sound strategy. Lenovo-branded smartphone sales have doubled year-on-year, and its overall smartphone product line became profitable for the first time. The company's worldwide tablet sales volume increased by 77%, and Lenovo's Mobile Internet and Digital Home Business Group (MIDH)—tasked with creating mobile Internet devices such as tablets, smartphones and smart TVs—now accounts for 11% of Lenovo's overall revenue.

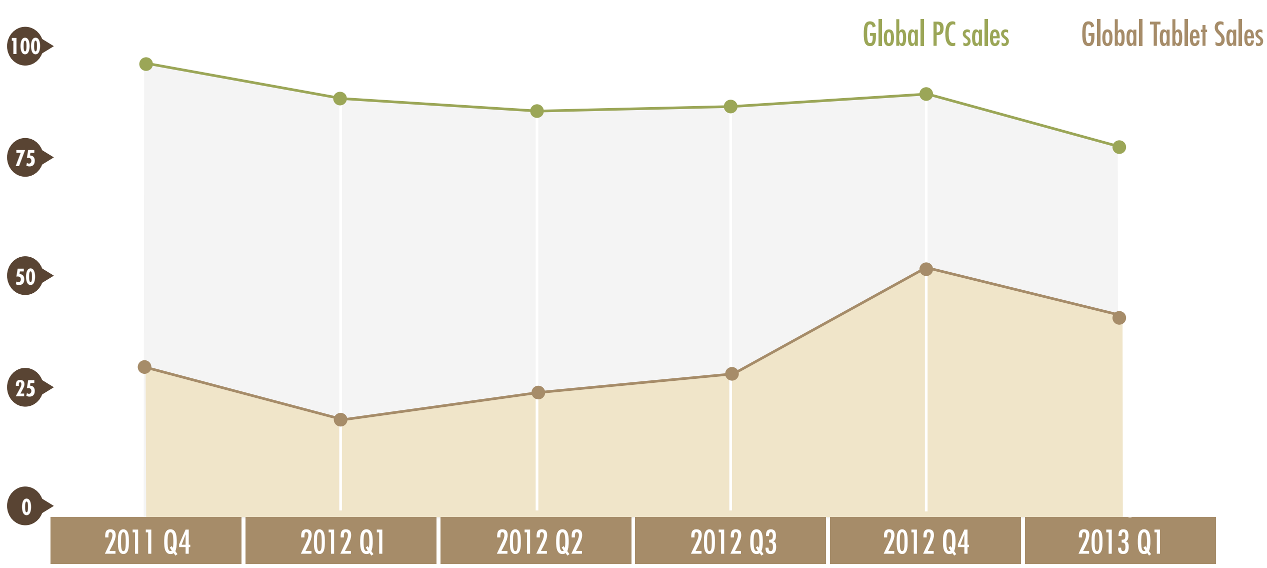
The 'protect' part of the equation is particularly key as much of Lenovo's success can also be attributed to China, where its PC sales outnumber those of its next four competitors combined. 44% of Lenovo's sales came from China alone. None of the Chinese PC manufacturer's major competitors can fall back on markets where they enjoy this kind of home field advantage.

"We are really good at protecting our core businesses," says Lenovo's Millward.

But having China in its pocket hasn't

The Tablet Advances, the PC Retreats

Global quarterly PC and tablet sales from 2011-2013 by volume (millions)



Source: IDC

stopped Lenovo from making efforts to innovate its PC product lines.

For instance, the company's latest offering, the IdeaCentre Horizon, claims to be a family-centric multi-user touch interface tabletop PC. This deviates from the traditional definition of "personal" computing by creating a platform that groups of individuals can use simultaneously, rather than individually.

"In truth, the Horizon started out as a desktop PC, but we realized that personal interaction was limited to calling somebody over to briefly share in your workspace on this kind of platform. Real-time interactions happening in the real world remained rather small. The Horizon changes this by creating a device that groups of individuals can use together to create a stronger community environment," says Millward.

Lenovo has even inked deals with gaming industry titans Electronic Arts (EA) and Ubisoft to customize games that combine physical gaming hardware with touch-screen game play—an activity that Lenovo refers to as "phygital".

Lenovo is clearly exerting effort to keep its PC products fresh in an age where even the word 'PC' evokes images of clunky boxes sitting atop drab work desks. Lenovo's laptop/tablet hybrid devices such as its IdeaPad Yoga and its smaller counterpart, the IdeaPad Yoga 13, feature a 360-degree hinge that allows them to be used as both personal computers and tablet, making the products the first in the market to offer four 'modes', or positions, in a single device. In the IdeaPad Yoga, Lenovo caught on to a key consumer demand trend: versatility in as tight a package as possible.

"We don't want consumers being tied to having multiple platforms to meet their needs. Consumers are looking for a device that adapts to needs on the fly. Multi-mode devices such as our YogaPad are a perfect example of the kind of innovation that has kept us strong in the PC space," says Millward, adding that Lenovo has maintained a 40% US market share in this category.

In contrast, HP CEO Meg Whitman openly admitted in a February 2012 investor conference call that her company "underinvested in innovation for the last several years and we've been late to market too often".

> "The company does not want its two product groups to steal the other's market share
>
> Tiger Shang
> Account Director
> Milward Brown

HP, for instance, does not offer laptop convertibles similar to Lenovo's YogaPad, nor has it announced plans to create multi-user devices to compete against the Horizon. Rather than innovate, HP has followed a more traditional approach by upgrading traditional laptops and ultrabooks with longer battery life and faster processing speeds, which has failed to find traction with modern consumers.

Dell used to be an industry leader in innovation in the early 2000s by offering customizable PCs on its online stores, but during the past decade it has lagged behind its competitors in offering new products, such as tablet PCs, and shut down its smartphone business globally in 2012. Executives at Dell have said that the company will expand its software and service business for large companies, but have not given specifics on how it will revive its low-margin PC business.

...And Attack

Smartphone shipments totaled 671 million units in 2012, 45% more than shipped in 2011, according to Juniper Research, and sales are predicted to nearly double by 2016 as new phones continue to enter the market, according to NPD DisplaySearch.

Smartphone industry titans such as Samsung, Apple and Nokia credit a substantial portion of their revenue streams to the successful rollout of increasingly powerful handsets. With profit margins like Apple's 37.4% and net profit increases like Samsung's 42% climb from 2012, it's little surprise that Lenovo has re-directed its attention on the mobile market.

Lenovo has confirmed its commitment to become the number one supplier of handsets in China—and maybe the world—by unveiling six new models at the Consumer Electronics Show (CES) in Las Vegas earlier this year.

Lenovo is betting heavily on its ability to steal customers away from China market leader Samsung through enhancing brand awareness, the introduction of new devices like the company's new IdeaPhone K900, and expanding its retail network.

Taking a page from Nokia's playbook, Lenovo has also signaled that smaller and simpler smartphones at a lower cost to the consumer may appeal to users in developing markets and BRICS (Brazil, Russia, India, China, South Africa) nations. Lenovo offered its first touch-screen handset in China in 2010, and has rapidly expanded sales in India, Vietnam, Russia and the Philippines in the past year.

Lenovo finalized a deal in January to purchase 100% of Brazilian electronics manufacturer CCE, one of Brazil's leading manufacturers, allowing Lenovo to double its market share there. In India, Lenovo announced late last year its intent to solidify its presence in the Indian handset market by launching five new Android smartphones. Lenovo calls this its "global-local" strategy, another way of saying it will adapt to local market conditions, and quickly at that.

Speed to Market

Lenovo's ability to catch trends and develop corresponding products quickly has been a company trademark.

Another example of speedy delivery is Lenovo's LePhone A60, one of Lenovo's newest smartphones to hit the Chinese market. The LePhone took less than six months to develop, less than half the time it takes its competitors to research and develop a new product. By comparison, Apple unveils a new iPhone once a year. This shortened research and development cycle allows Lenovo to rollout new devices faster than its competition, which in turn allows it to corner market share as a first-mover.

"This is our secret formula to success," says Millward, declining to go into details. IDC's Yang says it's a question of budget and personnel allocation, but it looks like for now the secret sauce is staying secret.

Less secret however is Lenovo's recent internal restructuring, which factors its strengths and weaknesses in order to stay nimble and responsive.

Divide and Conquer

Lenovo Chairman and CEO Yang Yuanqing has indicated his hopes that a recent organizational structure within the company that divides the company into two business groups (Lenovo Business Group and Think Business Group), may allow Lenovo to better target the high-end segment.

