



# HIGHER AND HIGHER

Winning in Construction Materials in China



As Western economies are showing hesitant growth paths and uncertainty is freezing investment plans, growth options are dwindling for multinational companies (MNCs) and many heads are turning to China. The construction materials industry is no exception, but its complexity is a major challenge. How should MNCs compete to secure profitable growth and overcome local competition?

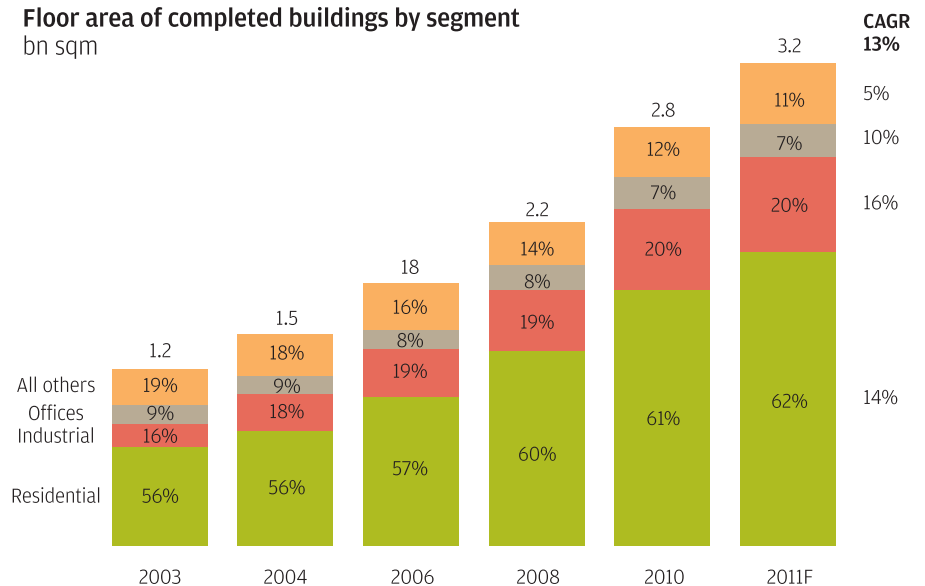
# A FAST GROWING MARKET WITH HUGE POTENTIAL OVER THE LONG TERM

China is one of the biggest construction markets in the world. China is building every year as much as the existing constructed area in Canada! It represents 6.6% of GDP vs. 3.8% in the US and around 5% in most European countries. It's been on a 13% per annum growth rate, and is likely to continue, albeit with occasional bumps.

- Most of the growth comes from the residential market (as opposed to the commercial and industrial segments), and the need for housing is still dire

## The construction industry has been growing at a double digit rate, with the residential segment driving the growth

Floor area of completed buildings by segment  
bn sqm



- The average area per cap is still small: 30 sqm per head in 2009 in urban areas vs. 35-45 sqm in Europe
- The influx to cities is still huge despite the limitations on resident permits (the current urbanization rates increase city population by 1% p.a., or 8-10M people per year; it is expected to grow from its current 47% to the mid-60s longer term, that's an additional 300M urban dwellers!)
- More and more people can afford property :
  - the number of high net worth individuals has grown from 364,000 in 2008 to 585,000 in 2011...
  - ... but more importantly Chinese baby boomers who will represent the majority China's population by 2015 are more financially stable and more globally aware than the previous generation, thus supporting greater consumption and quality upgrades.
- The current market is one of home owners; 89% (as of 2010) of the population actually own their own homes and thus tend to care more for their set-up and up-keep.

## There may be periods of slower growth. Two factors will tamper uncontrolled volume growth for a time: a rise in prices and government intervention

- The current market experiences high inflation in property prices (9% overall over the last 10 years, but 18% in Shanghai and Beijing, with recent peaks over 50%) some of which is due to speculation
- The government plays a large role in the control of the construction industry's growth
  - Both the **central** government, by using an array of tools:
    - Controlling the interest rates through state-owned banks
    - Screening of loan beneficiaries
    - Setting purchasing limits directly, or floors on the amount required for down payment (50% for a second property)
    - Introducing property taxes in some cities
  - Building low-income housing projects
  - Promoting fully furnished rentals
  - Influencing who can play (some curbs on foreign contractors)...
  - ... And how they play (no EPC).
  - And the **provincial** governments, by promoting environmentally-friendly building materials (e.g. toxic-free paint, limiting usage of tiles on the exterior of buildings) or encouraging the adoption of energy-saving HVAC standards (central heating), or even limiting high energy-consuming industries (e.g. exterior insulation cladding as a form of thermal insulation).

