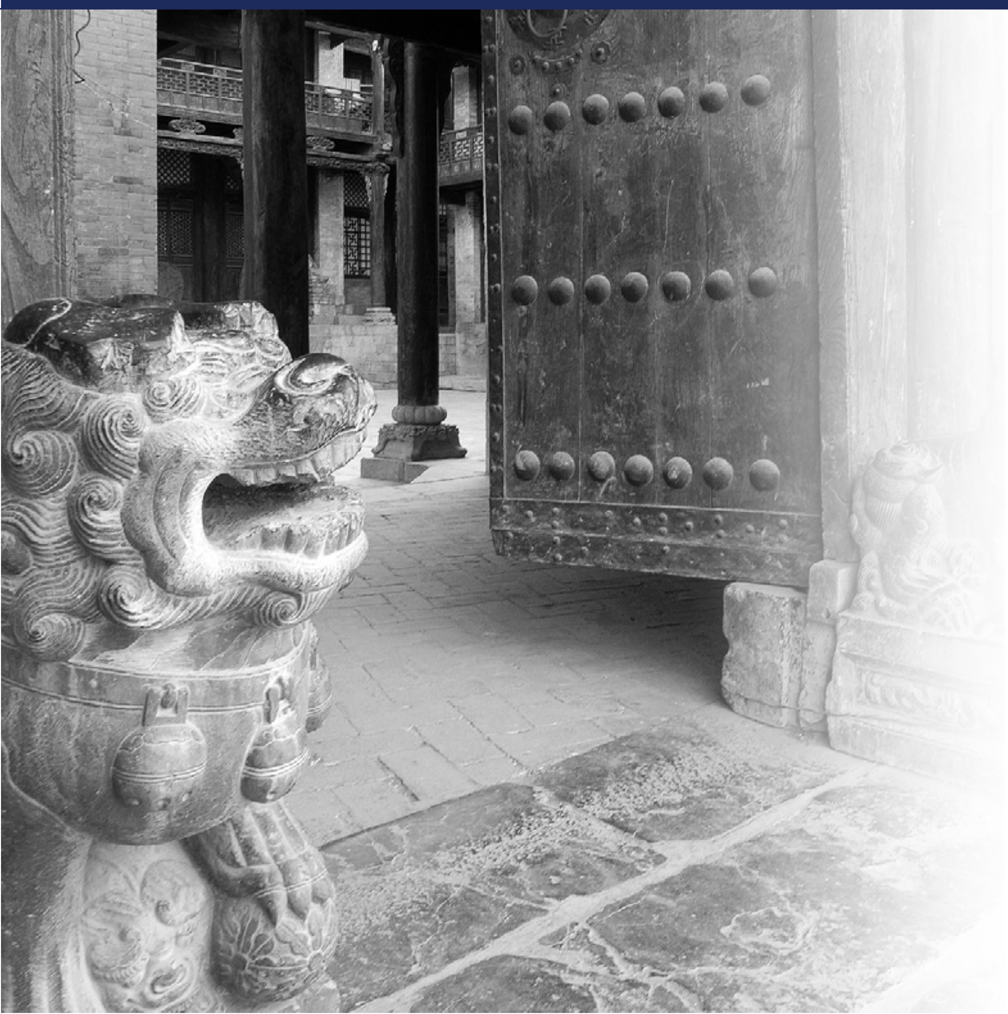
InterChina Insight

InterChina
英特华

How Companies Can Boost Innovation to Win Over Chinese Consumers

By **Jason Zhang** | July, 2014



InterChina Consulting
英特华投资咨询有限公司

Beijing

Shanghai

Madrid

Strategy | M&A Advisory
IMAP China IMAP
www.InterChinaConsulting.com

© 2014 InterChina Consulting All Rights Reserved

Gone are the days when product adaptation was sufficient to meet the needs of Chinese consumers. International companies used to be able to bring their global brands to China, tweak packaging or flavors, and then focus on building sales and distribution.

But China's consumer class has been growing in experience and sophistication, and consumers are increasingly being shaped by a myriad of domestic influences. The onus is now on consumer goods players to think afresh. Indeed, leaders of multinational companies that make fast-moving consumer goods (FMCG)—such as soft drinks, processed foods, and toiletries, among others–are investing heavily in new product development specifically for the Chinese market. The pressure is on to get it right, as the methodical multinationals are up against the experimental locals, each group taking different approaches to this frenetic market place. It may well be that innovation is what separates the winners from the losers in the next decade.

Michael Smith is a 40-year old German national who has been working in China for the last decade as the country manager for a leading European beverage company. Early in his career in China, he began to spend his weekends at People's Square observing what the public drinks, what is on the front shelves of the local hypermarkets, what attracts people to the shelves, and what is ultimately chosen from those shelves. To this day, Smith says this exercise is one of his most crucial decision-making tools.

"In the past, when discussing growth potential, it was all about availability. This meant expansion into new markets and channels, as well as in-store programs. Now we've reached the point where, wherever there's a shelf, there's our product." Smith says.

