

Growing in China

by

Jean Berg

Vice President, Estin & Co

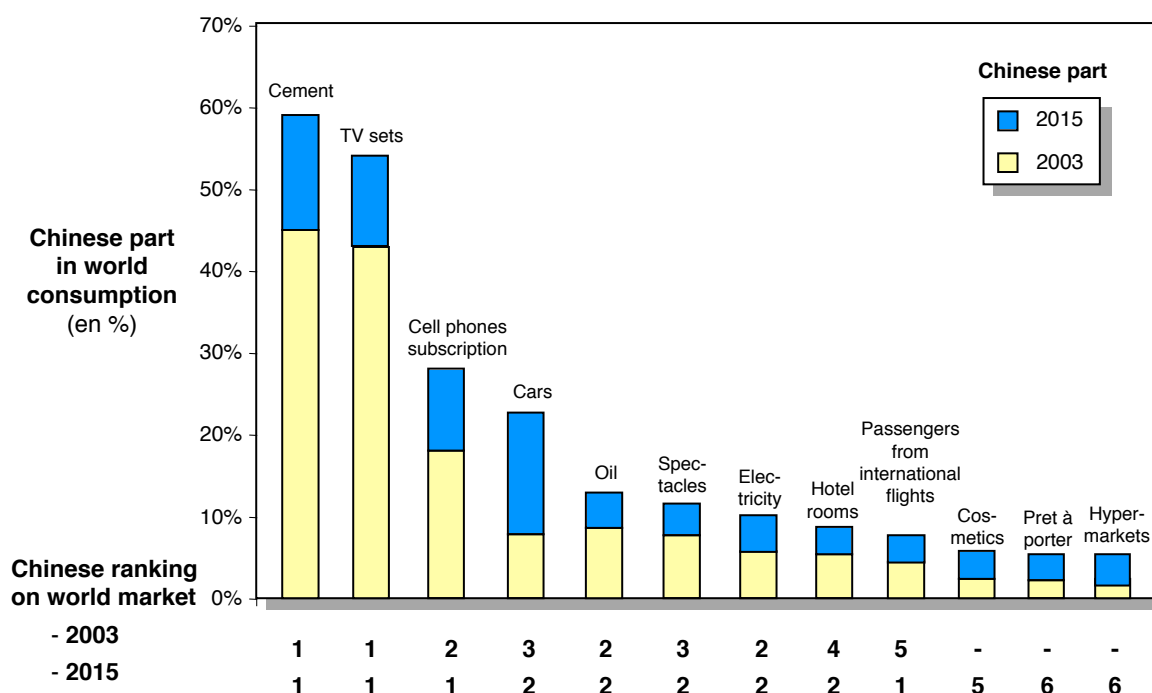
Translation of article published in the "Revue des Mines", September 2007

For the last 10 years, China has experienced annual growth of over 10%. This growth allows the development of Chinese players which, in terms of volumes and price, results in an increase in competition on European markets. These players represent a short- and medium-term threat.

However, China is no longer simply a location to expand production to. It is also the market of the future and therefore an opportunity for profitable growth. Today, the question is no longer "Should we enter the Chinese market?" but rather "When should we enter the Chinese market?".

- Table 1 -

In many industries, China will be the first or second market in the world in 2015



Source : China Automotive Industry Yearbook, Goldman Sachs, International Fertilizer Industry Association, OCDE, rapports annuels, Worldbank, CIA World Factbook, World Tourism Association, Economist Executive Briefing, Harvard Business School Publications, rapports annuels d'Essilor, Missions Economiques Françaises, analyses Estin & Co

1. Why grow in China?

China is expected to represent one quarter of world GDP growth over the next few years.