**WHILE IT MAY EXPERIENCE PERIODS OF LOW-DOUBLE DIGIT GROWTH, THE CONSTRUCTION MATERIALS IS SET TO CONTINUE GROWING AT A HEALTHY PACE IN CHINA.**

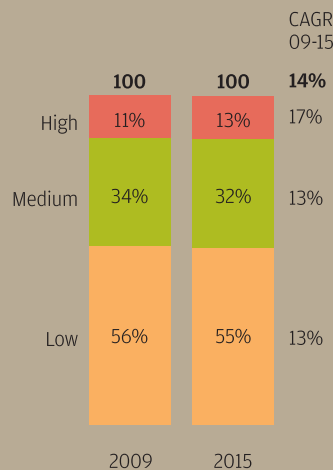
# BUT ACHIEVING SUCCESS WILL REQUIRE CAREFUL CRAFTING

## Product mix

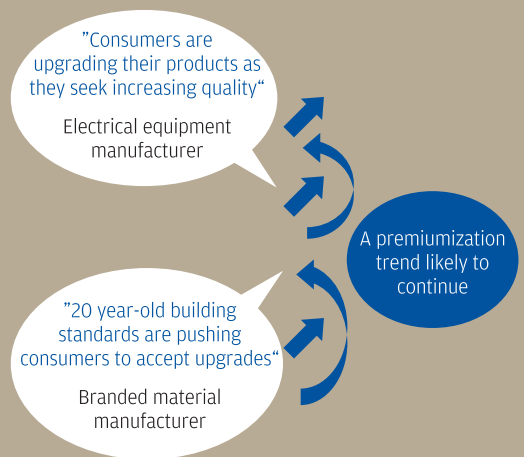
While low-end products still account for the majority of products sold in the construction industry, premiumization of products is an important trend and our clients expect a general uplift in quality. Consumers, frustrated by poor construction materials and fittings in 20 year-old buildings which prove difficult to maintain (or even replace) are upgrading and requiring increasingly high-end products.

We can expect a premiumization from consumers seeking to increase quality

% of volume in retail channel



Market structure over time



## Technology

It's a fact: increasing shortages of both skilled and more importantly unskilled labor in some major manufacturing centers in China such Guangdong are pushing labor prices up (15% p.a. over the last 5 years). The consequences will be far-reaching for China as a whole, and they will be felt in particular in the Construction industry. There will be a tipping point when labor wages reach a level at which it will become more economically sensible to shift to new product technologies.

## Innovation

Just like in consumer industries such as Luxury or Cosmetics, our clients tell us that local Chinese competitors are very quick to produce me-too's or even just product look-alikes which don't have the same features or properties as MNC's products crafted after years of research. Their speed-to-market can be as little as two months, cutting sales and earnings potential dramatically.

## Branding

In most western economies, construction material companies' positions have been created through cooperation with distribution channels. Whereas the day-to-day battle for margins has always been fierce, construction material companies and distributors have over decades come to a clear and fairly stable equilibrium based on an understanding of their mutual interest. As a consequence, construction material MNCs are very skilled at managing their channels of distribution ("push" strategies) but much less so in building their brands at user or even consumer level ("pull" strategies). In China, where distribution is still very fragmented and where no historical "deals" with distributors are in place, building such positions through "push" only is impossible. Rather, building strong brands to generate consumer pull and increase leverage with the Trade will be essential.

