The New Japanese

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Yesterday they were small low-factor-cost sub-contractors; today they are industrial giants using up-to-date processes, unleashing economies of scale and consolidating their markets sector by sector; tomorrow they will be global technology pioneers in many fields. They are leading Chinese companies, who, with a 40-year lag, are now retracing the footsteps of the Japanese majors.

Back to the future

Remember the 1950s, when Japanese companies were known above all for their "low-quality" textile exports; or the 1960s, when they were famous for their dumping practices; or the 1970s when their strategies to capture market share were made possible only by low interest rates. Not until the 1980s did anyone recognise Japan's competitive advantages in terms of costs and industrial productivity, quality management and technological innovation.

In the 1950s, Toyota was a small manufacturer of low-cost trucks and buses working with small production runs. Panasonic assembled entry-level bicycles, while Honda specialised in lawn mowers.

A surge in Japanese companies' volumes in the 1960s, 70s and 80s, first on their domestic market and then globally, led to economies of scale and new production facilities that, in turn, resulted in a massive increase in competitiveness in spite of higher factor costs. This came with a significant improvement in product quality, which allowed the companies to penetrate foreign markets even when they lacked repair and maintenance channels. Further on, in the 1990s and 2000s, Japanese companies were poised for global leadership in terms of volume, value and technology, with breakthrough technologies such as hybrid vehicles in Toyota's case.

Yesterday's small Japanese producers of textiles, mechanical equipment or electrical components are today's world-leading technology giants in carbon fibres, automotive, fibre optics, superconducting cables and critical components for printed circuit boards.

Leading Chinese companies' three phases of competitiveness

Major Chinese groups are now retracing the same path. Their current base of competitiveness and development model are not the same as they were 10 years ago. And their base of competitiveness will be very different in 10 years from what it is today.

Yesterday, labour costs: since the mid-1990s, a stratum of Chinese SMEs has developed in textiles and entry-level garments, small household appliances, basic mechanical equipment, electronics and other areas, based on labour costs that are seven to seventeen times lower than in Western countries (when including payroll costs and adjusted for differences in productivity), and working mainly as sub-contractors to major Western clients, designers and engineers, with no scope for their own commercial or marketing development. Products produced by these SMEs now arrive in Europe enjoying cost advantages ranging from 20% to 40% (after transport costs), depending on the sector.

This advantage will obviously shrink as average living standards rise among the Chinese people but it will still be around in a generation. According to the most likely scenarios, average Chinese labour costs will not move up to Western standards until 2050 or 2070, based on current exchange rates or a little sooner depending on the speed at which the yuan gains value. For comparison's sake, Japanese wages took 40 years (from 1950 to 1990) to catch up with, and then exceed, Western levels and South Korean wages took 50 years to reach 80% of today's Western wages (based on average wages).

Today, industrial scale and competitiveness: the stratum of SMEs is still there, but since the mid-2000s major industrial groups have emerged, consolidating their sectors, developing modern industrial facilities, and generating unheard of economies of scale, thanks to the (current and future) size of their domestic market and the portion of global output captured by China. They now have the means for R&D, commercial development, proprietary brands and strategies for accessing markets directly, both inside and outside of China.

In all core production segments, and despite the inevitable rise in labour costs, leading Chinese companies will *become much more competitive* over the next few years, thanks to economies of scale, the pace of growth and the consolidation of the Chinese market. Contrary to hopes expressed in the West, they will not become less competitive.

Indeed, major Chinese groups are growing by *20% to 50% annually*, depending on the sector, versus 2% to 15% (at best) for their Western competitors. With a growth gap like that, the battle for industrial competitiveness in mass-production industries will inevitably be won by Chinese leaders, even without the edge they enjoy in factor costs.

Tomorrow, technological innovation: technological leadership inevitably follows on from industrial leadership and, in turn, spurs it on. Depending on the sector, leading Chinese companies on average lagged ten to fifteen years behind leading Western companies around 1995. They were five to ten years behind in 2000, and are now two to four years behind, again depending on the sector, and have even taken over leadership in some sectors.

Within eight to ten years, major Chinese companies will be the leaders or close to it in aerospace manufacturing, the automotive sector, nuclear energy, photovoltaics, telecom equipment, thermal power plants, drilling ships, railway construction – all major industries that Western politicians believe they can ring-fence (manufacturers, on the other hand, see things more clearly).

China, for example, has become the top producer of flat-screen TVs in less than five years and now accounts for 80% of global output in this area. Technologically speaking, the Chinese leader BOE was 15 years behind Philips in 2004. It is now just two years behind the technological leader Samsung (which itself is now far ahead of Philips in this area).