Overall Chinese growth is strongly differentiated:

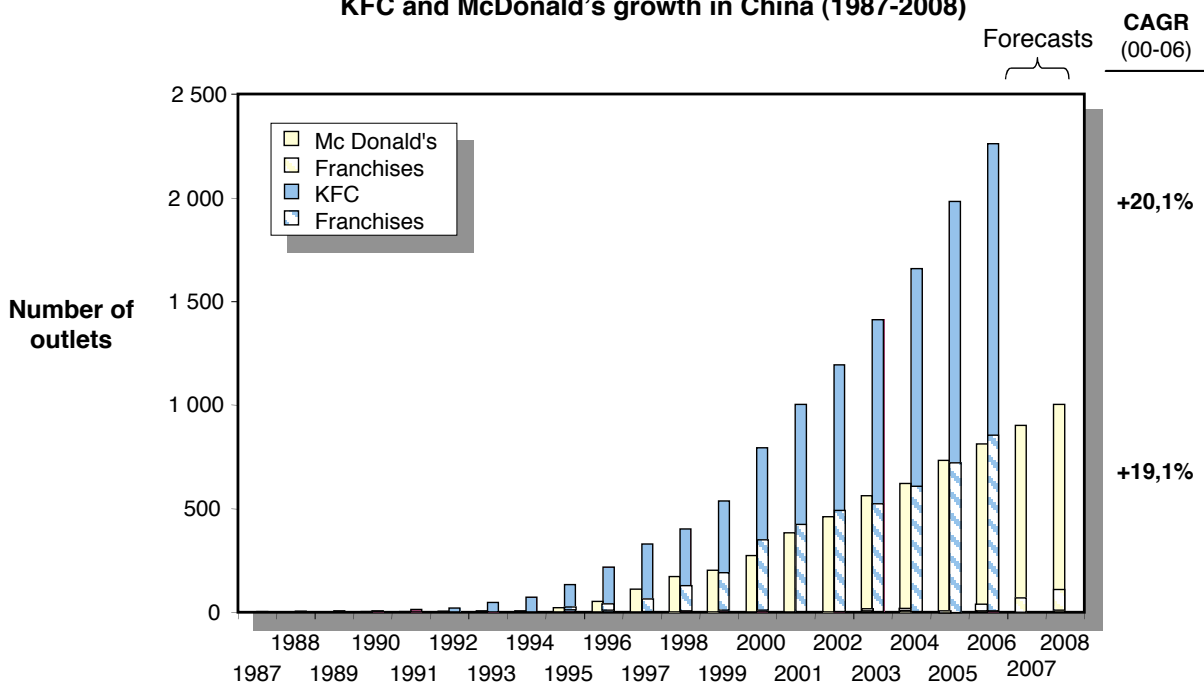
- *As a function of industry:* Capital equipment and consumables for original equipment can reach annual growth rates of over 20%. Growth rates in the health or personal services sectors are lower.
- *As a function of geographical area:* There are now over 30 million inhabitants living on the coast and having a standard of living that is higher than that found in Greece. The proportion of persons equipped with a cell phone is greater in Shanghai than in Paris or New York.

Consequently, for mature sectors, the main – or even the only – sources of significant growth are currently, and for the near future, in Asia or markets that are driven by Asia.

China is thus expected to represent almost 60% of the world cement consumption, 75% of the world coal-fired generator coal consumption and almost 20% of the world car consumption (c.f. Table 1). China should reach 45% of world automotive growth over the next ten years and become the foremost world market, ahead of Europe and the US.

- Table 2 -

KFC and McDonald's growth in China (1987-2008)



Openings	KFC	1	1	2	2	4	9	26	25	60	85	111	73	134	258	159	141	218	247	324	277
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246 openings per year in average since 2000
 - 72 in franchise
 - 174 directly

McDonald's	1	0	1	1	2	15	30	60	60	30	30	70	110	80	100	60	110	80
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87 openings per year in average since 2000
 - 86 directly
 - 1 in franchise

Source : Recherches et analyses Estin & Co

The implications of this strong growth for European companies are twofold:

Firstly, this means that any European company that decides not to expand in China will be depriving itself of a high-growth market. The European or North-American markets currently have annual growth rates of less than 5%. However, to create value sustainably, it is necessary to grow at a rate that is significantly higher than that of the economy. This requires profitable growth in emerging economies, in particular China.

Today, for certain companies, growth on the Chinese market is having a major impact on their results.

Kentucky Fried Chicken (KFC) has enjoyed strong growth in China since it entered the Chinese market in 1987. It has grown regularly, reaching over 2,000 restaurants (c.f. Table 2). This growth has been achieved essentially on the basis of the original concept, adapted to the local market. Franchising was used only to a limited extent to maintain the control of the process. China now represents over 15% of the company's value. Above all, the Chinese market has contributed to over 40% of the increase in share value over the last 5 years. The weak growth of the value of MacDonald's is (at least partially) linked to a more conservative Chinese strategy.