"Now, however, we see a shift of priorities towards competing for consumers. This is not just happening with a specific category, but increasingly between adjacent categories, especially as new categories emerge. Satisfying our consumers is not good enough anymore; now we need to stimulate and delight them as well."

Smith's challenge is widely relevant across consumer goods-oriented companies with operations in China. Innovation is becoming the key focus rather than expansion. Innovation, in this case, is not defined as an alteration to the current product offering. For example, food and beverage companies have been "renovating" flavors and formats for a long time. True innovation for the China market, however, is the next frontier. A company's approach to new product development will increasingly become a key differentiator and competitive factor in retaining and building market share. And conversely, those that fail to pay sufficient attention to new product development will suffer dwindling performance and margins. Establishing a sustainable approach to new product development that moves at a faster pace and employs creative thinking can unlock untapped growth potential.

Winning over Chinese customers with innovation

For mature consumer-oriented companies, effective innovation needs to strive to recruit shoppers by piquing curiosity to realize returns. Companies must evaluate trends, such as whether low frequency shoppers have much of an impact on market share, consumer fatigue that forces brands to differentiate at a faster rate, and increasing local Chinese competition. Examining this information can help companies with consumer-oriented innovation that combines cultural and consumer insights, and creates these products more quickly and efficiently than ever before.

Chinese consumers have increasingly unique needs. Consumers expect new varieties of new products at a speed never seen before. This increasingly demanding consumer base is becoming more sophisticated in its demands and companies must strictly understand what that means to their success. Furthermore, compared to eight to 10 years ago, consumers are more heterogeneous across geographies, generations, genders, ages, income levels, lifestyles, and habits.

Local tastes

Multinationals can no longer win over Chinese consumers with purely overseas concepts. They now are demanding online shopping platforms and social

© 2014 InterChina Consulting. All Rights Reserved

media expertise to gather product information and details. They also seek brands and products that speak to their specific aspirations, interests, and needs.

Novelty
Consumers have become conditioned: they are used to change and now expect it. They are easily dissuaded by old product offerings and frequently try new brands, products, and varieties to avoid product fatigue.

Sophistication and further segmentation
Luxury goods took a massive hit recently as a result of the austerity campaign the government implemented in 2013, but entrepreneurs and consumers are finding alternatives to luxury products. For example, wine connoisseurs in China used to favor Bordeaux wines. But Californian, Australian, Italian and Burgundy wines are now gaining popularity. Moreover, Chinese wine drinkers are not just changing what they drink, but how they drink: They are drinking by themselves, with friends, at home, not solely at restaurants. For the first time, they are choosing wine purely for personal enjoyment.

Trading up
Chinese consumers are increasingly prepared to pay for value, indulgence, safety, and wellness. Meanwhile, costs in China are rising, putting the already-low margins of FMCGs under even greater pressure. Innovation of premium products is needed to encourage consumers to trade up, while continuously searching for better margins.

Challenges to FMCG innovation

MNCs face a dilemma. On the positive side, MNCs can always leverage substantial R&D resources elsewhere in the world to successfully launch new products locally. Additionally, they have mature and proven processes and advantages in terms of industry expertise, such as market research, technology, production, marketing, and branding.

On the other hand, the time it takes to deliver a new product offering is long because it requires working through the established global processes. Various levels of leadership must approve new products, which can cause a loss of market share, especially compared to local competitors that can respond rapidly. But MNCs can take steps to encourage innovation and make up for some of their disadvantages in the China market.

Local-level autonomy
To swiftly respond to the market, MNCs need local teams with decision-making power on the ground in China. When approvals need to flow up the chain to headquarters, competitiveness is often lost. There are many fast-growing Chinese players that are benefiting from having hands-on owners that drive decision-making. This gives them, in addition to a strong sense of consumer needs and interests, supreme agility in meeting those needs.

Connect the dots
Discover opportunities to reshape entire product categories by gathering deep consumer insights. Xiangpiaopiao, the inventor of milk tea cups, reinvented a product category that others had dismissed as over saturated. The company successfully created a popular take-away milk tea cup concept that offered convenience and used a recipe that was tailored for Chinese tastes.

Take risks
New product development requires substantial financial investments and introduces risks. But companies that innovate create opportunities to lead in their markets. Examples of conservative, slow-moving companies that miss emerging opportunities and lose market share to Chinese innovators are plentiful. Lipton lost its market leading position in the milk tea category when Xiangpiaopiao and Uloveit introduced milk tea cups with more attractive flavors.

For both large MNCs and mid-sized foreign companies in China, adapting with the changing times is essential. Companies that best predict the market and adapt to consumer needs will stay ahead. Companies must develop a structured and systematic process that accepts a degree of uncertainty for the benefit of speed-to-market. As such, we expect to see more companies using pilot testing, followed by continuous reassessment and refinement to get things right.

© 2014 InterChina Consulting. All Rights Reserved

Oreo Learns Its Lesson

The famed Oreo cookie is an early example of how new product development can unlock success.