"We tried to push the Lenovo brand in mature markets but we realized that, as a brand, Lenovo only works in the mainstream and low-end market. In the high-end markets, Think is our best brand asset and the only brand which can compete against Apple," Yang wrote in an internal company email in January that was leaked to Chinese online forums.

"It makes sense for Chinese companies to separate their premium brands from their more local brands," says CKGSB's Teng. "This kind of division would give Chinese companies more flexibility, allowing them to target both global and regional markets."

> Lenovo approaches its PC business group and mobile business group as two separate businesses, this has allowed them to grab more market share
>
> Teng Bingsheng
> Associate Professor
> CKGSB

The Think Business Group will focus on Lenovo's Think-branded PCs, as well as enterprise business products. The Lenovo Business Group will focus on lower to mid-range PCs, tablets and smartphones.

As with any changes made to a company's internal organization structure, Lenovo runs the risk of overextending its iconic Think brand in its attempt to appeal to a larger consumer base.

"Lenovo must be strategic in how it positions its brand image. The company does not want its two product groups [Think and Lenovo] to steal the other's market share," says Tiger Shang, Group Account Director at brand consultancy Millward Brown.

Although Lenovo needs to be cautious in how it positions its two independent business groups to limit internal competition, its position in China will offer it flexibility in operations abroad.

China Equals Security

No other major PC manufacturer can rival Lenovo's presence in the China market, and as the country's lower income citizens rise to middle income status, Lenovo can bet on millions of eager consumers to purchase their first personal computer in the years to come—likely a Lenovo product. So while we can laud the company's shrewd business strategy, product innovation, and speedy R&D, it can't be ignored that security in the China market is undoubtedly what allows it to 'attack' new markets with vigor. But Lenovo is producing lines of products that point to a larger industry truth about the state of the PC and whether it's in decline or in a transitional period.

Despite claims to the contrary, the personal computer is still relevant in that the definition of 'PC' is getting hazier and hazier, allowing for all kinds of traditional technical demarcations to evaporate. Who says a tablet with a detachable keyboard isn't a PC? IDC's exclusion of such devices from their PC definition is arbitrary. It used to be that a PC was defined by an internal disc drive, but when was the last time anyone used a disc that wasn't a movie? Things are no longer so black and white.

Lenovo's lesson for those companies outside of China is whoever jumps head first into the new gray areas will reap the benefits. In a way, all smart device makers are playing catch up to Apple, but Apple is an extremely premium brand with premium price tags to match. If lower market PC manufactures can redefine themselves just as the PC has been redefined, offering products that breach traditional boundaries, then Lenovo may find itself in good company.

Conversations

"In 2-3 years, I believe, the yearly revenue target (for JD.com's global business) should be over $100 million. In three years probably we're going to hit that target, but secretly I want it to be even bigger than that"

52

Shi Tao

Vice-President (Retail), Jingdong

55

"Bottom of the Pyramid 2.0 thinking begins with the premise that taking product categories from the 'Top of the Pyramid' and transposing them down will probably fail, and that you really need to generate new categories"

Stuart Hart

S.C.Johnson Chair in Sustainable Global Enterprise and Professsor of Management at the Samuel Curtis Johnson Graduate School of Management, Cornell University

"The consumer classes in the second, third and fourth-tier cities consist of 200 million households or approximately 650 million people. That's a massive opportunity"

59

Kunal Sinha

Chief Knowledge Officer, Ogilvy & Mather Asia Pacific

62

"All one can ask from a society is not an equality of outcome—not that everyone is going to be rich, but that everyone has an opportunity to be rich"

Lady de Rothschild

CEO, E.L. Rothschild

Testing the Waters

Shi Tao, Vice-President (Retail) of Chinese e-commerce retailer Jingdong, on some early lessons from the company's global push

By Neelima Mahajan and Iris Mir

Jingdong (JD.com, which was formerly known as 360buy.com) began as a brick and mortar electronics retail company in Beijing's Zhongguancun market in 1998. But the 2003 SARS epidemic hurt business as people stopped going out for shopping. The ingenious founder Liu Qiangdong smelt an opportunity here and dabbled in an experiment in selling his goods online. The results were encouraging and led to the creation of China's largest B2C (business to consumer) e-commerce company.

As an e-commerce company, Jingdong is barely nine years old. Yet it has ambitious plans to go global and debuted its global site in October 2012. Shi Tao, Vice-President (Retail), Jingdong, hopes that in 2-3 years, the company will clock yearly revenues of $100 million from the global operations. There's still a long way to go as the global markets are very different from Jingdong's home turf of China. Shi, who has previously worked with Amazon, elaborates on differences between Western and Chinese e-commerce players, Jingdong's global play, the challenges they have encountered and the learnings so far.

Q. Jingdong began as a brick and mortar outfit, but it managed to very successfully transition to e-commerce. For others looking to make the same transition, what were some of the key learnings from your experience in the Chinese e-commerce market?

A. We were quite lucky in some things, like the entrance category. If you start from low-priced items, you end up just selling that forever. It's hard for you to expand into new categories. Fortunately Jingdong started with computers and cellphones, which are high-priced. In the beginning, we acquired customers very slowly. People didn't trust the internet to buy high-priced stuff, but after you have more customers shopping on your website, you cultivate confidence and trust. This gives you the power to expand into other categories that customers don't really worry about.

Q. What would you say are the key differences in the evolution of e-commerce in China vis-à-vis the US? Also, what do Chinese companies have to do differently to be relevant in this market?

A. I have worked in both Amazon and Jingdong. (They are) very different companies, not only because Amazon is international and Jingdong is local, but also because the working style and culture is totally different. In Amazon, you can't make your decision locally. You have to report to Seattle in order to get the decision (approved). But in Jingdong, every buying manager can make decisions by themselves. They can quickly react to market needs, they can do different promotional activities, and different merchandising and marketing. In Amazon there is only one model, which is the US model.

There are probably three major reasons why Jingdong can go a lot faster.

One, (we have a) self-run delivery service. In China you can't just use a service like UPS or FedEx like in the US. You just don't have it. The only thing you can use is China Post, whose service is terrible so you can't count on them. There are a couple of small players, but they cost a lot. If you build it yourself, it will give you a big competitive edge. The second one, of course, is the category entrance strategy. The third one is passion. When I was in Amazon, I didn't feel that I had a lot of passion, because for everything there is a regulation or a policy you have to follow, and you don't see anything for which you can make a contribution.

Q. What are some of the peculiarities about the Chinese market and consumer that you factored into your model from the beginning?

A. Everyone one of our delivery boys has a point of sales (POS) machine that allows customers to use their credit card, while Amazon doesn't. Every Jingdong delivery boy has it, so no matter whether customers want to pay by cash or credit card. That was very important at the very beginning, because you have a high-priced product, and customers won't have so much cash in their hand, so they have to use their card. But Amazon thinks (that by letting customers choose), they are doing better service. The customers are always lazy. They don't choose, or they forget to choose, or they don't even see the page (where they need to indicate their payment choice). When you come, they say, 'Sorry, I don't have the cash.' So you just go back. That's the only differentiation that we created at the beginning. Because we used our own delivery service, and Amazon used third-party it cost a lot.

Amazon is price-driven, which means 'everyday low price'. It is a philosophy that old American companies believe in. Walmart also insists on 'everyday low price', but the Chinese customers are not attracted by that so much. They want to see huge promotions, discount sales, and if you just keep low prices everyday, they don't think you want to offer them better prices. So that's a huge difference. Amazon has the whole system to keep their prices competitive. They trawl through all the competitor websites, get the price and match the price by their logic. What we do instead, from time to time, is offer huge promotions. That's a good way to acquire new customers and also make customers believe that you can offer better prices than your competitors. That is quite China-specific.

Q. Jingdong recently went global. What is the level of ambition we're talking about here and what is your global strategy?

A. I don't have any concrete picture of our overseas business in the future. We will definitely will keep our core values: that we're the company that's trying to create value for customers. So customer-centricity will probably be the only and the most important thing for us. Other than that, we have to learn about the global market, because we don't know anything at this stage. We should learn about their culture, category and payment preferences, and even their legal and governmental environment.

Right now we are working with a Russian company called Ozon, which is a Taobao type of company in Russia. We want to build a partnership so that they can handle customer service, delivery, the last-mile delivery, even credit cards and payment. We offer the products, our website, price, everything. This probably will be the better way to launch in different markets.

But Amazon went a totally different way. They set up their own company or acquire a company and build their own team, and do their own buying and selling. Probably in the future that won't be the only way to do this global business.