Huawei was a small local manufacturer of digital switches and PBX in 1995 with no markets outside of China. It is now one of the world's top three telecom equipment makers, with 70% of its revenues generated outside China, 18% global market share and 30% annual growth.

A predictable trend

Leading Chinese companies are following in the footsteps of the major Japanese companies, and the path they will take is therefore quite predictable:

- From small sub-contractors with no direct market access to the development of exclusive products and technologies, patents, proprietary brands and global market share;
- From being competitive on the sole basis of labour costs to being competitive on economies of scale and large production runs, advanced industrial processes and technological innovations;
- From low-quality products to technically sophisticated, high-quality products;
- From low-value-added industries (textiles, industrial commodities, etc.) to high-value-added industries with high technological content (telecommunications, aerospace, nuclear energy, etc.);
- From small outfits with little financial wherewithal to market capitalisations equal to, or greater than, their Western competitors', which have opened the door to growth strategies, R&D investments and ambitious acquisitions (which in turn justify these valuations).

What to do now?

Western groups obviously must fight and win.

General Motors did not lose to Toyota when the latter inevitably carried the day. It lost because it did not initially believe that Toyota could make quality cars. It did not see any value in Toyota's bypass strategy in peripheral markets (Africa!) to build economies of scale and to lower costs. It did not believe Toyota was capable of penetrating the US market. It was unwilling to adapt its products and business model. It did not see any reason to develop a global expansion strategy in a timely fashion (or was unable to do so).

It lost because it did not want to alter its strategic vision; it did not believe in its competitor's strength; and its perceptions of that competitor were always one step behind the reality.

Toyota now enjoys a 17% share of the US auto market, which accounts for 32% of its global revenues.

Western companies that believe that their basic problem is that they are waging an asymmetrical battle with small Chinese competitors that do not comply with quality standards, that work on a semi-official basis, and that shamelessly copy Western innovations – those Western companies have already lost the game. They do not see that the real battle will be much more fearsome, that it will be fought over competitiveness, with weapons being wielded in the form of high-performance industrial facilities, products whose quality will improve, and increasingly innovative technologies.

Half of winning is keeping a clear head, rationally analysing the realities and taking competitors seriously, whether one is in a defensive or offensive posture.

Defence, offence … and alliances

For leading Western companies or niche players, the worst-case scenario is the least likely of all.

In defence: the international expansion of Huawei, Haier, Sinopec, CNCC, Chalco, Lenovo, Harbin Power, CSR and others is the precursor of more massive international deployment of leading Chinese companies, first in "peripheral" markets (Africa, Middle East, Brazil, Indonesia, etc.), before striking at the heart of the United States and Europe.

However, US and European markets will not always be in the strategic interest of leading Chinese companies. Why dilute resources trying to grow in mature markets, where competition is cut-throat and competitive positions well established, instead of those same sectors in China, which will be growing at 15% to 25% annually for another 10 to 15 years, where the markets are not yet highly concentrated and where leaders can still profitably grow at 25% or 30% annually (with valuations to match)?

Unlike Japanese leaders, who had no alternative in building up industrial competitiveness but to expand their global market share, Chinese companies have a gigantic domestic market that will continue growing strongly for some time to come. Many of them believe that their strategic priority is to win in China and not to dilute themselves on anaemic Western markets with the risk of being overtaken on their local market by nimbler and more focused Chinese or *Western* competitors.

For those who do venture there, US and European markets are far from being a sure thing. Expanding in mid-range core markets would be an arduous process, not because of the necessary quality standards (which will soon be reached) but because of the specificity of products and business models, proprietary brands, small and fluctuating production runs, multiple marketing teams, differentiated service levels, and the pinpointed marketing approaches that would be necessary, with all the complexity that would entail. China may be a moving target, but the situation in the United States and Europe has become one of trench warfare, requiring different skills and no longer offering the same value.

Acquisitions (costly when purchasing leaders, risky when purchasing marginal players) will be hard to avoid for Chinese companies seeking to accelerate their penetration into Western markets. Will they truly create value?

In offence

Contrary to popular opinion, and unlike Japan, China is an open, albeit ferociously competitive, market. It is profitable for the leaders. Western groups have an opportunity there that they never had when the Japanese market was growing from the 1950s to the 1980s, to wit: to expand in China, to establish leadership there, to take on Chinese competitors on their own markets, and to buy up Chinese companies before they become excessively powerful competitors.