## Distribution

Getting the product to market requires exploring multiple channels and points of entry, each with their own rules of the game:

- Geographical differences are large: regional companies can dramatically change the competitive landscape; consumer uses of the product will change from one province to another; in the paint category for instance,

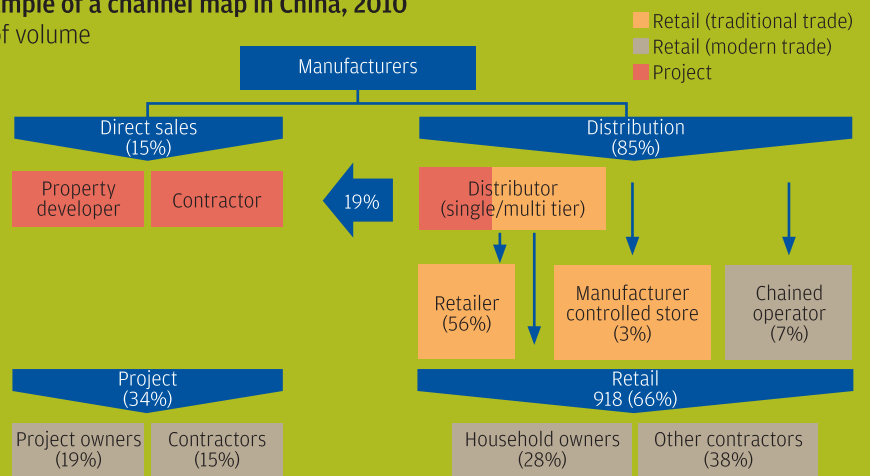
amount and location of the application of paint will differ from North to South; importantly, local government policies and product requirements are set independently of each other.

- Still a very fragmented road-to-market:
  - Many players: Wholesalers, developers, contractors, with complex interactions amongst them
  - Downstream: a very fragmented landscape, difficult to navigate