As early as 1996 the American brand, Kraft, introduced its most popular cookie, Oreo, to China. However, by 2005, Oreo only controlled 3 percent of the Chinese biscuit market.

Oreo had three problems in the Chinese biscuit market. First, Oreo was only competing in the sandwich biscuit category. But the Chinese biscuit category is split between seven sub categories: sandwich, plain sweet, wafers, plain savory, cookies, soda crackers, and egg-roll biscuits. Second, Chinese consumers have a very different palette and preference compared to Western countries. Chinese customers thought the original Oreo was too sweet. Third, Oreo's packaging added too much to the final cost of the product for the Chinese market. The price per package was two to three times more expensive than local offerings.

After 10 years of stagnant growth, Oreo shifted gears and decided to make a more suitable offering for Chinese consumers. In 2006, Oreo created an original, localized Chinese version of the cookie after testing more than 20 unique Oreo formulations. Kraft began by altering the Oreo package size by introducing a smaller size to reduce the pick-up price and make it more affordable. Oreo then began to widely distribute to locations where shoppers make impulse buys, such as mom-and-pop shops and small neighborhood grocery stores.

At the same time, the Oreo platform was used to penetrate the wafer market. Kraft launched the Oreo wafer stick, with white crème coated in chocolate, which appealed more to the Chinese palette.

Within five years, Oreo had multiplied its market share by five, amounting to 15 percent of China's biscuit market by 2012. This represented the highest market share for Oreo in the world, including its home market.

MNCs' R&D Best Practices in China

Procter & Gamble

- **Facilities**: P&G's largest global R&D center was established in Beijing in 1998. To effectively test the market, P&G created an experimental factory directly inside the R&D center.
- **Function**: The center supports P&G's business across the majority of Asia and devotes massive attention to innovation for the world market. Thirty percent of its efforts test foreign products introduced in China, while 70 percent focuses on the development of new products through existing platforms.
- **Approach**: P&G invested heavily in its center, with an annual investment of $60-70 million or 1-2 percent of its China revenue. The center uses consumer insights, idea testing and screening, and complex solution experiments.

Nestlé

- **Facilities**: Nestle operates four R&D centers in China catering to its various products, including nutrition, seasonings, ice cream, coffee, and confectionery. In 2001, Nestle established its first R&D center in Shanghai. By 2008, the company opened its second R&D center in Beijing. In 2012, the company announced plans for two more centers in Xiamen and Dongguan.
- **Approach**: Introduce new products from international Nestle R&D centers into China and utilize China's unique technology around the world. Focus on cutting-edge R&D to ensure food quality and safety.
- **Research area**: Nutrition and health, food science and technology, quality and safety, and sensory and consumer science.

Mondelez International (formerly Kraft Foods Inc.)

- **Facilities**: In 2009, Kraft established its Asia Pacific R&D center in Suzhou, equipped with a production line for new product testing, flavor differentiation and review, cutting-edge product design and quality control technology, as well as the experimentation and development of state-of-the-art food technology.
- **Approach**: Kraft granted decision-making power to China to accelerate new product development cycles. The company now plans to concentrate R&D efforts on biscuits, chocolate, and candy, both expanding existing brands while looking for new platforms.

This article was first published by China Business Review

© 2014 InterChina Consulting. All Rights Reserved

英特华

Co-contributed by
Mr. Jason, Zhang,
Principal,
InterChina Consulting
Beijing Office

Zhang.Zhijun@InterChinaConsulting.com

Jason Zhang, a Chinese national, is a principal with InterChina based in Beijing, and has been working with clients in the consumer sector on market development issues for the past 10 years.

© 2014 InterChina Consulting. All Rights Reserved

InterChina Consulting

Specialist in China

InterChina is one of the leading advisory firms in China, and the number one alternative to the global consultancies and investment banks.

We were founded in 1994, and through our unique combination of capabilities, have delivered the highest quality of services to clients for nearly 20 years.

Our team of nearly 60 professionals has conducted over 500 strategy projects and closed more than 160 transactions, with an aggregate value of USD 6 billion.

Multinational and Chinese clients choose to work with us because we provide real understanding, deliver practical results, and know how to get things done.

Strategy Consulting

We work with clients to capitalize on top line growth opportunities while also addressing long-term profit protection.

Our practice of 25 consultants is organized around sector specializations with substantial project experience.

We pride ourselves on being practical, developing real understanding through fieldwork, and delivering workable results to an actionable level.

M&A Advisory

We provide full cross border M&A advisory services to multinationals expanding in China, Chinese companies investing overseas, and on strategic divestments.

Our practice of 25 advisors is comprised of senior Chinese negotiators with strong corporate development, investment banking, private equity and Big Four backgrounds.

We conduct ~40 mandates each year, providing clients with transparency and control from start to finish

InterChina is also the exclusive China partner of IMAP, the oldest and largest global organization of independent mid-market M&A advisors.

Contact Us

We have two operations offices in China (Beijing and Shanghai) supported by one liaison office in Madrid.

For further information, please visit our website at www.InterChinaConsulting.com

© 2014 InterChina Consulting. All Rights Reserved