Q. What are your target markets globally?

A. Our advantage is low price because the products are made in China and sent from China. Our team costs are definitely smaller compared to launching a company in the US or Europe. We are definitely going to keep these advantages when we do the business. Our team is based in China, but people can buy from the other markets and then we ship from China. That's one way. We will probably stock some products in certain countries and we will ship from there too. (We can use) both these ways to (stock) top products, (shorten the delivery time) and give customers a better experience. But for 'long-tail' products, when customers are not speed-sensitive, they can allow a longer time to deliver, so we use a combined strategy. This is different from what Amazon is doing.

Right now 70% of our orders are from the US. It is quite interesting because you think about emerging markets like India or Brazil, but then actually the people who have more money and a stronger sense of online shopping probably will make for the biggest market. We're not in a position to educate customers for certain markets. That is the local players' job. If the market is already developed, we think there will be a chance.

Q. Can you explain your plan to launch your website in other languages?

A. Within the European market there are so many different kinds of languages. There are French-speaking places, German-speaking places and Spanish-speaking places. (For us) probably they will have priority, but Italian or Norwegian won't. It also depends on whether we have a partner there to help us land in those markets, like in Russia. Of course, we want to offer Russian language.

Q. What is your revenue target for the global business?

A. At this point, it's difficult for me to do a forecast. But in 2-3 years, I believe, the yearly revenue target should be over $100 million. In three years probably we're going to hit that target, but secretly I want it to be even bigger than that.

Q. Going global also means going head to head with Amazon and eBay which understand those markets better. How will your value proposition and strategy be different?

A. Honestly speaking, there is no such strategy right now. Even (if) the US is the biggest one, I don't want to confront those giants. It's not smart. There are some other markets where we have the opportunity to win. But in those developed markets, I will still use (the same) strategy (as) today: based in China, we'll sell products to those countries, (and these) will be in niche markets. There are certain things that Amazon or eBay are good at but not everything, otherwise I wouldn't have orders from those countries, such as low-priced clothing. It's something that China has a huge advantage in so we can focus on it. But for consumer electronics, maybe we should focus on emerging markets. So this is going to be a 'category strategy'.

Q. How have you adapted the global site to the global customer?

A. We launch the website first, and then we test the shopping behavior of people: what they click, pictures they like, areas they like. Such as our 'browse' tray: that's the most commonly clicked place, but not those big promotion banners. So we'll change that. But then different countries have different cultural perspectives. That's really challenging. Now we have only one platform, one palette on which we can base our offering of different languages. But in the future we can say, 'If this country likes red color, we should make the website red.' We don't know the answer yet, but we will definitely test everything in order to make a right decision.

We've changed the categories quite a few times. First we put computers and accessories on top of the 'browse' tray, and books at the bottom. Now we have moved books higher because there are so many overseas Chinese buying books from us. We didn't realize that before we launched the website. We'll cut off some categories that people never visit. Now we've listed more products from Jingdong's website because we found people are really interested in our domestic website, but they couldn't buy (from there). They come to our foreign website and they didn't find the same products. So we listed more domestic products on this overseas website.

Q. What are some of your biggest challenges in overseas markets? Is selling 'Made in China' products in foreign countries an impediment due to negative perceptions about quality?

A. That is not the most challenging part, because China-made products have two main characteristics. One is low price, the other is not fancy, but just commonly used stuff. People don't expect too much and it doesn't have a brand name, but it's okay for everyday use. We focus on those. We don't pretend we're selling brand name products. If you go to Walmart in the US, 90% of the products are made in China. So they are getting used to it.

The biggest challenge for us is shipping. We have to use international shippers like UPS, FedEx and DHL. We also have to use China Post or Hong Kong Post. People have to wait for a long time before they get the products, and that (impacts) sales. Once people place the order and don't receive the product after a few days, they cancel the order. That is a very serious challenge. We want to offer customers express service for all products, but then we tried to bear part of this cost, and let customers lower their costs. To do this we have to do a lot of calculations and bargain with international shippers, and also optimize our process to lower the cost. Normally, the products selling to the international market have bigger margins, so you can also balance out those margins to cover some of the shipping costs and make it reasonable.

The second one is payment. They have to use online payment, and right now we only have PayPal. Not everyone uses PayPal. A lot of people use credit cards—Visa, MasterCard or American Express. So we have to expand our payment by working with credit card companies and that takes time. Also, there are banking regulations the Chinese government wanted to impose on businesses. So we have to juggle with those.

Q. What are some of the early learnings from your globalization drive?

A. The most challenging is shipping. At the beginning we didn't really realize that the customers pay a lot of attention to shipping. We thought they'll focus on products: place their order and wait for it. Now we are seeing a high bounce rate from the order pipeline, which means customers put something into the shopping cart and later drop it. They don't want to buy the products anymore once they see the shipping charge is too high. So we are trying to improve shipping.

The other thing is, we learn that we have to change very quickly, like with the currency. Now we only offer US dollars, but people send us emails and even call us asking if we have prices in pounds or euros. They want to know the price in their own currency and they don't want to calculate it based on the exchange rate. We thought it's so easy: you go to Google and check how many dollars equal how many pounds. But people don't do it. They want to make quick decisions to decide if they want to buy this product. So we have to offer their currency.

Q. Jingdong has set up a POP platform (Plan of Open Platform on which vendors can set up their own e-stores). You were a B2C (business to consumer) company, and now you seem to be evolving to B2B2C (business to business to customer), which is practically speaking, Alibaba's model. With this expanded model are you now trying to compete with Alibaba now?

A. Not every category is good for B2C. There are many categories only good for B2B (business to business) or B2B2C. For example, clothing is the biggest category for Taobao, but the smallest in Jingdong because it's hard for you to take care of that stuff in huge warehouses which have a lot of dust and open space. It can be very well taken care of by those sellers, in their small places. If you have a lot of sellers selling this category, and if you add up their small warehouses, the space can be huge. Taobao has over 7 million sellers, and if each seller even has 10 square meters, that would be a huge space for products. If there's something we're not good at, we should let other people do it.

(To read the full interview and to watch the video, please log on to http://knowledge.ckgsb.edu.cn/)

Bottom of the Pyramid and Beyond

Stuart Hart on the idea that revolutionized business thinking

By Neelima Mahajan

Stuart L. Hart is the S.C. Johnson Chair in Sustainable Global Enterprise and Professor of Management at the Samuel Curtis Johnson Graduate School of Management at Cornell University, where he founded the Center for Sustainable Global Enterprise. He also serves as distinguished fellow at the William Davidson Institute (University of Michigan) and president of Enterprise for a Sustainable World. He, along with well-known management guru C.K. Prahalad, is considered one of the founding fathers of the Bottom of the Pyramid theory. In 2002 he co-authored the first seminal article on the Bottom of the Pyramid along with Prahalad. Hart is also the author of books like **Capitalism at the Crossroads** ***and*** **Next Generation Business Strategies for the Base of the Pyramid** ***(with Ted London).***

In the year 2002, C.K. Prahalad and Stuart Hart published a groundbreaking article in *Strategy+Business* magazine that introduced to the world the idea of the Bottom of the Pyramid (BOP). The idea, which says that the poor present a vast untapped business opportunity, and if companies serve the poor, they can help eradicate poverty and also make a profit, revolutionized business thinking. Funnily though, before 2002, the idea had no takers: various management journals including *Harvard Business Review* didn't publish Prahalad and Hart's article for nearly four years because it didn't have enough evidence in terms of multinational companies who had successfully experimented with the idea.

Years later, the idea caught on. Companies like Unilever, Cemex and S.C. Johnson came up with innovative business models to tap the so-called BOP markets in places like India, Brazil and Kenya.

Today more than a decade has gone by, and the idea has come in for some amount of criticism as well. Some of the most vocal critics, such as University of Michigan's Anil Karnani, have accused the model for being 'exploitative' and 'imperialistic', and for viewing the poor only as consumers.

Hart, one of the two proponents of the idea (Prahalad passed away in 2010), still stands by the original concept. However, he believes that the idea of BOP needs to evolve to something he calls BOP 2.0. Companies need to involve local communities in co-creation so that they create more innovative, relevant, sustainable—and lasting—products and solutions. In Hart's words, "BOP 1.0 typically takes our mental models, our categories and transposes them to the base in a cheap form, affordable form. BOP 2.0 thinking begins with the premise that taking the product categories from the 'Top of the Pyramid' and transposing them down probably will fail, that you really need to think about new categories, it's a way to generate new categories."

Hart, the S.C. Johnson Chair in Sustainable Global Enterprise and Professor of Management at the Samuel Curtis Johnson Graduate School of Management at Cornell University, was in China recently. In this interview with *CKGSB Magazine*'s Neelima Mahajan, Hart, talks about the evolution of the idea of the Bottom of the Pyramid and his work in building sustainable strategies.

