



TELEOS

THE INTELLIGENT WAY TO U.S. MARKETS

THE COPY-TO-CREATE PARADIGM

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THE COPY-TO-CREATE CONTINUUM

*HOW LOW-COST ECONOMIES AND PRODUCERS BREAK OUT OF THE
COPY PARADIGM AND BEING CREATING NEW PRODUCTS*

INTRODUCTION

No shortage of words has been written to discuss the global impact of China's modernization. For many who can see only the upside potential, China represents everything good about globalization. Others discount China's constructive potential for reasons as varied as protectionism, isolationism or those who disagree with deriving benefits from what they believe to be potentially exploitive labor practices in yet developing countries. Regardless of these, the competitive pressure currently felt at the hands of China's industrialization by most businesses in developed economies is unlikely to abate in the near future, even if restrictive trade policies are thrown up by various international trade alliances or governments who do so for entirely political reasons. The underlying cultural and governmental stimulus within China for advancement is simply too strong and multi-faceted as to be wholly dissuaded by external factors. Like any developing economy, in the short term the Chinese will have to face the fickle fate of an export economy inherently dependent on the international economy, its own problems with growth such as too-rapid industrialization creating excess capacity coupled with bad bank debt and, to a lesser degree, the political mood of its export partners.

In a 2004 article from the *Harvard Business Review* (HBR), Ming Zeng and Peter J. Williamson identified a group of Chinese manufacturers who have successfully moved from a business model entirely based on captive production of another's products to owning their product marketing, distribution and sales' channels. The recognition that a Chinese business' competitive model must change typically comes in two stages: the first is when the business encounters the reality that simply producing an existing product at a low price is insufficient to achieve additional sales' growth. The

second stage comes when the business must deal with a foreign competitor who comes to China and sets up business, taking advantage of the native benefits the domestic business had previously had entirely to themselves (lower cost labor, reduced overhead expenses and advantageous raw material prices). As the *HBR* stated, these two stages are leading to stratification within Chinese businesses, with manufacturers broadening their perspectives and focusing on what it will require of them to take additional ownership over their future and the character of their success:

“China’s national champions are using their advantages as domestic leaders to build global brands. The dedicated exporters are entering foreign markets on the strength of their economies of scale. The competitive networks have taken on world markets by bringing together small, specialized companies that operate in close proximity. And the technology upstarts are using innovations developed by China’s government-owned research institutes to enter emerging sectors such as biotechnology.”

“The Hidden Dragons”, Harvard Business Review, Ming Zeng and Peter J. Williamson (pg. 58, 2004).

As China’s national champions begin to focus on building global brands, they will have to introduce into their organizations knowledge and skill sets that they currently do not have, whose presence is largely intangible and historically undervalued. This evolutionary step will require businesses whose competitive model was previously heavily weighted on pure price competition to increasingly focus on questions of branding, marketing, product development strategies, and management of product distribution channels. These issues require a business that had previously emphasized tangible issues within their business such as quality and manufacturing cost to focus on intangibles such as the product functionality expectations of the consumer, brand recognition, and the means by which these are to be effectively measured and controlled.

For many Chinese businesses, the realization that they must do more than simply compete on price comes either on the heels of a devastating public relations problem that could have been resolved with preparatory market intelligence work or when their customer brings on-line a

competitor to displace them. Additionally, if a company's growth has been entirely predicated on a limited group of customers, Wal-Mart providing the classic retail example, then the Chinese manufacturer may only come to terms with the needed changes to their business model when their customer fears that their captive manufacturer is gaining too much leverage and moves to develop alternative vendors. Additionally, many times the latter occurs when their customer integrates into their area of manufacturing competency and obsoletes the need for secondary production capacity.

