

Opportunity Construction China

How to realize profitable growth in the Chinese Construction Industry



The construction market in China alongside with the Middle East and Eastern Europe represents one of the major growth opportunities for global construction suppliers and service providers. This growth is fuelled by the ever growing 'middle segment' and forces multinationals into developing ever more innovative strategies to succeed in this competitive and aggressive marketplace against entrenched local 'middle segment' companies. Additionally these incumbent Chinese companies are preparing to leverage their domestic middle segment cash cow to ultimately expand into the mature home markets of the established multinationals.

Growth opportunity China

The construction industry in China is expected to maintain growth rates of 11% annually in the next coming years. Factors that drive residential, industrial and infrastructure construction have the greatest influence on the total construction industry. They represent almost 87% of the entire market value, and the rate is expected to remain stable. The number of households is expected to reach 425.5 million in 2010, an increase of roughly 11% since 2005. Industrial output and manufacturing industry value are expected to grow with an annual rate of 9.9% and 10.7%, respectively. Infrastructure industry's output will increase 9% annually. Other drivers such as the real per capita income or the rate of urbanisation are soaring, too (see figure 1).

Although China is slowly developing towards a market economy the old state regulated system is still very evident in today's market. International companies are encouraged to invest in China through the "Go West" strategy of the Chinese government. Geographical imbalances are still striking where western provinces are showing a construction area density up to ten times lower than the prosperous eastern provinces.

The government encourages foreign companies to these Western provinces with a reduced corporate income tax relaxed limitations on cooperation forms and investment constraints compared to eastern China. The effect of "Go West" can be clearly seen in the building material sector. Advanced technology is

already moving from the East to the West and from 1st tier to 2nd tier cities, for example Zhengzhou, Wuhan or Chengdu.

Challenge Middle Segment

Most multinational companies have targeted the high-end segment in China's construction market with their global products. For most products this segment constitutes five to ten per cent of the market, which is too small for these firms to achieve profitable growth and dilute their high fixed costs. Inevitably, firms have to expand to the middle-segment where the market is driven by increasing customer purchasing power, economic progress, and stricter policies on quality, safety and environment. One example for cement producers is Shanghai's ban of on-site concrete mixing and the higher quality requirements for cement used in construction projects (P.O.42.5 above, middle-high quality level). This has triggered a major growth impulse for the "qualified" cement and ready-mix concrete producers, with numerous new entrants supplying this booming segment.

For foreign companies this middle segment is vital due to the huge growth potential and represents a wise extension to the niche premium segment which is too small to fill established production facilities and finance the existing overhead.

In addition the emerging market middle segment is slowly evolving into the next crucial battleground in