Germany's current success in economic growth is to a large extent linked to Chinese growth and its investments in capital equipment. Not expanding in China means depriving yourself of high-growth markets that can be profitable as of today.

Secondly, a strategy for growth on the Chinese market can also be used to counter the growth of Chinese competitors. It should allow market shares to be won before or at the same time as the Chinese leaders, if necessary acquiring certain of these competitors before they become world leaders.

It is currently considered that there is a differential of 25 to 50% between European and Chinese production. Contrary to the commonly held view, it is not expected that this difference will fall. It should even grow, for the following reasons:

- Personnel costs should rise but the experts consider that they should not catch up with European levels before 2060-2070: Chinese companies typically make use of workers from regions increasingly to the west. Using this approach, a domestic appliance company based in East China in the Fujian region has profoundly changed the origin of its workers: Fujian in 1995 to Sichuan (close to Tibet) in 2007, passing through the Hunan region (central China) in 2000. Thus, the company was able to control the increase of its labour costs by changing its teams every 18 months.
- Chinese companies go through their learning curve quickly due to the size and growth of their domestic market, which allows them to improve their productivity and minimize their structural costs. This is achieved at production volume levels that are significantly higher than those observed for the Asian dragon economies (South Korea, Hong Kong, Taiwan and Singapore). Historically, these economies have never had more than a marginal impact on the European economies due to the relatively limited influence of their economies on the world economy. These countries have had an influence on prices for certain industrial sectors and have contributed to the delocalization of product volumes in limited quantities: their success has had an effect on profit margins but has not resulted in the substitution of entire industrial sectors at a large scale.

The size of the economy and the potential production capacities in China allow such substitutions to be envisaged in the medium term: complete reversals of competitiveness can take place in just a few years.

- This also allows the Chinese to develop technical prowess and technological know-how, even if we do not take into consideration cases of partnerships or joint-ventures. China is progressively reaching core western markets for increasingly complex activities: yesterday for textiles, domestic appliances... now in the areas of electronics, computers, cell phones... tomorrow the automotive, aeronautical construction sectors... China is reproducing the history of the Japanese industry over the last 50

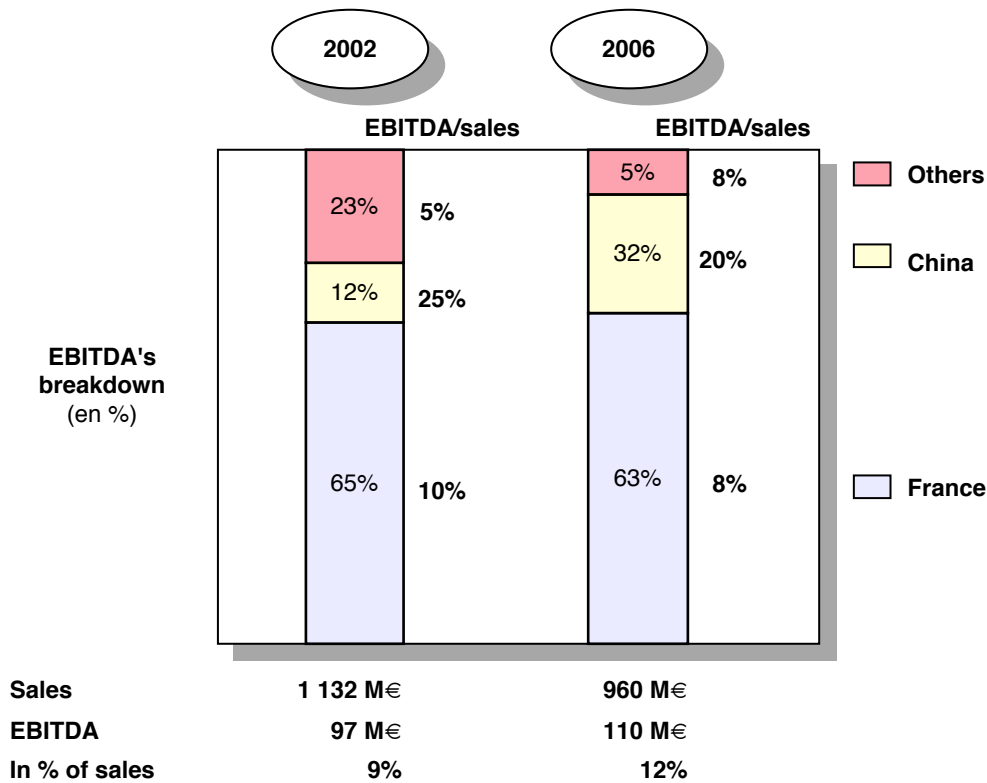
years: In the 50s, Japanese companies had a reputation for "unfair" competition in the area of low-quality textiles. Today, Japan has repositioned itself in cutting-edge technologies.