The development of the Chinese market is, in fact, one of the biggest business opportunities of the last 60 years for leading Western companies, or at least for those that have the ambition, the (very considerable) means over the (long) timeframe needed, and (suitable) business models and execution capacities. They may suffer from some handicaps but their origins clearly do not disqualify them from success. KFC is now the fast-food leader in China, with three billion dollars in revenues, 3,000 sales outlets and 27% annual growth. Coca-Cola is the leader there in soft drinks, with 50% market share; Colgate-Palmolive is a leader with 30% market share in dental hygiene products; AMD has 55% market share in microprocessors, Schneider has 20% market share in low-voltage equipment, and so on.

Major "peripheral" countries, such as India, Brazil, Russia, Saudi Arabia and Indonesia offer similar development potential.

Leading Chinese companies, like leading Western companies, can't be everywhere. *Choices will have to be made*. With so many (worldwide) growth opportunities, nothing has been lost… or won by leading Western companies. The true battle will be waged on fast-growing markets and countries, not on the markets of the past. *The true challenge will thus be to allocate resources properly in a world experiencing strong and sustained growth*.

Within alliances

In many cases and given the scope of the challenge, partnerships, including equity partnerships (e.g., acquisition of stakes, mergers) will probably be more profitable to shareholders of major groups than direct competition. Chinese groups will find it in their interest to join forces with Western groups to speed their technological development, acquire managerial know-how, or develop international brands in China. Western groups will find it in their interest to team up with Chinese groups to speed their expansion in China and to have the financial resources necessary to back their global growth.

How to go about it? And with what partners, so that the mergers and alliances are as profitable as possible? What direction will they take and, ultimately what form of governance and dynamics will apply?

The new Americans

Tomorrow's clear leaders in many sectors will be Chinese. Will these leaders truly be international? Will they undermine the existence of leading Western companies? Not necessarily.

While the dynamics are similar to those that were at play with major Japanese companies 40 years ago, they could ultimately turn out differently. The enormous potential size of the Chinese domestic market will give rise to new groups that are larger and more powerful than Japanese companies. In many sectors, the market's size is making it less necessary and even detrimental in the short term for a leading Chinese company to pursue an ambitious international strategy. The growth and openness of the Chinese market (as well as other major emerging markets) are in the meantime giving leading Western companies unprecedented opportunities for expansion.

Ultimately, China's medium- and long-term development path is looking more like the United States in the first half of the 20th century than post-war Japan. *"The new Japanese" are, in fact, the new Americans*.

As with Japanese and American companies in the past, the leading Chinese companies will take only a small part of the global market outside of China and emerging markets, with wide disparities from one sector to another (Japanese companies seldom enjoy more than 20% to 25% market share in Europe or the United States in sectors in which they are the leaders). But their emergence will destabilise the competitive landscape and Western players.

The biggest losers will be marginal Western competitors that do not have the means to invest in China (or other fast-growing economies). They will be the first to lose market share in the United States and Europe, and will be targeted by leading Chinese companies seeking acquisitions.

Next in line among the losers will be the leading Western companies that will have misallocated resources on a global scale, torn between defending their historical positions and expanding into new markets, and that face choices for expansion of a number, size and with necessary resources that were unimaginable just ten years ago.

There will be many losers in both categories.

June 2010

Estin & Co is an international strategy consultancy based in Paris, London, Geneva and Shanghai. The consultancy assists senior management of large European and North American groups in their growth strategies, as well as private equity funds in the analysis and valuation of their investments.

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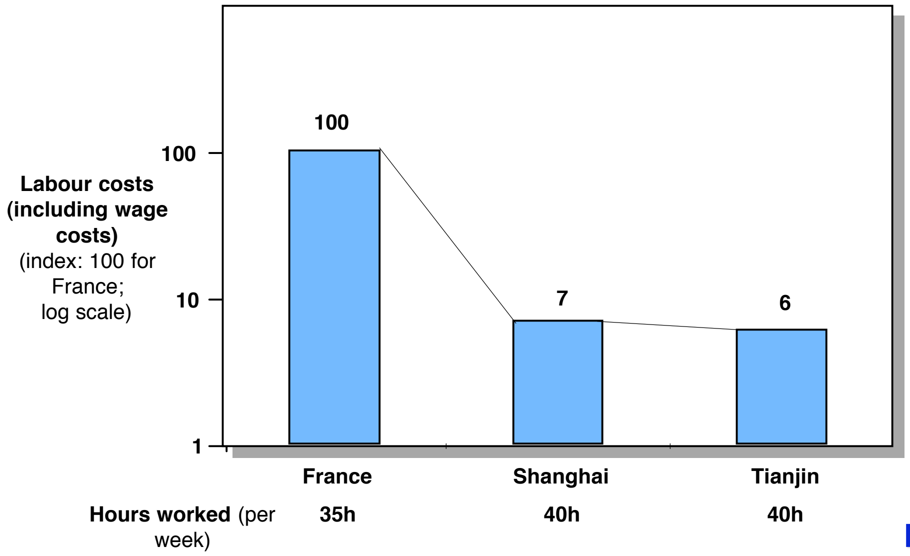
- The three phases of Chinese groups' competitiveness -