## Capturing the growth opportunity requires to navigate across the multiple channels

### Example of a channel map in China, 2010

% of volume

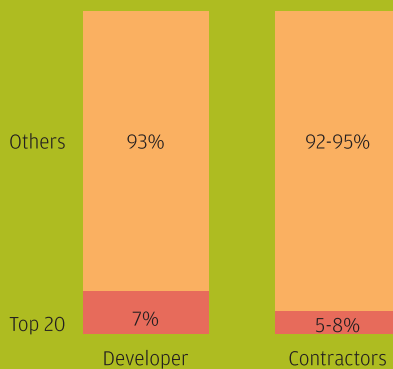


## The downstream landscape is highly fragmented

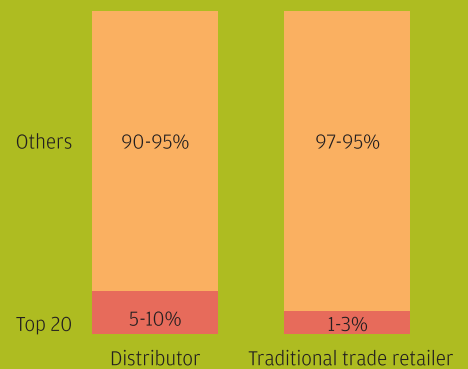
### Downstream landscape

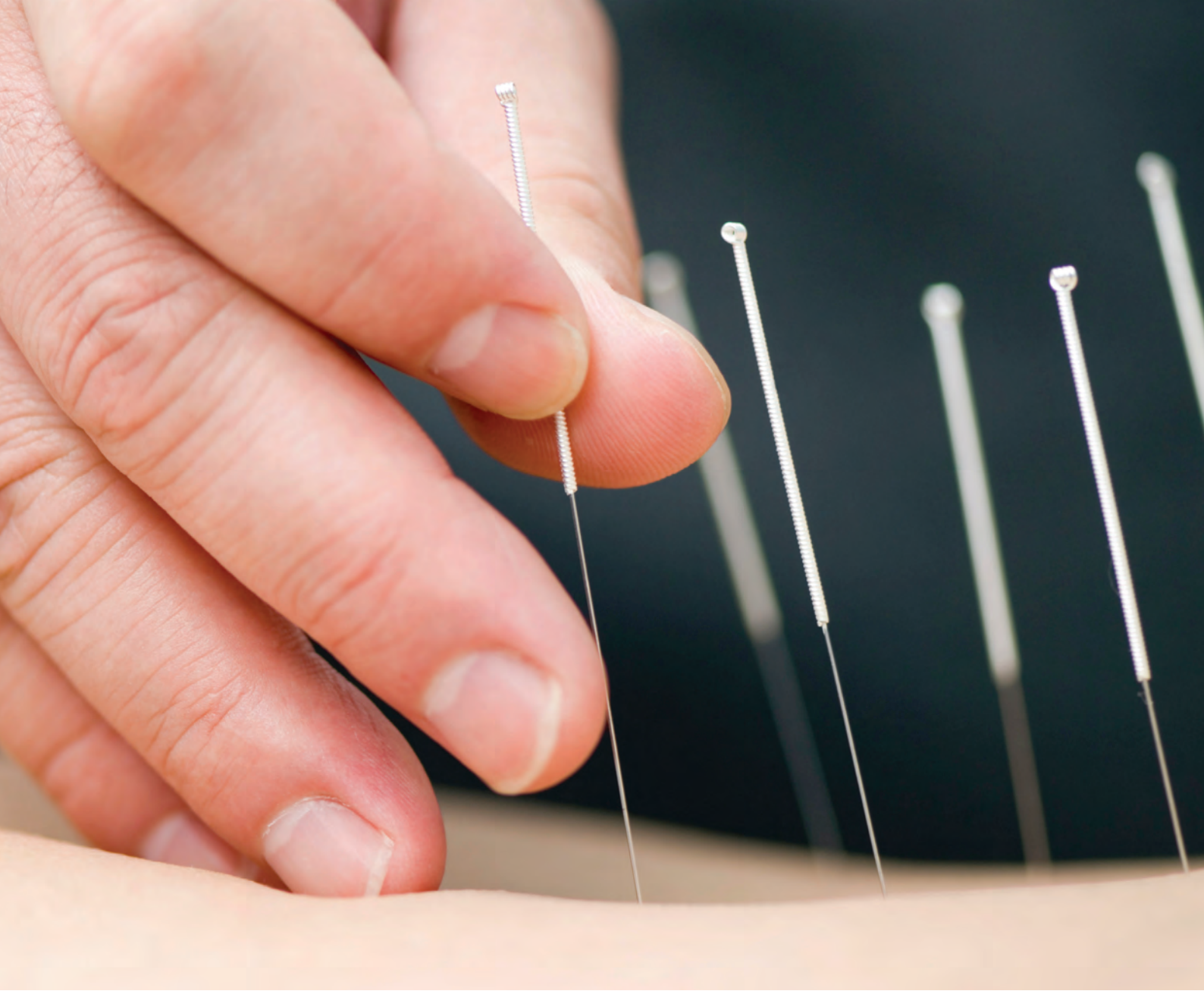
### Flooring and paint examples

#### Estimated shares in project channel m sqm of space completed, %



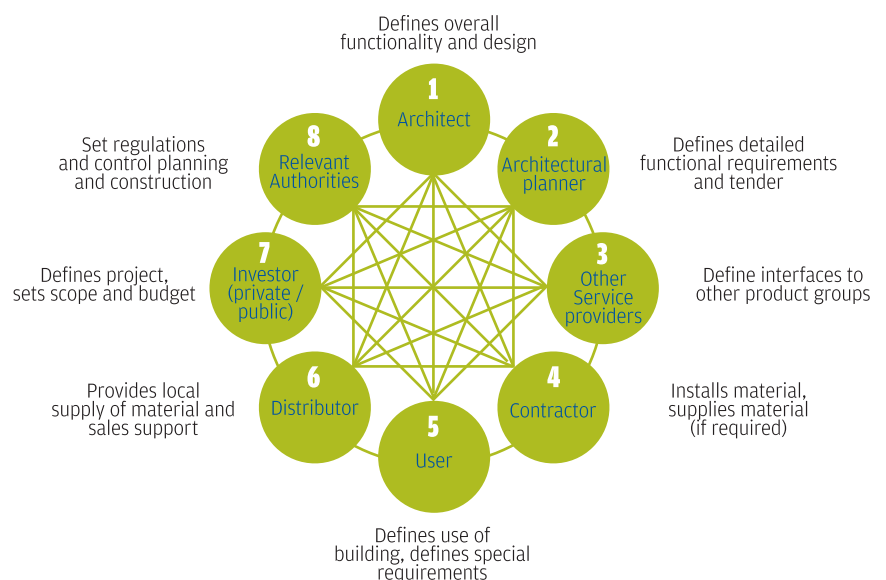
#### Concentration in retail channel No. of shops, %





- The decision process is very complex in most cases and will vary from one material to the next. OC&C's experience taught us that finding the most influential parties and the real decision makers is a must, but can be tricky. In many categories, the consumer himself has a very clear and definite opinion on what he wants. Targeting them with appropriate Sales and Marketing actions is critical. Copy-pasting European solutions in China will not work.