- The increase in world energy and raw-materials prices, resulting from their strong growth, is compensated by economies of scale achieved thanks to their growth rate of 25 to 30% per year.

The growth in China is therefore a fantastic opportunity to develop, especially in view of the zero-growth European markets. In certain cases, it is also a necessity to maintain world leadership.

In each sector, those companies that will consider the Chinese market as an opportunity (development of a major new market, change of business model, modification of segmentation areas and competitiveness levers...), and not simply as a threat, will succeed.

**- Table 3 -
China stands today for 25% of Etam's EBITDA**



Source : Analyses Estin & Co

2. The Chinese risk

In view of the political risks, on which everyone has their own opinion, the questions posed with regard to development in China are the same as those posed by American companies with respect to Europe over the period 1950 – 1970, or by European companies with respect to the US over the period 1960 - 1980.

The question is no longer “Should we enter the Chinese market?” but rather “How can we enter the Chinese market?”, i.e., the definition of a suitable company strategy:

- Which customer segments to target? Through which channels? Against which competitors (local and international)? With which level of competitiveness?

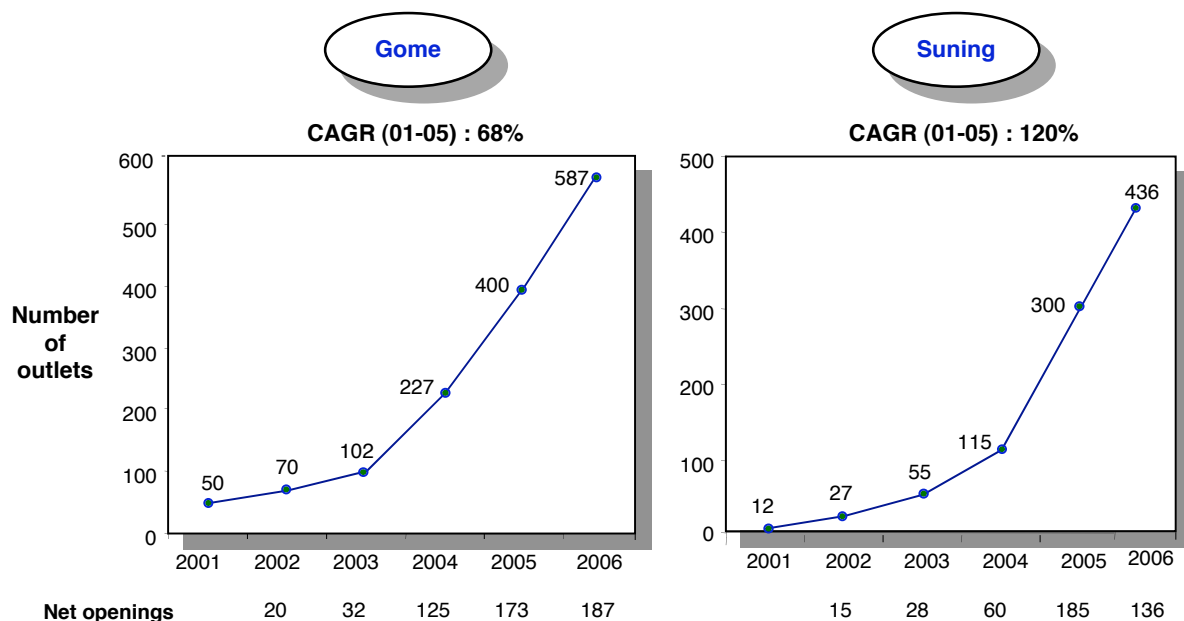
- Is the proposed product suited to the marketing and logistics resources to be deployed and the price that the customers are prepared to pay? Today and in the future?
- What level of negative cash flow should be foreseen and how long will it take to establish a competitive and stable position? Do we have the means to finance this from other activities and other geographical zones?