Q. You and C.K. Prahalad came up with the concept of the Bottom of the Pyramid in 1998. When you look back at the idea now, especially since we have the benefit of hindsight and we have seen how companies have implemented it, what do you think of the idea as you originally conceived it? Would you change anything?

A. The fundamental conception hasn't changed at all. What C.K. Prahalad and I were trying to do in that original piece was really draw attention to the fact that prior to that there might be a financial or enterprise-based approach that could affect low-income people or poor communities. Microfinance preceded it. There certainly have been lots of NGOs that have been working their territory for a long time. We drew attention to the fact that large corporations could actually play a role. Prior to that, it just wasn't on the radar screen. From the point of view of drawing attention to that potential opportunity, the original piece stands. The concept says that it's possible for corporations to become engaged with the two-thirds of humanity that they had systematically ignored in the past, and to do so in a way that actually, one, generates innovation, and two, has the potential to actually lift the base, not exploit it. I stand by the original concept.

Q. The concept came in for a lot of criticism as well, particularly in 2006. A research paper by University of Michigan's Aneel Karnani called the fortune at the Bottom of the Pyramid "a mirage" and accused the concept of propagating an imperialistic notion. To what extent is that a function of the concept itself, or is it something to do with execution?

A. Aneel does raise some valid points. I would be the first to admit, and so would C.K. Prahalad if he were still alive, that you can always find examples of exploiters in any field. It's not unique to BOP or anything else. But I didn't find that critique particularly useful. If you look at cases where this hasn't worked so well, who could dispute that? But if you look at other cases where there is an honest attempt to try to actually create a product or service of some kind, and why it hasn't worked, I think we can learn some important lessons there and some of Aneel's work points to some of things that I think are worth considering. But a blanket dismissal doesn't make any sense.

One of the things we have learned from many of the early attempts to do this by large corporations, and probably some of the original ones, even where they were beginning to experiment with this when Prahalad and I first started writing the piece—like Hindustan Lever in India (the Indian subsidiary of Unilever, now known as Hindustan Unilever), they were reacting to what they perceived as threats coming from local companies, like Nirma in India (Editor's note: Nirma is an Indian company that manufactures soaps and detergents). They were gearing up a competitive response, and I think there was a certain degree of mimicry. Other companies then began to see what Unilever was doing: the innovation of sachet packaging (Editor's note: Unilever tapped BOP markets in India by offering low-income consumers products in sachets and single-serve packaging. By reducing the quantity, they were able to lower the costs) and there was a little bit of a pile-on effect.

I've thought about it, and my colleagues Erik Simanis, Ted London and others have thought about this as sort of a BOP 1.0 version. One of the things we have learned from the first decade of activity is that simply coming up with a lower cost version or single-serve version, sachet-packaged version of current products, then seeking out distribution into rural areas or into slums with NGO partners, or outsourcing to NGOs, getting production costs down, is structural innovation. It's important because for a large corporation thinking about this completely different business model, is a significant change. If we are honest with ourselves, and we look at the results of companies that have tried to do that—take existing products, take the cost out of them somehow, and then trying to get extended distribution usually using NGO partners—it just hasn't worked very well.

Maybe on either count it hasn't necessarily been pulled in by the communities themselves. In other words, there hasn't been a huge demand response. For most of the companies, it has not been a particularly profitable venture. In many cases, they've moved it over to the philanthropic side of the company. If we're honest, that's the reality. If you take the Karnani critique, there is some validity to it.

Some of the conclusions that we began to take away from this is that one, the whole concept of just thinking of this as a target market when you can come in with a 'rifle-shot product', doesn't work, for a couple of reasons. This sort of marketing research-based rifle-shot product works in the upmarket because you have people who are used to being marketed to, and all the infrastructure to support such a strategy is already in place. But that just doesn't exist when you are thinking about the lower income space, either in rural areas or in slums. It's necessary to think about a wide and compelling value proposition, and that probably the only way you get that is to actually engage people in the community itself in the process of creating it. This is where a lot of the work on co-creation comes from.

It's necessary to actually engage people in those communities for a couple of reasons. One, we're just not smart enough to know what to do in terms of a targeted product that we're going to go and market there.

That model just doesn't work, and two, it's necessary to engage the people themselves in this process because that's the best way to create a wider value proposition.

Q. A lot of what companies such as Unilever in India have been doing in this domain is very BOP 1.0, as you call it. How can companies move to BOP 2.0, a better, sophisticated and more sustainable way of the same concept?

A. New approaches were coming in even in 2003-04 with the Base of the Pyramid Protocol (Editor's note: This is a business incubation process created by Hart and his colleagues to enable multinational companies to generate new business opportunities at the BOP), with S.C. Johnson, with DuPont. A recent example is of Godrej's Chotukool refrigerator. Maybe five years ago, Godrej, a large business house in India, saw a tremendous need, in this case lack of refrigeration, especially the rural areas. They set on a path to develop a 'BOP refrigerator'. They did everything that you would expect would be done under the 1.0 model, and there's nothing ill-intended about that. It's just what most existing corporations know how to do. They go out, they collect the marketing research data, they do household expenditure patterns, studies, do some focus groups, get an idea of what the price point needs to be and come up with a product that hits that price point, then repurpose some of their direct sales people along with NGO partners to go and sell it.

So they came up with this little thing that looked like a little metal box, with a little freezer compartment. They were convinced that because they hit the price point, this was going to go out there. They began trying to sell it and it just completely fell flat.

The important thing is that they didn't stop there. They took a step back and they asked what went wrong. Long story short, they brought in some collaborators and went through a co-creation exercise, where now some of the people from the company themselves joined the team and lived in the community for some time. They began to gather potential partners, mostly women, as opposed to just collecting data about household expenditures. Now they were in the community, becoming immersed, attracting potential partners interested in becoming entrepreneurial partners in the venture, as opposed to just consumers. They ultimately came up with this artifact called the Chotukool, which means 'little cool' in Hindi. It's not a freezer, (just) a different category.

BOP 1.0 typically takes our mental models, our categories and transposes them to the base in a cheap form, affordable form. BOP 2.0 thinking begins with the premise that taking the product categories from the 'Top of the Pyramid' and transposing them down probably will fail, that you really need to think about new categories, it's a way to generate new categories. So the Chotukool is a new category, it's not a refrigerator, and it is functional, because it doubles as a work surface. It actually was a leapfrog innovation too, because it doesn't use a traditional compressor as the cooling agent. It's a leapfrog technology all in the lid. It can use any power source, including solar or biofuel or anything else. It can be moved around inside the home. The women in the community themselves were involved in the development, and also are agents both for selling and servicing, so it's income generating in the community. BOP 2.0 has a wider value proposition, it's just not going in with a single product that you are trying to sell, it has engaged the entire community in this enterprise that you had a hand in designing it, and they are part of the business model as well.

Q. Moving on to your work in sustainability, most companies are caught in a very one-dimensional view of sustainability: one small initiative here, one small initiative there, and they think they have done their bit. How would you really rethink the idea of sustainability so that it includes a lot more than what companies are used to thinking about?

A. I've tried to think about it now for some time, not as a set of one-off side programs in corporate social responsibility (CSR) and reporting, but how do you embed this in a fundamental way in the corporate strategy of the company. Has the world come around to that? I'd say a lot more now than 20 years ago. But I'd say that the dominant way of approaching this, somewhat unsurprisingly to me, still is for existing corporations, number one, eco-efficiency which I now think has really caught on in a very substantial way. It makes sense because it simply makes the current business model more efficient, so it reduces costs and reduces risk. So it shouldn't surprise us that the eco-efficiency, pollution prevention—what I've called 'greening strategies'—have taken root first. But on the social side, what's taken mostly is what we would call CSR activities, which have tended to be corporate volunteerism, philanthropy, starting up, kind of doing good work and allowing people in the company to participate in them. They don't always have much to do with the core strategy of the company.

It's not a bad thing but it's not going to change the world. It's not possible to donate your way out of the challenges that we face, so eco-efficiency and CSR, I think, have now taken root in a pretty substantial way. It's great that that has happened on some level. Eco-efficiency is more embedded in business performance because it's all about reducing risk and costs and operations, CSR has been more separate from business strategy, but it's seen as a reputation play: building up the company reputation, and maybe attract employees if they notice the good work that's going on.