## A complex network of different players is involved in the overall decision process - finding the most important ones to target is critical



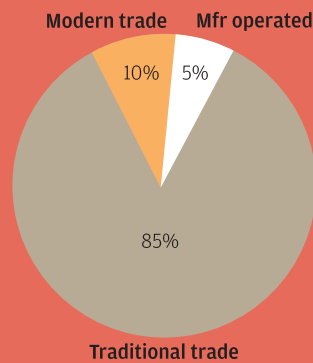
- Modern Trade (equivalent to DIY): it's still very small; China is mostly a DIFM - Do It For Me market. It suffered punishing blows during the crisis; rebounding may happen, but contractors, property developers and home owners still consider MT as a showroom, to look at new products and peg prices; Home Depot is down to 10 stores; B&Q has reduced its exposure. On the other hand, China is also witnessing the rise of new retail concepts like the Macalline concept: a multistory showroom where brands come to showcase their products and where full design services are offered, based on the products displayed.

## Modern trade is still small, being used as a showroom and price benchmark by many end-users

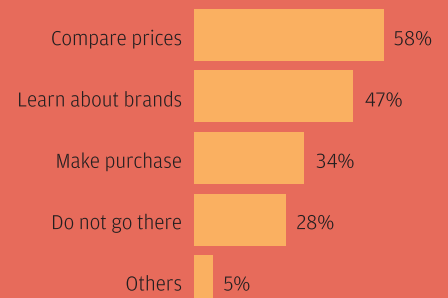
### Downstream landscape

### Home interior example

Stakeholder shares in retail channel  
No. of shops, %



Consumers' key reasons for visiting MT stores  
%, N=2276



- Traditional Trade (equivalent to the professional channel in the West, but actually open to all customers): a very fragmented universe; outlets for one category are usually localized in the same areas around the city; they are critical to reach what is still essentially a capillary market.





## Pricing control

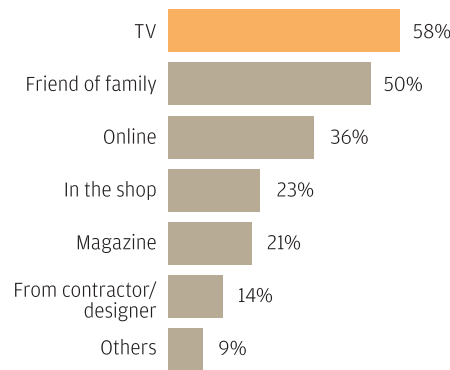
Because the supply chain is very complex and wholesale layers pile up, so do mark-ups, rendering price control at retail almost impossible.

## Promotion

TV is still the most important source of brand information for consumers of construction materials but national TV is very expensive even when compared to European standards; there are, however many opportunities to use local TV stations. On-line portals are actively used by consumers and may provide an alternative to traditional media.

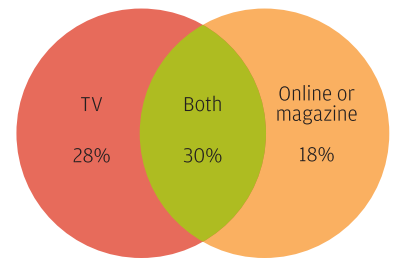
### Customers are brand savvy. TV is the most common way to acquire brand knowledge while online/magazine can come close to match TV influence

Consumers' knowledge sources in category



Example

Source of brand awareness comparison - TV vs. online/magazine



Online + magazine usage pattern is similar for buyers across different price tiers and different regions

## Consumers actively use the internet as a research channel for building materials

### Online portals for construction materials

#### Website types and functions

##### All-in-one websites, incl:

- Blogs/forums
- news articles
- product information
- etc.

##### Online shopping malls, eg for:

- furniture
- home appliance
- construction materials

##### Experience sharing/

- exchange platforms
- Group purchasing websites

#### Examples of popular websites for building materials



Finally, local competition can't be ignored. Local competitors usually benefit from solid regional strongholds, supported by popular local brands and a cost advantage from being regional. Some may also benefit from the scale afforded them by export volumes.