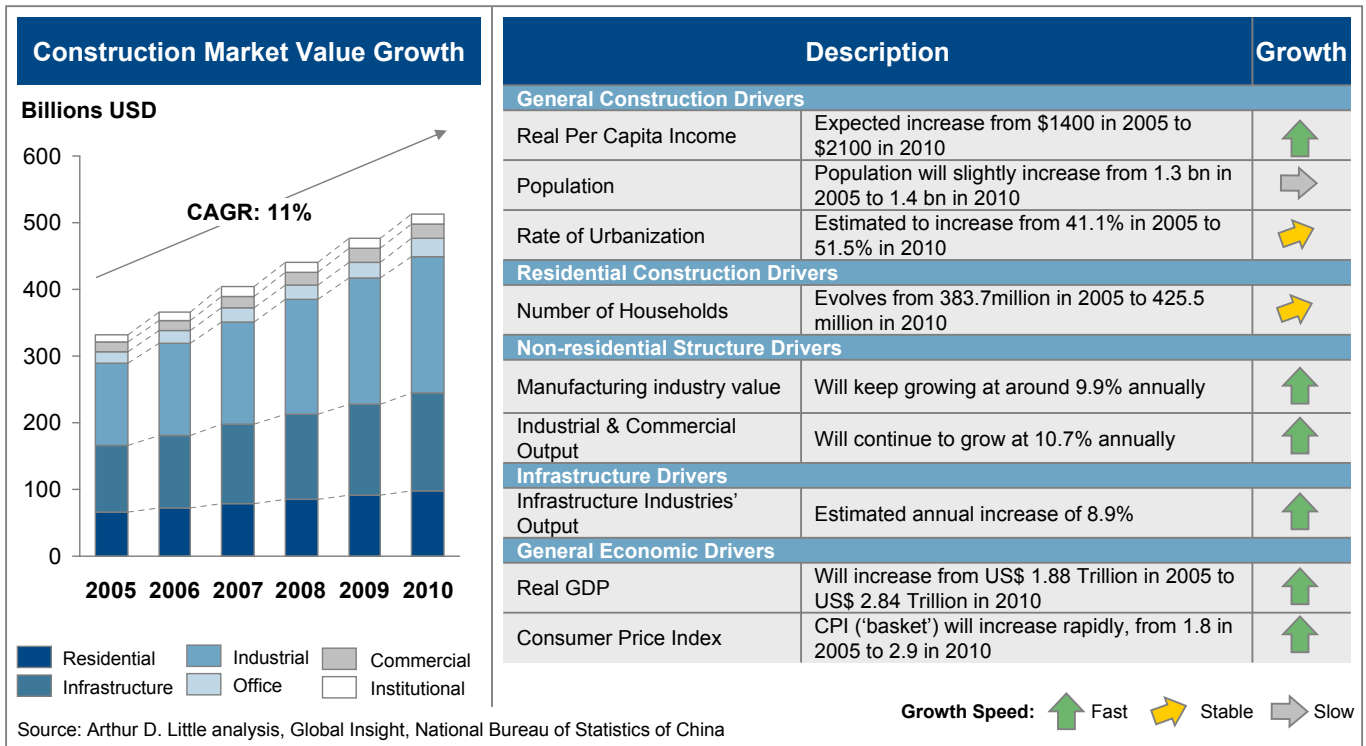


Figure 1: Growth China

the race for global dominance: Well established Chinese companies are rapidly catching up with international companies developing the required competencies and are now using their strong local presence to even attack multinational companies in their established markets. In order to protect this competitive advantage, international firms need to strike back and enter the emerging champions' profit generator – the middle segment. This move will not only affect the local champions' profitability, but will also enables foreign players to develop the core competencies to be successful in this segment.

International construction industry players have to step beyond their historic globalization philosophy and adopt a China 2.0 Strategy to match local mid segment champions. Three critical success factors constitute the core of a winning China 2.0 Strategy:

Fight: Link international brand power with emerging champion go-to-market approaches to win the fierce fight for share in the middle segment.

In the middle segment, quality is not the key distinctive factor. International firms need to combine their international brand reputation with doing business the "Chinese way". In many cases a "steal with pride" approach enriched with selective marketing & sales elements from mature markets creates a winning formula to compete on a par with local champions.

Focus: Invest in regional clusters which can still provide a dominant position.

The critical step is to establish a strong market position (#1-3) in one regional cluster and use this as a rollout platform. The rollout roadmap has to be defined with care, selecting geographies (e.g. tier two and three city clusters, specific regions around tier 1 cities) that maintain their attractiveness and ability to attain and maintain a leading market position.

Simplify: Step beyond 'de-engineering' of international products and develop fully localized platforms for emerging 'middle segments'

The definition of middle segment products in China is different to the concept in developed markets. The value proposition can be described as "good enough", compared to "value for money". By means of full localization of product design, sourcing and production the firm's offering can be simplified in order to meet the local market's expectations and become a market leader.