But what I would see as really the most important element of all this is what I call 'beyond greening'. It has probably gotten the least traction so far, and again I'm not surprised by that. In fact, from the beginning I saw this as a long-term proposition: that if 'greening' is about the continuous improvement of current products and processes, emission reduction, pollution prevention, waste reduction, product stewardship, engaging stakeholders around current products, maybe thinking about changing the supply chain, think about how you could design the product differently to be able to take it back. That's a little more radical than just pollution prevention. But those are 'greening' strategies.

'Beyond greening' is about leapfrogging to next-generation inherently clean technology, which would make what you are currently doing, in many cases, obsolete, and it's about getting to those who have been less underserved, or actively exploited, and communities that fit that description as well, which we call the base of the pyramid. So 'beyond greening' is about tomorrow's technologies and tomorrow's potential markets that have to be created. 'Greening' is about today's products and processes.

We shouldn't be at all surprised that 'greening' is what's happened first. It builds off current routines and current capabilities. 'Beyond greening' requires the development of new skills and capabilities. It's potentially disruptive for some of the current core businesses within a large established corporation. For entrepreneurs less so: they can start with pure plays that are 'beyond greening' and go right after those incumbents. But for incumbents it's something that looks potentially disruptive on the surface, but clearly would require new capabilities and skills in order to carry it off.

Q. One of your key contributions is the idea of the Sustainable Value Framework which links the challenges of global sustainability to the creation of shareholder value by the firm. In theory, this makes complete sense as it will make it easier to solve some of the tough problems we are facing in the world today. How can companies make the Sustainable Value Framework a business imperative, especially when they are trying to achieve tomorrow's goals even while they are operating within today's business model? All of that put together is a tough act.

A. It's a matter of being a realist about what the current conditions are, and then where things are likely to go over time. The last 20 years have been all about economic globalization and the emergence of China and India, especially the rising middle classes. Most existing corporations from the West focused all their attention on catering to those rising middle classes. That's really what emerging market strategy has been. Frankly, that's what most Chinese and Indian companies have done too: they focused on either the elites, which they always did, or for growth the rapidly rising middle class. There were a large number of people who joined that category over the last 20 years. The problem is that strategy of catering to that rising middle class can't last. We've now reached a point where the whole approach—taking what we are already doing at the top and then moving it incrementally down market—the environmental implication of that becomes so onerous and difficult to imagine that you're confronting meltdown. It's not possible to take the resources and waste-intensive model that existed previously and multiply it by three or five, let alone taking it all the way to the base. The environmental implications are just unthinkable. So environmentally I think we're reaching a point where that strategy just won't go any further.

But we're also reaching a point where that strategy now is reaching its limits purely from an economic and financial point of view. You can only strip so much cost out of a high-cost model as you step it down, that eventually you start to run into the limits. As you try to move further down the income pyramid, people simply can't afford this stuff, or doesn't really fit what they need. The first attempt was BOP 1.0, you just strip more cost out of it, put it in a sachet package. It hasn't worked so well. Environmentally and from a purely financial affordability point of view, it does not (work well).

As we look forward to the next 20 years, if companies are going to grow and they are driven by growth, they are going to have to figure out how to reach out to the rest of the world, the other 4 or 5 billion people at the base of the income pyramid. A lot of people have said, 'You're interested in the base of the pyramid, or BOP, so what are you talking about? Is that the bottom billion, less than a dollar a day?' Obviously the 4 or 5 billion people that Prahalad and I talked about, people who earn less than $3-4 a day, that's 4-5 billion people today. They're not all the same, this is not just some monolithic demographic. And we're not focusing just on the people that are under a dollar a day, if you did that that's a billion or so, we're talking about 4 or 5 billion. Focusing exclusively on the bottom billion as a business strategy is pretty tough. That's more the domain of pure aid, but you can think about strategies that cut across all of this, because communities are made of people that cut across this income range. That's increasingly where we're headed. How do we begin to conceptualize, through this co-creative process, new products and services embedded in inclusive business models that lift the base and open up and create this entirely new market that didn't exist before, and at the same time improve people's lives, generate income—that's how you lift the base. That's what the next 20 years is going to be all about, and that is the 'beyond greening' agenda. We've arrived at the point where there's actually not a lot of choice. If you are a large incumbent global firm, there's not a lot of other territory for you to expand into.

Q. Is that thinking starting to trickle into boardrooms today?

A. I think it is. Compared to even 10 years ago, let alone 20 years ago, the kind of conversations that are going on in the C-suite and boardroom would boggle your mind. This is on the radar screen, and people are beginning to engage this challenge in a very thoughtful way. It's only a matter of time. As long as there is easier low-hanging fruit to pick, it's understandable why companies would go after that. But I think now we're arriving at a time when there just isn't a lot of easy, low-hanging fruit left, so if you're serious about just looking at it purely in a mercenary, corporate growth and profitability way, if you are serious about continuing to grow the company for the future, you have to look at this or else you don't have a future.

(To watch the full interview on video, log on to CKGSB Knowledge: http://knowledge.ckgsb.edu.cn/2013/05/21/finance-and-investment/bottom-of-the-pyramid-stuart-hart/)

The Next Big Thing

Ogilvy & Mather's Kunal Sinha believes that China's lower-tier cities hold the key to the country's growth

By Neelima Mahajan

If you thought that China is all about big cities like Beijing, Shanghai and Guangzhou, think again. The next big areas of growth are lower cities in China's interiors. With 200 million households, rising incomes and growing opportunities, China's lower tier cities offer companies a huge, compelling and relatively untapped growth avenue. According to AC Nielsen research, tier-one cities had a disposable income value of RMB 1 trillion, while second to fourth-tier cities had a combined disposable income value of roughly RMB 8 trillion.

Kunal Sinha, Chief Knowledge Officer and Cultural Insights Director at Ogilvy & Mather Asia, has been researching this for a while now, and recently released a study titled 'China Beyond—Change & Continuity', the third such study in seven years.

In this interview, Sinha elaborates on the findings of this study and the implications for marketers.

Q. How big is this opportunity in China's lower tier cities?

A. The consumer classes in the second, third and fourth-tier cities consist of 200 million households, or approximately 650 million people. This is seven times the number of consumers in tier-one cities. Interestingly, even now, advertising and marketing spent on these consumers in relation to tier-one cities is about 4.5 times. Clearly, the potential is much greater than what most companies are thinking.

Q. What is the typical lower tier consumer in China like?

A. These people are far more community-driven in general with a far greater sense of family values. There are more likely to be three-generation families within most of the households. There are young people who are slightly different from that norm. Thanks to their exposure, (they) have far greater expectations and they want to lead change, not just follow the young people in first-tier cities. As we go from the second-tier towards the fourth-tier, there is an increase in the affinity towards nature and a more easy-going pace of life.

> "Young people now realize that they have an opportunity to challenge expected norms

Q. How have the aspirations of the lower-tier city youth changed?

A. These people (have) suddenly (realized) thanks to technology and greater exposure to other cultures and lifestyles, that they are not anymore the 'left-behind youth', a term for young people, especially from small towns, who can't get through the competitive *gaokao* system, and can't go to the best universities. But now there are greater opportunities for people to make a difference. Young people in fourth-tier cities say that they want to be entrepreneurs. They are seeing that opportunity. They're seeing other people who've been successful as entrepreneurs, who may not have had a privileged education, but they still made it in the new China.

The first-tier city youth are inclined towards working in multinationals and the fields of technology or financial services.

Q. People in lower-tier cities pay a huge emphasis on traditional values in the face of encroaching modernity, via things like the urbanization and the internet. How are these forces reshaping the landscape in lower-tier cities?

A. Traditions are being challenged in a good way in corporations. In the old way it was impossible for a 25-year-old to challenge or question the authority of a 45-year-old. But now the 45-year-old has no qualms in admitting that he or she is not as technologically savvy as the 25-year-old, and is willing to learn. It's the same thing within the family. That's an interesting dynamic. On the other side, young people now realize that they have an opportunity to challenge expected norms. We are seeing a lot of young public opinion through Sina Weibo on corruption or pollution.

Q. What are some of the big changes you have seen over the seven years that you have conducted this study?

A. The youth mindset has changed from almost a defeatist mindset to one that is far more optimistic. There are other significant changes, driven purely by the physical changes that have happened in these cities because they now have far more options for entertainment, education and employment. Seven years back everyone wanted to get out of the smaller towns. For the first time, people are interested in coming back from the big cities into smaller towns.

In retail formats, 6-7 years back the mainstay for consumer goods retail in small towns was the local mom and pop store. They had a personal relationship that went back 20-30 years. But now the shoppers want a better shopping environment. They are upgrading to modern format stores, like supermarkets or hypermarkets. That has significant impact on how you communicate with consumers and how you put your brand out there.