Labour costs

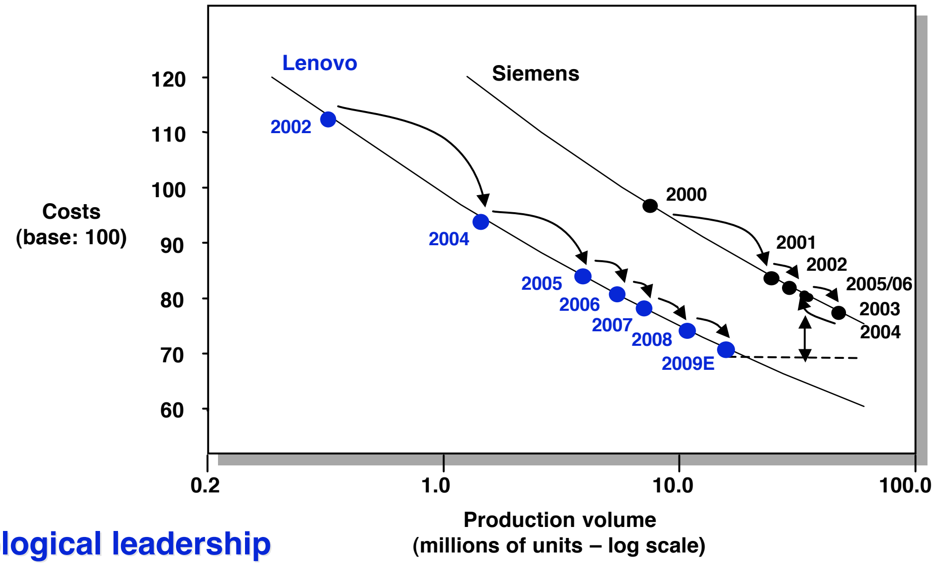
- Toy industry -



Yesterday

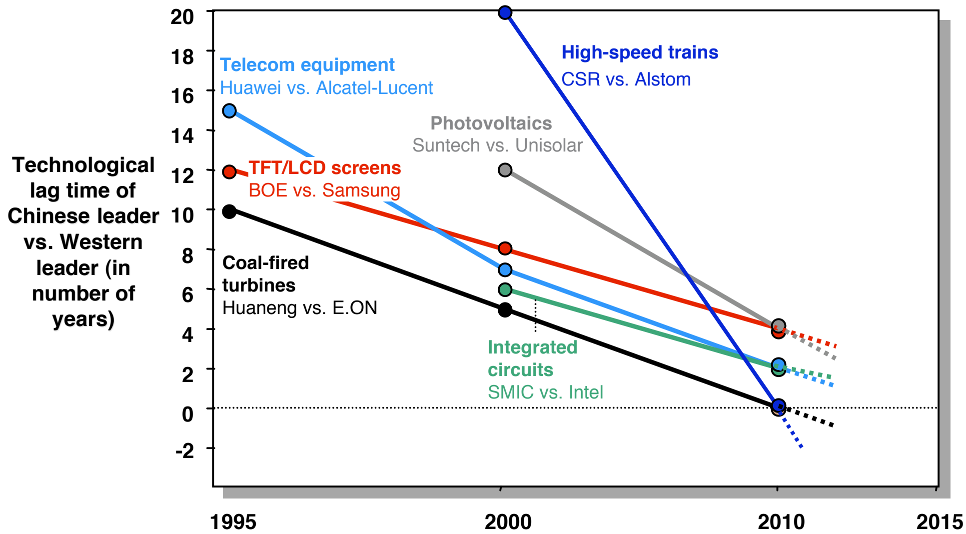
Economies of scale and industrial competitiveness

- Mobile phones -



Today

Technological leadership



Tomorrow

Source: Estin & Co. research and analysis