Casestudy: Beijing New Building Material

Beijing New Building Material (BNBM), one of the largest construction material groups in China, dominates the plasterboard market with a market share of 28%. It operates in all key tier one cities and many tier two cities across China and generated sales of RMB 2,97 bn (EUR 276.6 mn) in 2007 and a net profit of RMB 287.9 mn (EUR 26.8 mn). Its product range includes plasterboard, stone wool panels, fibre-cement boards and related building materials and systems.

BNBM runs a two-tier strategy, with high-end plasterboards under the "Dragon" brand name and mid-level plasterboards under the "Taihe" brand. The Taihe plasterboard company was acquired in 2005-2006. Dragon plants are mainly located in Beijing whereas Taihe plants are located throughout China.

The company is the industry leader, particularly at CAPEX, overhead and production costs. Overhead cost on sales, marketing and administration is significantly lower than average, since fewer sales people are needed to achieve the sales targets and administration is shared with other businesses within the group (see figure 2).

retailers. In the mid- to low-end segment, BNBM directs 90% of sales with salesmen serving as agents. The remaining 10% of sales are made directly with project businesses.

The firm's well-established sales and distribution network covers more than 100 cities and could be leveraged for other building material businesses in the future, for example the glass wool business. In this scenario, BNBM would most likely acquire glass wool plants near its high end plasterboard plants and then, in a second step expand into either the Shanghai area or the fast-growing mid-west of China. This would create synergies with the traditional plasterboard businesses and foster BNBM's position as market leader in the construction material industry (see figure 3).

Most international competitors struggle to even match the dominance of BNBM in China. Already today BNBM is reaching out to export its business model into other emerging markets and is well on track to challenge established international players. The emerging champions like BNBM need to be carefully monitored and reviewed as potential role models.