Another area is the rise of e-commerce. That has suddenly put all those products that were not previously available to consumers in the lower-tier cities, available at literally the click of the mouse or their mobile phones. They are beginning to exercise that option.

Q. Five years back, China's urbanization drive and urban migration was the big thing. Now we are starting to see reverse migration. How big is this trend currently?

A. All those young people who went to the big city 10 years ago were thinking of making a career, buying an apartment and a car, sending their kids to school in the big city, etc. They have realized that after slogging from 6am to 8pm, they still cannot achieve those dreams simply because the cost of housing, education and healthcare has gone through the roof. The cost of buying a car and the registration plate for the car is astronomical. It means that they can't achieve all those dreams. But what makes it possible for them to return to the second-tier city is the fact that they have developed thanks to the government's modernization drive. There are more employment opportunities, good quality housing, and more entertainment and education options. This big city experience that they have gained in the last 10 years makes them valuable employees when they go back home. If they choose to become entrepreneurs, even that is valuable because they can bring their experience and put it with their traditional networks of relatives and friends.

Q. One always associated lower-tier cities with low purchasing power, and suddenly you have people who can afford luxury brands like Gucci and Prada. What are the income distribution patterns and wealth ownership in the lower-tiers like?

A. If you look at it in terms of just the proportion of the number of people who are wealthy in the lower-tiers, it will be small. But when you have 200 million households and aggregate that up, it can be quite a sizeable number. In fact, in the last three years (it's just slowed down a bit this year), most major store openings have been in the second and third-tier cities. It's perhaps a mistake to believe that people did not have the money. There are 42 million small and medium enterprises in China, and many of them are in smaller cities. It's not that the (entrepreneurs) didn't have the money, they just didn't have the avenue to spend it. Now with the opening of luxury stores, they are beginning to do that. The other thing that has happened in the recent past is that the norms for traveling abroad have been eased a bit and tour operators are taking planeloads of lower-tier entrepreneurs, and flying them to outlet malls in the US or Europe. They are buying not just for themselves, but for gifting to other people, which has been part of their tradition.

Q. In luxury at least it seems like marketers will have to focus a little more on the lower-tiers, but generally speaking do you think we are reaching some kind of a tipping point where companies will have to reexamine their strategies in a big way?

A. We are reaching a point where it will be key to look at segmentation within the Chinese luxury shoppers. China is already the second-largest luxury market in the world, and now it's just a matter of when it will become the world's largest luxury market. There are more than a million millionaires in China already. The wealth not only comes from people who are entrepreneurs, but also from people who are salaried employees of very well-performing companies. It comes from inheritance in many cases. Within the luxury market there is a segment called the second-generation rich. Are you going to look at someone who is second-generation rich, who's already had some experience of buying luxury goods and is now moving into the luxury experience market, or are you looking at the first-time buyer who is not just buying for himself or herself, but buying for a whole lot of other people for gifting? Those are the dynamics of the luxury market that the brands have started defining more clearly, and designing experiences based on these needs.

Q. Do other sectors also have to reexamine their lower-tier strategy in such minute detail?

A. Absolutely. In these markets, the consumer landscape is becoming extremely competitive. Companies will start to define their strategy based on whether they are introducing their brand into the lower-tier shopping basket, or are they going to take the local players head on? On the flipside, how does a local Chinese brand which is already there with significant customer engagement, react to the entry of a foreign brand to the same marketplace?

Q. Is there an example of a company that approaches both the lower-tiers and the upper-tiers well?

A. It will be hard to find examples, because by and large you find companies that have either done well in the tier-one and tier-two cities, and those which are relatively better performers in tier-three and tier-four cities. When we asked respondents across the city tiers what their favorite brands were, the top three brands remained pretty much the same: Haier, Samsung and Nokia. Nokia is a surprise because people think that it's a brand that is dead and buried. They seem to offer value-for-money and technology as a combined proposition to the consumer. But the way these brands would sell in the upper-tier city would be quite different from the way they would sell in a lower-tier city, because in the lower-tier city you have to go out to the consumer, you have to highlight the new features of the brand, whereas in the upper-tier city you perhaps want to draw them in with some news, you have to generate conversations around the brand, especially if you got something new in the new products that you have.

Q. Are there particular industries that are better poised for the lower-tier opportunities?

A. It is mostly the Chinese companies which understand where the opportunities are. To take an example, and it is not just for the lower-tier but in general, there are local companies such as this one which created a mobile phone just for the seniors market. Seniors are willing to spend on technology, just that they don't want a phone that is packed with 50 features. These companies realize that what seniors want is big buttons, they want the display to be relatively big, and the phone should have voice dialing and maybe an emergency button which automatically calls a hotline or their son or daughter. Chinese firms understand some of these specific needs very well.

(For the full interview and to watch the video, please log on to CKGSB Knowledge: http://knowledge.ckgsb.edu.cn/)

Lady Lynn Forester de Rothschild is a former corporate lawyer and telecom entrepreneur. She is the CEO of E.L. Rothschild, an investment company she founded with her husband Sir Evelyn de Rothschild. E.L. Rothschild has investments in media (The Economist Group, UK), information technology, agriculture (FieldFresh Foods, India), weather forecasting and real estate. Lady de Rothschild is a director of the Estee Lauder Companies as well as The Economist Newspaper Limited.

Recently Lady de Rothschild became Co-Chair of the Henry Jackson Initiative for Inclusive Capitalism (HJI), a non-profit working towards building a more inclusive capitalist system. Among other things, HJI proposes that companies should invest in training, nurture small and medium-sized enterprises, and fix corporate governance.

Reinventing Capitalism

Lady Lynn Forester de Rothschild believes that capitalism is not a lost cause. It only needs long-term thinking and a more human face

By Neelima Mahajan

Can capitalism be fixed? Ever since the financial crisis, scholars and academics have been pondering over this vexing question. Capitalism began on the right note after all—it seemed like the ideal system that would spur economic growth, encourage private enterprise, crank up the innovation machinery and lift millions out of poverty. But over the last few years the flaws of the capitalist system have come to the fore: it has led to the concentration of power with a few big corporations, short-term thinking, joblessness and increased income inequalities.

Lady Lynn Forester de Rothschild, CEO of investment company E.L. Rothschild, believes that capitalism can be fixed.

During a recent visit to CKGSB, Lady de Rothschild explained that the world needs to move towards a more inclusive idea of capitalism. Excerpts from an interview:

Q. Despite the big financial crisis, all the big excesses and abuses, you still remain a firm believer in the power of the capitalist system. Why?

A. I'm a firm believer in the principle of free markets and free trade. An economic system that focuses on consumers rather than producers lifts more people out of poverty and creates more wealth. That was Adam Smith's fundamental thesis in *The Wealth of Nations*: take away the power from the producers, create more entrepreneurs and there will be better wealth for everyone.

Crony capitalism, where big business and big government collude for their own advantage against the ordinary person, is not the kind of capitalism that we can defend. The kind we can defend is one that has a profit motive, but also sees its responsibility in terms of the larger society—not only because of a moral imperative, but also for (its own) sustainability.

All one can ask from a society is not an equality of outcome—not that everyone is going to be rich, but that everyone has an opportunity to be rich.

Q. A lot of companies have a myopic view of who the stakeholders really are. How does the conventional notion of stakeholders need to change?

A. In the 1960s, Milton Friedman proposed that the objective of a corporation is to make profits for its shareholders. We know now that a focus only on shareholder value is too narrow. For a company to be sustainable, it has to focus on its customers, employees, shareholders and management. Paul Polman, (CEO) of Unilever has said to his investors, 'If you care about long-term sustainability and the good of all individuals involved in our enterprises, invest in Unilever (but) if you care about quarterly results, invest in someone else's stock'. More and more corporations are saying, 'We need to invest for the long term.'

CEO compensation has gotten way out of whack, because of this emphasis on shareholder value and stock options. From 1943 to 1983, the average CEO in the US made 40 times the average worker. Today, it's 243 times. That's not sustainable, and it's not justified. (So) you have investors beginning to say, 'Well, those pay packages that were tied to share results in a market that until 2008 rose for 13 years, (and) created disequilibrium'. There is a readjustment of shareholders' understanding of long-term value creation from corporations, which means corporations engage more in their society.

Q. By and large, we are still seeing short-term behavior: an excessive focus on getting the stock price up, no matter what the cost. Where do you think the push for change will come from?

A. The most certain trigger will be if investors demand it. In the work that we've done with the Henry Jackson Initiative on Inclusive Capitalism, one of the pathways we focus on is how to get investors to demand long-term thinking, and how do they measure it. If the capital requires better behavior, then the behavior will become better. Look at what happened to Barclays Bank after the LIBOR scandal. Doing the wrong thing, Enron blew up. If shareholders demand long-term businesses that care about the sustainability of their business and the community in which they live, management will change.