The latter point is particularly critical. The speed and size of market growth requires major investments (and therefore financial resources) that must be planned. This will perhaps require prioritization with respect to developments in other geographical regions.

The success or failure of the development will therefore be linked to the success or failure of the strategies, as it was the case for Carrefour (failure) or Renault (failure), L'Oréal (success) or Michelin (success) in the US over the period 1970 - 1980.

The real difference resides in the size of the investments. The investment is being made on a high-growth market of significant size. In this context, strategic errors (or errors of implementation) will be more strongly felt than on smaller markets. Furthermore, resilience and continuity of actions will be required, at the risk of losing the benefits of past investments. For example, Céline was one of the first luxury brands to invest in China at the start of the 90s, opening around ten retail outlets. The Asian crisis at the end of the 90s obliged them to close the majority of these. Today, the brand now lags behind players that pursued their efforts during the crisis.

**- Table 4 -
Domestic appliances retailers**



Source: analyses et estimations Estin & Co

3. The implications for European companies

Development strategies are mandatory for entering the Chinese market and must include certain essential ingredients to ensure success:

- *Clear vision of the evolution of market dynamics to determine the size and speed of growth.* The annual growth rate in China for certain markets is greater than 50%. Preparing for a growth rate of 15% may prove to be insufficient. For example, electronics retailing is a market that has seen annual growth of above 70% over the last five years (c.f. Table 3). The two leaders, Gome and Suning, are currently opening

around one hundred stores per year. In this sector, in which the regional market share is large, it is necessary to keep pace with such growth rates. Otherwise, the end result may be high investments with no profitability due to a market position that is too weak.

- *Strong differentiation with respect to local competitors.* Overall, the profitability of a sector varies as a function of its nature, the entry barriers and the sources of differentiation. The Chinese market offers a whole range of investors ready to invest in profitable, growth sectors. Consequently, the sources of differentiation must be defined precisely. They must also be evaluated as a function of the feedback from the corresponding customers.
- *A strategy that is tailored in terms of positioning and business model.* European and American companies often have the approach of increased offering specifications. However, growth in China on the core market generally requires an offering at a price (and therefore at a cost) that is below that of the western markets. For example, in the automotive sector, the European entry-level offering is not easily accessible to the mass market. European companies must therefore re-learn how to design a basic offering that is differentiating for the core market. Simply replicating western business models may prove to be insufficient.
- *A strategy that is coherent with the company's ambitions and resources.* Developing on the Chinese market requires relatively long time scales. The start-up strategy consists of targeting population segments or companies that have reached a certain level of growth. It is necessary to be aware of the fact that the investment phase can be relatively long. Profitability once at cruising speed can be high. Nevertheless, growth and new developments generally require investments that must be financed.
- *Accumulating and exploiting experience.* On a new market such as the Chinese market, the experience effect is of fundamental importance and can have an influence at several levels (business concept and model, management of relations with the authorities, management of human resources, recruitment and loyalty building...). It is therefore necessary to plan for the effects of inefficiency and errors over the first few years. It is also necessary to define an organization that allows the company to exploit this experience.
- *An organization allowing the growth objectives to be attained.* Beyond the strategic positioning and the definition of a business model, the challenge of growth requires recruitment and organizational deployment over a short period. Starbucks had weak growth between 2000 and 2004, not because of a poorly performing concept, but because of an inappropriate organization, whether it be for the search for potential sites, the construction of stores or the recruitment and training of employees. Since 2005, an initial effort to improve organization has allowed the opening of 50 stores per year.

Only if these conditions are met will it be possible to turn opportunities into reality.

September 2007

Estin & Co is an international strategy consulting firm based in Paris, London, Geneva and Shanghai. The consultancy firm assists CEOs and senior executives in major European and North-American groups in defining their growth strategies, and provides support to private equity funds in analyzing and maximizing their investments.

ESTIN & CO

PARIS - LONDON - GENEVA - SHANGHAI

43 avenue de Friedland 75008 Paris

Tel.: 33 1 56 59 87 87 - Fax: 33 1 56 59 87 88 - Email: Estin@estin.com