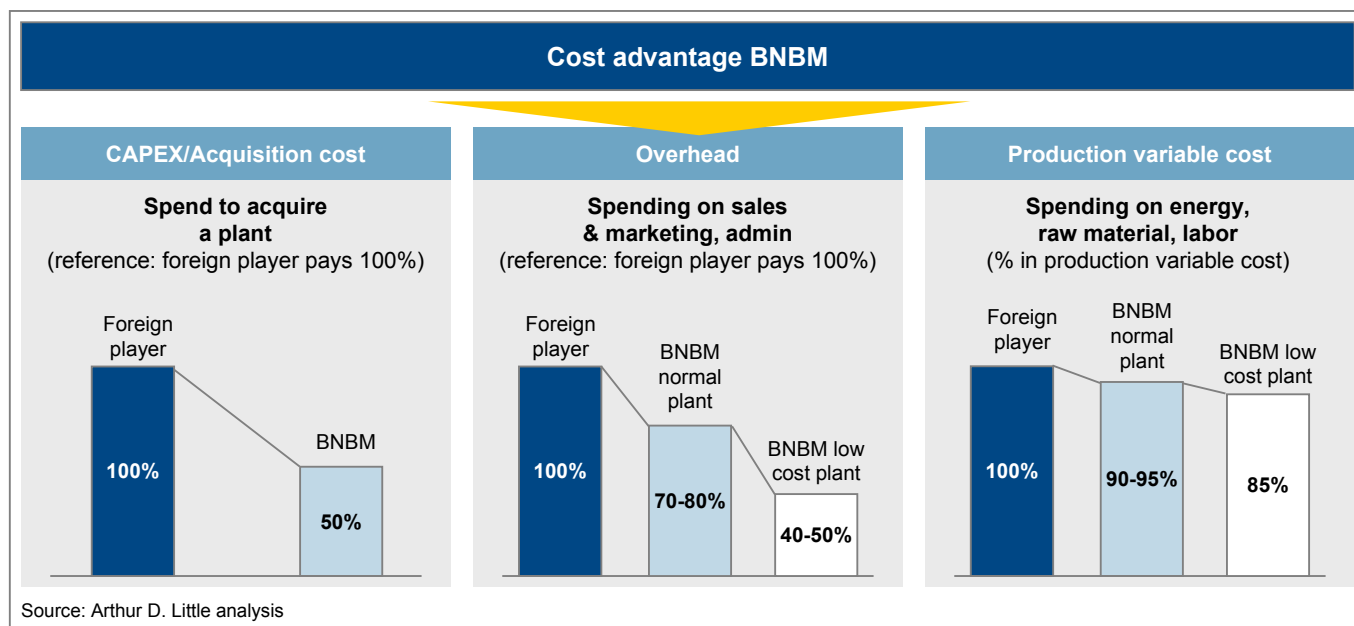


Figure 2: BNBM cost position

The third success factor of BNBM is its flexible sales strategy that enables the company to deploy different sales approaches for different building material businesses. In the middle to high-end segment BNBM's sales strategy focuses on the strong brand name and the existing customer base. Sales offices direct 75% of all sales to distributors who act as intermediaries with retail customers and construction projects. Twenty per cent of the sales volume is made directly with project businesses and five per cent is sold to

Case: Electrical components manufacturer

A global electrical components manufacturer for building applications (ECM) is of the few multinational good practice case studies in the China construction middle segment. The firm offers products in several quality segments for industrial, commercial and residential markets in urban and rural areas.

In order to reduce costs, ECM localized product design, sourcing and production. It created an R&D

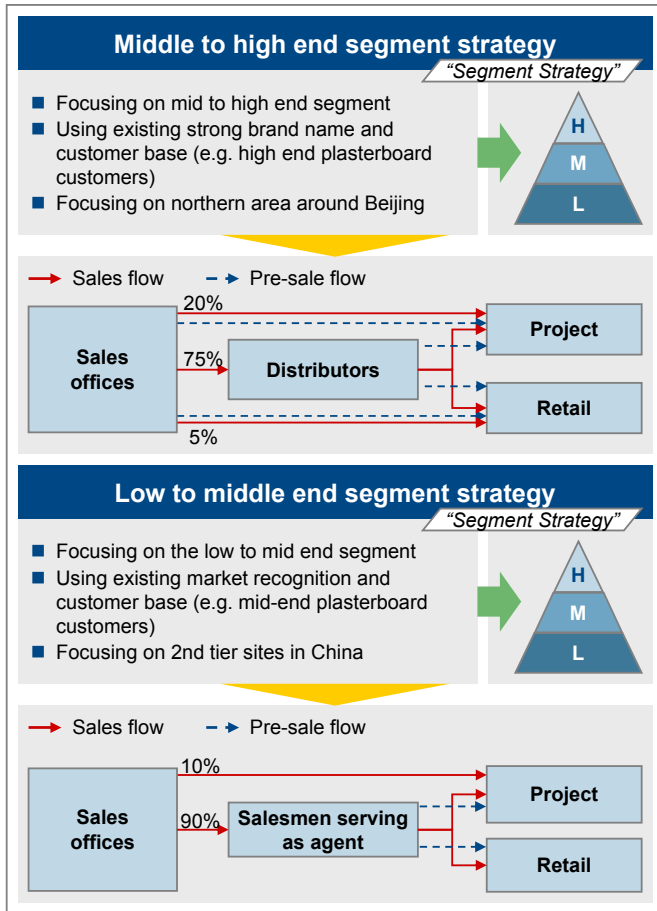


Figure 3: BNBM sales approach

centre in China for the development of low cost products to match country specific requirements. This increased the firm's responsiveness to local market needs, improved its ability to comply with certification requirements and decreased labour costs for engineering staff. Furthermore, sourcing and production were localized, as soon as the sales volumes reached the critical economic level.

A practical example of this is the localized design of thermal relays which allowed a 50% cost reduction while quality remained "good enough". In a multi brand approach, ECM offers its localized products at a competitive price and holds almost the entire market in this segment. Local copies use inferior components and thus have unstable trip parameters. With its global products, the firm targets the high-end segment at a price more than twice the localized product's rate (see figure 4).