Q. Within inclusive capitalism, you talk of things that companies can do, such as education and nurturing small and medium-sized enterprises (SMEs).What is the imperative for a big corporation to really do that? How will it tie in with their existing business model?

A. The first consideration for behavior by corporations that take a broader view is that this will make their company more sustainable for the long term. Twenty-five years ago, Rolls-Royce decided—not because of corporate social responsibility, or because of any philanthropic reason—that they need people who have Rolls-Royce 'inside' them working for them. So they created an academy, an apprenticeship program, where they would send their employees to basically be educated later on in their career. Twenty-five percent of the current management of Rolls-Royce went through that academy.

Hewlett-Packard opened their operations in the UK and said that by 2015, 10% of everything that they buy as a company will come from SMEs: (not) circuit boards, but pencils, glassware and furniture. It diversifies their supply chain. IBM created something called the Supplier Connection with $10 million of Foundation money, so it wasn't a business decision, it was a charitable decision. They created a website, and then invited other Fortune 500 companies—UPS, Federal Express, JP Morgan, AT&T—to put their supply requirements for mundane things on their website: carpeting, chairs, lighting,…. Companies that employ fewer than 50 people can compete online to supply to the biggest corporations in America.

Q. Does this intersect with the idea of socially responsible business?

A. Yes. In an ideal world, socially responsible business will be a redundancy, because business will not survive if it's not socially responsible. Unilever started as a business because Lord Lever got worried that the sanitary conditions in Victorian England were so awful, so he created a little cheap soap powder that people could wash their hands with. It became a global business that would survive for a 150 years. He started with a social concern and he created a business around it.

Q. As a company, you want to make the transition to inclusive capitalism, but you still need to deal with short-term pressures such as share price and quarterly results…

A. Educating and empowering shareholders to ask the questions (will make a difference). We have something in America called "say on pay" to give shareholders the right to understand or to approve or disapprove the compensation packages for management teams. That's a step to right direction. Shareholder activism will lead to more than just quarterly results.

(To read the full interview and to watch the video, log on to CKGSB Knowledge http://knowledge.ckgsb.edu.cn/)

Great Expectations

CKGSB's Liu Jing explains how China's housing bubble relates to buyer expectations and why now is not the time to buy

Liu Jing is Professor of Accounting and Finance and Associate Dean at CKGSB. His research has been published in leading academic journals such as the Journal of Accounting Research, Accounting Review *and the* Review of Accounting Studies. *His work has received the Outstanding Research Award from CKGSB, Eric E. Juline Research Award from the UCLA Anderson School and the Barclays Global Investors (BGI) Best Paper Award from the* Review of Accounting Studies. *A member of the editorial board for the* Review of Accounting Studies, *he is also a director at several Chinese companies and an advisor for a number of financial institutions*

The real estate market in China is essentially no different from other markets, there are two kinds of buyers: one is looking for a place to live, the other is looking to invest or speculate. But in China, the housing market is driven much more by investment than in other markets. Housing is really one of the country's major investment vehicles, as a result the market is much more speculative.

The government sees the speculation as the principal cause of the recent housing price increases, and subsequently responded with measures to curb speculative buying and hopefully keep prices down. The cooling measures are having an effect, but I don't think the current methods of the government are optimal.

In order to prevent the bubble from getting bigger, we need to first understand what's really driving the bubble. The current methods on the table are that of a surgeon trying to treat a patient using surgery by removing a 'bubble-tumor' from the economy. But the economy doesn't really have a tumor. Rather it has a chronic disease due to some systemic imbalances, and the housing bubble is just one manifestation.

China's housing bubble, as with real-estate bubbles in other markets, is driven primarily by expectations. The return on a housing investment has two components: income from renting the house to tenants and an appreciation in the price of the house. The rental yield is actually tiny, approximately 2%, but many people expect a major price appreciation from the time they purchase the house. So you can see that the expectation of the yield on investments is driven primarily by the expectation of future price increases.

So to control the bubble, you need to find a way to influence expectations.

The current cooling measures may actually have a negative effect in terms of managing expectations. For example, if you try to limit the supply of housing, then people assume supply will continue to shrink, causing even greater price appreciation in the future, which translates into incentives to buy, thereby making the problem worse.

Taking all this into account, it would be quite stupid to buy a house now. In this kind of speculative market, the short-term is very volatile. You may see housing prices go up, perhaps even violently, but the long-term reality is that the bubble will burst So people say, 'Okay I'll catch the short-term wave and cash out when the prices start to go down'. But that never happens. When the bubble is bursting, everyone wants to get out and when that happens there will be no liquidity. No one will want to buy.

In terms of investing, the only sensible thing to do is long-term investing, which means you should expect long-term appreciation of housing prices. Rental appreciation should also continue for the next 10 years. Looking at the Chinese income distribution, income hasn't expanded as quickly as the economy, so now we have a catch-up effect, and rental prices are directly correlated to income.

Now we've also reached a stage where government intervention is quite predictable. The government will likely be strict on the housing market for a long stretch of time. If the economy goes south, the government may use housing to boost the economy, if not then price control measures will continue. These measures of course don't alleviate the bubble. They only temporarily delay its bursting. Yet another reason not to buy right now.

It's important to remember that when assessing housing price increases, buyers should expect a certain level of appreciation. The China housing market should be high to reflect the increase in incomes and growth of the economy. But how high is too high?

Housing price increases are driven by three things: growth in real GDP, inflation and migration. Over the last 10 years average annual growth of real GDP has been 10%, so an overall increase of 150%. Inflation has roughly been 5% per year, so over 10 years that's another 50%. In terms of migration, city populations are 50% higher than they were 10 years ago. We don't need a fancy economic model, just adding these rates together gives us 250%, which is the kind of increase we should expect from the housing market if property prices grow with the economy. So much of the price increases are rational.

So how do you detect a fever versus rational appreciation? By my calculation, an annual appreciation of 3-5%, corresponding to inflation, is tolerable. If increases are way beyond that, than investors may find they're in the middle of a spree that will be either reigned in by the government, or lead to the bursting of the bubble.

The housing problem is systemic in the sense that it's really driven by the unequal distribution of income in China. Most of the wealth created by China's economic rise is being invested by a small percentage of rich people, and the investment portfolios lean heavily toward housing. That pushes prices up in a major way, which severely limits the options for common folks.

Therefore the root of this problem is the imbalance of the economy. It's not an isolated local problem that you can use surgery to move. We should be adjusting the economy in a systemic way, that's the only way to bring the housing market back to equilibrium.

(This article is based on an interview with Prof Liu Jing by Suzanne Edwards)

Sellers and buyers queue up to transfer property rights at a real estate trade center in Qingdao

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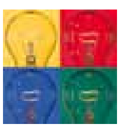

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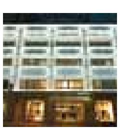

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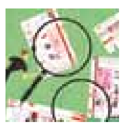


Social Commerce in China

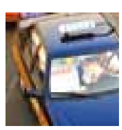
Dabbling in social commerce might help Chinese e-commerce companies deal with fickle consumers and heightened competition.
http://bit.ly/10ZjvXc

China's E-Commerce Companies Go Global

Domestic e-commerce companies like VANCL and Jingdong (JD.com) have tasted success in China but can they compete in international markets?
http://bit.ly/11cHz8s

Invisible Hand Revealed

A regular column by Brian Viard, Associate Professor of Strategy and Economics, CKGSB, examines basic economic principles and phenomena at work in China.



Mobile Apps that Move Cabs

Catching a cab in Beijing is no easy feat. Supply and demand are grossly imbalanced. Can the situation be improved with the help of mobile apps?
http://bit.ly/11mLsti

Bamboo Property Rights

The contentious issue of individual property rights has long been resolved within the ancient business of bamboo farming. China must follow suit.
http://bit.ly/10K2iDf

To Read or Write?

Edward Tse of Booz & Co shares his picks for financial and spiritual reads and offers a teaser for his own book

When it comes to reading I'm a bit old-fashioned. Of course I check Weibo for daily news updates, but as for books, you'll find no e-readers in my briefcase. These days I'm thoroughly enjoying Joe Zhang's *Inside China's Shadow Banking: The Next Subprime Crisis?* This is probably one of the most interesting books I've read in the past few years. It's a first-person account, which is more engaging than third-party analysis. Zhang had worked for UBS Investment Bank in the research department, but in this book he chronicles his experience working for a micro-lender in Guangzhou. He gives his view on what works and doesn't work in China's credit market.