CHINA'S MANUFACTURERS ARE EVOLVING

As Chinese businesses begin to realize they must revisit their business model in order to perpetuate their success into the next decade, they will begin to wrestle with changes to how they sell, their over-arching business strategy, as well as questions covering product design and marketing. Traditionally, business that have come to these realizations share a common set of beliefs and questions about the nature of their future success. These realizations include the following:

- **Management sensitive to the upper limits of their businesses' growth if their business model continues to emphasize price over any other competitive attribute.**
- **Businesses who have seen their non-domestic OEM customers locate their own captive manufacturing capability within China, moving a previously privileged supply position into a lower volume secondary supplier status.**
- **Ownership which recognizes their product design, marketing collateral and market-entry strategies need to be altered to reflect their export partner's own domestic sensibilities in terms of substance and style.**
- **Organizations who understand that before forcing products into non-native markets they must take into account tangible issues such as regulatory compliance, as well as intangible issues such as product packaging, before they can be entirely successful.**
- **Companies who realize that their current method of being represented by a third-party or some sort of middle man is not in their best interests either traditionally because of a lack of meaningful control over their representative agency or because they should not give up the margin the middle-man takes.**
- **Entities who have experienced an increase in domestic (intra-China) competitors, a shift in the awarding of export contracts, and who realize their future is limited if they can not provide something which differentiates their company from the competition.**

COPY & CREATE PARADIGMS

What the Japanese were to the 1970s the Chinese are to the early 2000s. This analogy has been so overused it is easy to trivialize were it not for its broad acceptance by the public. But China is not Japan: where Japan had limited natural resources and required the importation of various raw materials in order to participate in the global economy, China has a much more autonomous past, as evidenced by its unique position in history as a quiet power. In Japan, an economy based on the cheap injection molded toys held together by snaps and screws yielded to an economy capable of producing luxury vehicles, mainframe computers and a variety of advanced biotech products. This model of success has been paralleled in numerous Pacific-Rim countries including Singapore, South Korea and Taiwan. Each of these now-developed economies broke out from a competitive model based purely on cost by transitioning from an economy based on copying another's products to creating their own. For China to follow in the paths of its fellow-Asian success stories, it will have to navigate a similar path.

Early in the maturation of an economy, a country's manufacturing capabilities are rudimentary. As they enter the global marketplace, their only area of competitive advantage is low-cost labor. On rare occasions, some countries may benefit from an ability to export either natural resources or products unique to their culture in demand within particular export markets; however, in most cases this will not amount to sufficient stimulus as to meaningfully advance their domestic economy. A competitive advantage predicated entirely on low-cost labor is inherently dependant on external businessmen coming into the country with an existing need. Typically these needs are commensurate with low skill levels, ease of training and wide tolerances for product quality. As the economy matures one of the first indicators that this competitive model must change is that wage levels begin to increase.

One of the elemental characteristics of economies at this stage of development is that their own early form of entrepreneurship is heavily weighted towards copying existing products, most typically those products that were first brought into the country to be made. Entrepreneurs successful early on in this cycle may lose everything they have built as the pace of change accelerates and they find new competitors competing on attributes other than price. No economy can survive forever trapped inside the copy paradigm. In order to advance, they must begin to control their own destiny and create proprietary products. When an economy moves from its copy-stage to the creation-stage is when the underlying potential of the economy begins to significantly increase and gain inertia of its own.

China is currently heavily weighted in the copy stage of the paradigm, with a handful of select businesses working towards expanding into the create phase of the paradigm. Successful companies like Haier, Galanz, Huawei and Konka have come to terms with their need to make this transition in order to have a future that is not entirely dependent on their relationship with single point of sale U.S. retail customers. A company making this transition will look at its core technologies and attempt to differentiate itself clearly in the marketplace on the basis of new features and added functionality. Similarly, a company making this transition will begin to investigate various intangible factors in its business such as whether or not it should own its sales and distribution channels, or whether it can sustain a middle-man mark-up in perpetuity. Additional intangibles that will become of importance are issues such as brand-name recognition and related consumer marketing initiatives.

Haier is instructive with respect to the copy and create paradigms. When Haier began its efforts in America in 1997, it could content itself to making inexpensive knock-off dormitory refrigerators; however, by 2004 the company had introduced wine cooling systems, refrigerated beer keg dispensers, and a host of related white goods such as window-mounted air conditioners and the much more complex line of flat screen televisions. Like any business looking to ensure its future,

Haier realizes it will have to couple its low cost manufacturing position with a broader product portfolio, a skill that will only be realized by an aggressive bent towards product development:

"Thinking out loud one day last year, Michael Jemal¹ created the freezer of his dreams. It would open from the top but also have a bottom drawer that kids could reach into to grab an ice cream. The two compartments would have different temperatures--very cold for storage and not-so-cold for more frequently used products. And the whole unit would be small and stylish enough to be in the kitchen rather than banished to the basement or the garage.