# HOW SHOULD MULTI-NATIONAL CORPORATIONS COMPETE IN THIS MARKET?

## Pick your battles

There will be too few resources to go after all segments and fight many local competitors, especially as markets are often regional

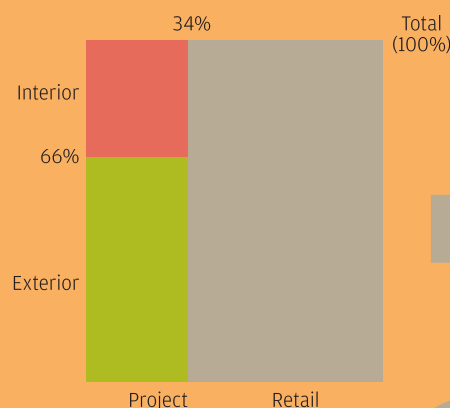
- Products/services need to have a sustainable competitive proposition, one where MNCs have an advantage in product design, technology/cost or product claim proof, e.g. health claims, supported by well-engineered innovation management, and not easily replicated by local competitors (yet)
- Geographies will be carefully chosen based on volumes, growth, competitive set and economic equations
- Build strong brands capable of generating consumer pull and bring some leverage with a complex multi-layered distribution: allocate resources to consumer and trade marketing in the right proportions to the right categories.
- Use appropriate promotional channels to do so, local TV to accompany roll-out, internet to showcase product features and provide services / training, in-store catalogs to generate the sale.

Category is predominately sold through the retail channel although the project channel is growing faster

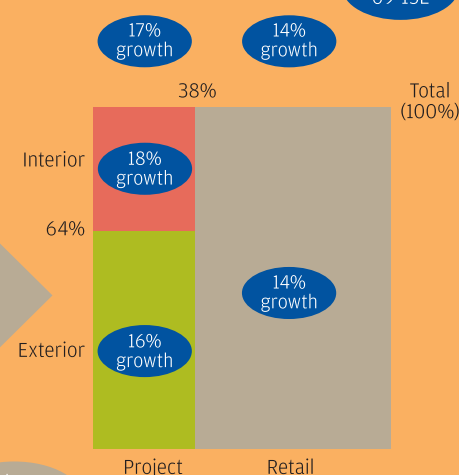
### Volume by product quality and by channel, 2009 vs 2015

m liters

#### Volume breakdown 2009



#### Volume breakdown 2015E



Total CAGR 09-15E 14.7%

CAGR 09-15E

## Build a portfolio of brands

to attack various chosen segments and speed-up market access

- Mid to high-end brands with corresponding features and proven quality, but perhaps with relatively low cost efficiency; the Chinese consumer values western brands
- Low-end products, potentially through a successful acquisition, with greater cost efficiency, relatively independent local management and local practices to tackle the capillary market

## Be prepared to invest heavily in branding

- Opposite a fragmented, multi-tier distribution, which in most cases will see no benefit in stable partnerships with manufacturers, the strength and reputation of a brand will become the primary asset for MNCs
- It will also be one line of defense against copycats and counterfeits, obviously not sufficient per se, but considerably stronger than presumed by many. The reason is that the Chinese consumer will increasingly need brands they can trust (see OC&C publication: Building brands that Chinese can trust)
- How to build the brand will require careful crafting: means which may not make full sense in western economies (e.g. flagship stores) may contribute powerfully to help build awareness of a brand and its offering
- We anticipate that for construction material companies the “advertising and promotion cost as a % sales” of their Chinese businesses will be much higher than in western economies.

## Scale does matter

Understand the role and economic viability of various channels and manage them with care:

- direct distribution can be an attractive full-control option but may prove expensive in upfront capex and often requires a full product range
- the modern trade is a growing channel but still relatively small; listing fees are sometimes steep and rates of sale may not suffice to keep retailers interested
- the traditional trade is still in many cases the key to national roll-out, but expansion must be controlled and traditional trade distributors need to be carefully chosen and incentivized

Explore the acquisition route - under the right conditions of control and ownership, acquired companies can help build a portfolio of brands and achieve scale, while speeding up access to some specific channels (e.g. traditional trade or direct distribution if the target is a local brand).

There are successful MNCs for which China is the growth engine worldwide, often contributing the worldwide sales and profit growth. But agility remains the key determinant for their success as they craft their strategies to build a portfolio of brands and scale in the segments they choose to compete in.

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