An additional success factor of ECM is its effective sales strategy. For the most difficult middle segment ECM copied the "McDonald" approach. Local partners are provided with brand and assembly franchise. ECM controls the quality by supplying core components and technical support. The local partner will leverage its strong relationship network to penetrate the local tar-

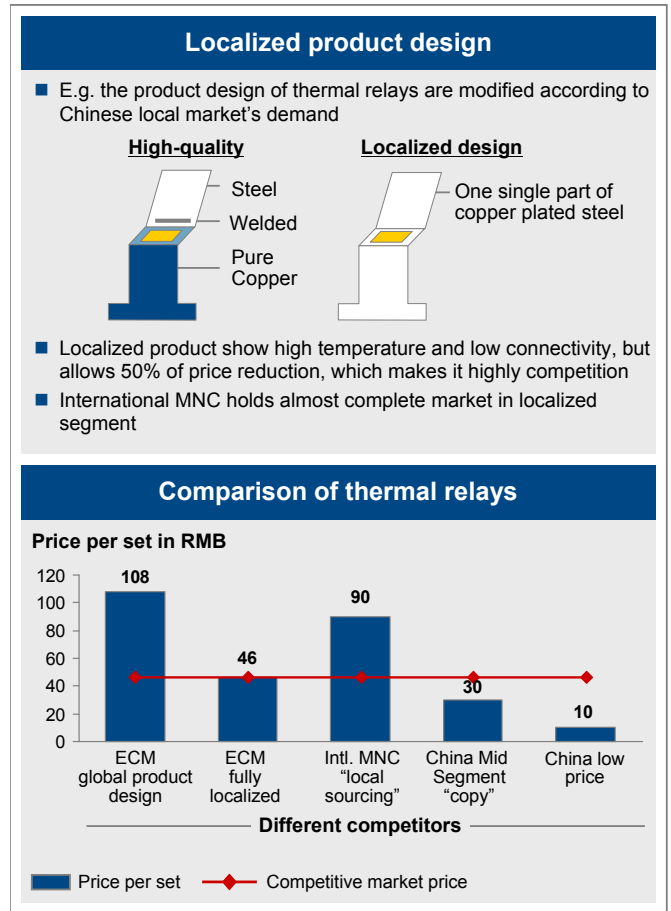


Figure 4: Cost comparison

get market. The partner network covers currently 20 partners in key growth clusters. In addition ECM works with more than 400 agents / system integrators to cover all major city clusters in China. ECM offers these agents highly attractive margins as key critical success factor. Finally a central key account management of ECM targets the large China accounts.

The broad product range, the superior cost base and its strong local network led to ECM's competitive advantage in the electrical components market in China.

Conclusion

China is next to the Middle East and Eastern Europe the key growth opportunity for construction service providers and its suppliers worldwide. Most global construction industry players have entered the high-end segment in China. Having passed the initial investment phase, many currently struggle to deliver against growth and profitability targets.

In order to achieve sustained and profitable growth, most firms have to reach deep into the large but highly competitive middle segment. However, competing with well-positioned local champions is a tough challenge!

International construction industry players have to step beyond their historic globalization philosophy and adopt a China 2.0 Strategy to match local middle segment champions:

- Fight:** Link international brand power with emerging champion go-to-market approaches to win the fierce fight for share in the middle segment.
- Focus:** Invest with priority in regional clusters where there is still a dominance potential.
- Simplify:** Step beyond “de-engineering” of international products and develop truly localized platforms for emerging middle segments “inside out”.

Facilitating your success in China

Arthur D. Little is uniquely positioned to support multinational companies in developing their growth ambition in China. We have extensive project experience in the Chinese construction and building material industry. We specialize in developing market entry strategies and business strategies.

We have been active in China for more than 20 years and have offices in Shanghai, Beijing and Hong Kong. Our local senior experts combine extensive experience with local insight and industry expertise. Being part of the global Arthur D. Little network we are best suited to facilitate your success in China.

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