It was just a back-of-the-napkin sketch that Jemal, who heads the U.S. sales arm of Chinese appliance maker Haier, outlined to Zhang Ruimin, the company's chairman and chief executive, during a visit to headquarters. Engineers, designers, and marketers, Jemal knew, would have to consider the idea first, then flesh it out, a time-consuming process. But the next day Zhang, barely able to control his glee, ushered Jemal into a conference room and unveiled a working model of Jemal's fantasy freezer. 'I knew he liked to work fast,' Jemal says, 'but I was still amazed.' Ten months later the waist-high Access Plus freezer, in an array of vibrant colors, was on sale at the Lowe's retail chain across America. And while the product went from concept to kitchen improbably fast, it is no rush job. Good Housekeeping has given the freezer its seal of approval."

"Haier Reaches Higher", Fortune Magazine, September 16, 2002

¹NOTE: Michael Jemal is the CEO and President of Haier-America.

The type of success Haier has had thus far in North America began with a cost advantage, but will be sustained only if Haier can continue to innovate in the face of other Chinese manufacturers who penetrate the retail community with low prices, emulating Haier's initial success. Few issues may be more critical to Chinese manufacturers looking to export their way to success than quickly escaping the copy paradigm. Companies stuck at this stage are likely to be exploited by their customers as the retail client knows that without their retail business, the Chinese company can not survive. While this is true of most businesses that serve the consumer through some form of retail outlet, for a Chinese OEM whose retail customer may amount to 90% or more of their total revenue, the loss of a retail customer can be unrecoverable. The Chinese OEM has no real leverage over the retailer unless it builds a brand name, and unless it creates a product that consumers specifically look for. As much of an oddity as it may seem today to picture a Chinese OEM with real brand name

recognition, this is a challenge that the Japanese firm Sony recognized decades ago and entirely circumvented.

The trick for Chinese businesses is to use their retail customers mid-way through the act of transitioning from captive production to real product development and branding to make the investment to build a quality infrastructure, then invest in new product development, and finally build their own identity in their export market. Because many major retail outlets in America have developed manufacturers in China precisely so they can shift power from the manufacturer to the retailer, the transition from the copy-to-create paradigm is fraught with danger. In what will be an interesting power-play that will develop over the next 3-5 years, insightful Chinese manufacturers are going to have to strategically do what is in their best interests, but will not necessarily be in the best interests of their U.S. retail customers.

WHY BREAKING THE COPY PARADIGM MATTERS

Most proponents of China's modernization point towards the long term potential within China as the development of its domestic consumer economy. As previously stated, this would be healthy for a number of reasons, one of which would be that it would diminish the significance U.S. consumption plays on the visibility of the Chinese economy. A related beneficial effect would be that a healthy Chinese domestic economy would more than likely mean a better balance would exist between retail outlets and the manufacturing companies whose innovation fuels much of the consumer drive to purchase new goods. But perhaps more importantly than anything else, breaking the copy paradigm in China would open up a historically creative culture to new products, services and technologies that have reached an impasse or simply become unimportant in other cultures. Among the possible regrets of history would be to see the potential of China be squandered at the expense of short term gain for developed economies, a development that would turn out in hind sight to have been wholly exploitive unless China can become something more than a dumping

ground for low cost work in conditions deemed environmentally or otherwise unsafe in the developed world.

More than any other opportunity, the internal questions posed by transitions from a copy to a create paradigm represent a unique opportunity. As has been seen with the struggle over the introduction of the Jiangling Landwind SUV in Europe versus the success of the introduction of Haier's expanded product line in North America, a Chinese company that takes the time to investigate its innovation opportunities gains a sustainable competitive advantage. Not every Chinese business will be sensitive to this type of view; however, those companies that are will be among the handful of Chinese companies which lead to the next level of sophistication for the Chinese economy.