By definition, a small microcredit company would not hire a company like Booz and Co., so in my work it's really difficult to understand the nitty-gritty of the micro-lending business. As a result, I realized there was much I didn't know about before reading this book, but through the author's experiences, I got to really understand the challenges of the banking system as a whole in China.

The shadow banking issue is a key issue in the financial services industry, and this book explores how these issues are couched in the wider issue of the way the financial sector is structured in China. There's a lot of distortion in the industry, hence the expansion of the microcredit industry, but the interest rates are extremely high, so micro-lending companies represent a sort of double-edged sword.

Over the years there have been a few books that have really impacted the way I view management and leadership. Marvin Bower's *The Will to Lead: Running a Business With a Network of Leaders* has been very influential. It's fascinating how he built up McKinsey and emphasized the importance of creating the right set of values at a consulting firm. I admire him and his book has shaped my view on how I ought to lead a consulting firm in China.

Of course I don't only read that which relates to my work and professional goals, I quite enjoy reads that have spiritual and philosophical resonance. One example is Eckhart Tolle's *The Power of Now: A Guide to Spiritual Enlightenment*. It details some very Buddhist principles. He did a great job of depicting this concept of 'living in the present'. It's difficult today, but awareness of this principle is growing all over the world. It's important to refresh yourself.

And while this may sound like a crazy way to refresh oneself, I quite enjoy writing, so much so that I'll have a book out next year on China's private companies, or *minqi*. I firmly believe the future of China's economy belongs to private enterprises. We're going to see more and more Alibabas coming up in the world, so I want to talk about how they're creating their own opportunities shaped for and by the China market.

Edward Tse is Chairman Emeritus, Greater China, Booz & Co.

Business Bestsellers in the US

- No.1 **Lean In** by Sheryl Sandberg with Nell Scovell
- No.2 **Infiltrated** by Jay W. Richards
- No.3 **The Duck Commander Family** by Willie and Korie Robertson with Mark Schlabach
- No.4 **The leadership contract** by Vince Molinaro
- No.5 **Steve Jobs** by Walter Isaacson
- No.6 **The Power Of Habit** by Charles Duhigg
- No.7 **Total Money Makeover** by Eric Schmidt and Jared Cohen
- No.8 **Eleven Rings** by Phil Jackson and Hugh Delehanty
- No.9 **Strengths-Based Leadership** by Tom Rath and Barry Conchie
- No.10 **Crazy Rich** by Jerry Oppenheimer

Source: *The New York Times*

Business Bestsellers in China

- No.1 **Shi Yuzhu's Bio: My Marketing Mystery** by Shi Yuzhu
- No.2 **How will you manage a team?** by Zhao Wei
- No.3 **Big Data** by Viktor Mayer-Schonberger
- No.4 **Infulence** by Robert B. Cialdini
- No.5 **The Effective Executive** by Peter F. Drucker
- No.6 **Please Give Me Results** by Jiang Ruxiang
- No.7 **Successful Sales Means Getting Through to People** by Ni Jianwei
- No.8 **The Minto Pyramid Principle** by Barbara Minto
- No.9 **Hi Di Nao: It Can't Be Taught** by Huang Tieying
- No.10 **Positioning** by Al Ries and Jack Trout

Source: DangDang.com

Brewing Sophistication

In China, tea is more than just a beverage, it's a living history as rich, complicated and sophisticated as you want it to be

By Mark Cheok

A seasonal winter tea being served in a traditional purple clay pot and tea cups

Legend has it that thousands of years ago a tea leaf supposedly fell into the legendary Chinese Emperor Shennong's cup of boiling water. The emperor was quite pleased with the result, giving birth to the rich tradition of tea drinking in China. Today, to say tea is the Chinese beverage of choice would be a vast understatement. Tea is infused in everything from medicine to toothpaste. The total output of tea in China alone exceeded 1.6 million metric tons in 2011, according to statistics from the United Nations Food and Agricultural Organization.

But beyond the simple marketability of tea is the increasing sophistication of tea culture. Just as the tradition of wine cultivation and consumption has reached seemingly endless layers of complexity in the West, so has tea culture in China. China's well-to-do are increasingly adding 'tea connoisseur' to their list of recreational pursuits.

"China is changing fast, people are getting rich, and social activity is getting more complicated. Also, cultural exchange is more frequent now," says Wing-chi Ip, Director of the China Tea Association and owner of Hong Kong-based Lockcha Teahouse. "Maybe 50 years ago, when I was very young, tea drinking in China was simple, it was just a beverage. But now, there are so many different ways of drinking tea and it's more sophisticated, and we have so many different styles of preparing tea."

One example Ip gives is Pu-erh tea, which was not very popular in the past and was only common in Guangdong province. But today it has become one of the most famous teas in China and its teacakes, where it is pressed into a generally round shape, can be relatively expensive. New York-based tea supplier and tea educator, In Pursuit of Tea, sells one Pu-erh tea cake for $260. Also, many new ways of preparing Pu-erh have been invented. Instead of just brewing it in a teapot, some boil it in special tea wares and silver kettles and cook the Pu-erh tea like a soup, which is a relatively recent development, Ip says.

"Of course, the traditional way is still going very strong," says Ip. "But they have more elaborate considerations, just like the temperature, the utensils, the quality of tea. All of them have improved a lot." Ip also gives the example of green tea, which is best prepared and served at lower temperatures in a fine porcelain or glass that allows the heat to dissipate.

A collectible bamboo teaspoon used to inspect the quality and aroma of the unbrewed tea

But before you can appreciate the differences in utensils and brewing methods, start with the basics.

All Chinese tea comes from the leaves of tea plants, Camellia sinensis, and is produced in more than 20 provinces of China, including Hainan Province in the extreme South, Shandong Province in the North, Jiangsu Province on the Eastern coast and Tibet.

While there are hundreds of varieties of Chinese teas, most fall into six basic categories—white, green, red, oolong, black, yellow—according to Ip. Reputed to provide the most health benefits, white tea is made from immature leaves that are picked before the buds have fully opened. Green teas are not fermented during processing, and thus retain the original color of the leaves. Known in the West as

The various colors and kinds of teas including green tea, black tea, white tea and pu-erh tea

black tea, red teas are made from oxidized leaves, which accounts for their darker color. Oolong teas are partially fermented, resulting in a distinct reddish color and a flowery flavor. Post-fermented tea, or black tea as it is known in China, is a class of teas that have undergone an open-air fermentation, making them more oxidized than red and oolong tea. Finally, yellow tea is a special tea processed similarly to green tea, but with a slower drying phase, where the damp tea leaves are allowed to sit and yellow.

"We have a big country with different climates, different soil," says Ip. "Each tea has its own character and its own history."

As tea culture develops to increasingly celebrate the unique character and history of various teas, buying habits are following suit. The Chinese tea market can be divided into two major segments, says Ip, sharing the results of a recent survey from the China Tea Association. The first segment falls into the RMB 100 to RMB 200 price range, where tea is bought mostly for personal consumption. The other popular segment varies from 500 to several thousand RMB, where tea is increasingly treated as a premium gift.

> Each tea has its own character and its own history
>
> Wing-chi Ip
> Owner
> Lockcha Teahouse

There is a yet more premium category of tea, where varieties such as Da Hong Pao tea, whose English name is Big Red Robe tea, can fetch up to $2 million per kilogram, according to the Confucius Institute in New Hampshire, a collaboration between the University of New Hampshire in the US and Chengdu University in China.

Beyond mere dollars, the intricacy of tea production has sparked various tea competitions across China. Ip, who frequently judges such competitions, employs an intricate marking system individualized to each kind of tea. For green tea he heeds the shape of the tea before and after blooming, which is mostly integral to the assessment of green tea, before the tasting part begins. But when evaluating Oolong tea, Ip and his fellow judges stick to the universal values of aroma, taste and texture.

So what does it take to become a tea connoisseur capable of evaluating such delicacies? Ip believes you need a sensitive palate, sufficient training, time and space in your schedule to appreciate the quality of the tea, and above all, passion. Over time, once you've stretched your palate and become accustomed to quality tea, you can develop your standards, Ip says.

Sebastian Beckwith, founder of In Pursuit of Tea, has a slightly more bohemian view of tea consumption.

"You can get two simple teas side by side, or drink one after the other, then even if you think you know nothing about tea, you can start to develop preferences for one or the other," says Beckwith, saying that it starts with paying attention to what sparks your preferences. "You need to have an open mind and be willing to try different things and to trust your palate, that's the most important thing."