

Fermentation in the China Beer Industry

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INTRODUCTION

As firms in many industries seek to enter new international markets to sustain their growth, they often find themselves in a strategic quandary. Product designs, marketing approaches, supply-chain management issues, and business strategies designed for one region of the world often require significant time and managerial effort to successfully reconfigure and adapt them to new markets. The evolution of customer demand, preferences, and buying patterns can vary markedly from one market to another. In fact, regional markets can exhibit profound differences even within the boundaries of a single nation. For example, in China, the sophisticated urban coastal mega-cities that line the Pacific shores teem with millions of customers willing to pay top dollar for foreign-branded goods. Yet, a few hundred miles inland, there are hundreds of millions of people who have yet to see a foreigner walk through their small city streets.

Entry into a large foreign market generates considerable strategic opportunities as well as challenges for both multinational firms and domestic firms. Foreign markets

often allow a multinational firm to introduce a new line of products designed specifically for that market, or to modify their existing products to better suit the tastes and needs of the targeted customers. These efforts can take considerable time and effort to yield success. Some firms may seek to establish a presence rapidly in a new market so as to capture first-mover advantages; others may move slowly in order to better understand the local subtleties and possible pitfalls of serving customers with very different preferences. Although firms in any given market compete with one another for customers, they paradoxically also become highly interdependent over time—in that they are impacted by a common set of underlying geographical factors and other macro-environmental conditions that shape the economics of competing in a given market.

This article examines the fast-evolving competitive dynamics that are now redefining the brewing industry in one of the world's largest markets—China. By examining the strategic approaches of domestic and multinational firms jockeying for market position in China, managers can better understand and act on some of the emerging

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critical success factors that surround market entry into a fast-developing country. As the Chinese economy continues its meteoric rise toward becoming another economic superpower, both domestic and multinational companies are discovering that competing in China is a double-edged sword. On the one hand, there is the promise of more than a billion consumers who are increasingly wealthy and crave new products. According to some estimates, tens of millions of Chinese enter the middle class each year. This means an enormous amount of purchasing power that well-positioned domestic and multinational firms hope to capture. On the other hand, the economic, regulatory, and even the geographical landscape of the country place an enormous burden on multinational firms seeking to build up their operations and supporting infrastructure. Although there are many cities in China that are beginning to display ultra-modern characteristics, vast portions of the country are left behind because of uneven economic development. The lack of transportation and communication systems complicates operational issues ranging from the supply-chain management to local labor pools.

The brewing industry in China crystallizes many of the paradoxes of competing in this enormous nation. Large, global players such as Anheuser-Busch Co., Heineken, SABMiller, and Interbrew have begun to invest heavily in the Chinese market in the past several years. These companies see China as the next frontier of rising per-capita beer consumption, which has leveled off or even declined in more traditional, mature markets, such as the U.S., Europe, and Canada. Yet, for many of these companies, entry into the Chinese market has proven difficult. Learning how to navigate the macroeconomic labyrinth of intricate distribution channels, poor transportation infrastructures, complex government regulations, and the seemingly endless number of domestic competitors of all sizes in every province and city has been an onerous task. All these companies have discovered that they must adapt their product and market strategies to

accommodate the economic reality that there are indeed “many different Chinas” when serving the mainland “Chinese” market.

VIEWING AND FRAMING THE CHINESE BREWING INDUSTRY

Ever since 1978, when former Vice Premier Deng Xiaoping began transforming the country onto its free-market path, economic development has proceeded somewhat unevenly. The urban areas along the Pacific coast of China have led the way, spawning hundreds of billions of dollars of investment in new factories, highways, real estate, airports, harbors, and other infrastructure projects that make Shanghai, Guangzhou, and other cities look space-aged. In some instances, port facilities in China are more modern than those found in Los Angeles and New York–New Jersey. The industrial north (formerly known as Manchuria) is China’s rust belt—home to aging steel mills, coal mines, and other relics of the nation’s centrally controlled, Soviet-style economy. The vast Chinese provinces in the central part of the country possess a majority of the country’s population and depend heavily on agriculture rather than industry for income. They have lagged behind in developing the necessary transportation and communications infrastructure that would begin to end many provinces’ centuries-old isolation from one another. Consequently, China is actually composed of many different regional markets—each with its own distinct set of competitive imperatives.

The economic and geographic complexity of China effectively means that regional differences can have a profound impact on product design and marketing. Any given product can evolve in very different ways, depending on each regional market’s specific competitive context. For example, leading-edge products, such as hand-held personal digital assistants (PDAs), and personal computers, can rapidly become commodities overnight in the eastern metropolises where competition is intense and dominated by

large, scale-driven competitors (e.g., Dell Computer Corp., IBM-Lenovo) competing with advanced technology and western-style marketing. On the other hand, older products (e.g., bicycles, regular film cameras) can sustain a very long and profitable life in the distant rural areas, since competition is much more localized and less subject to pressures from new product features. In addition, a high degree of state-ownership in domestic firms may also complicate the matter. They can impede the ability of other domestic and multinational firms to compete in a local market through regulations and other barriers to entry that make market penetration difficult.

Using a variant of a model developed in an earlier study that examined the impact of industry change on business strategy, we can examine the unique factors of competing in the Chinese market along parallel lines. This previous model highlighted the development of firms' competitive strategies as an industry enters different stages of evolution and change. Two defining characteristics that impact the strategic response of all firms in an industry or market are (1) the evolution of the product life cycle and (2) the rate of change.

Product Life Cycle

The early stage of an industry's product life cycle is characterized by rapid growth, an explosive proliferation of firms, and low barriers to entry, as many firms try to get their products accepted by customers. As the size of the market expands, large numbers of competitors seek entry. This growth provides considerable economic ferment that enables different firms to craft their own firm-specific strategies to compete in the same industry. Over time, however, as customers become more knowledgeable, and competing product attributes become more similar to one another, these declining differences lead to price-based competition. Ultimately, there is a shakeout in the number of firms left to compete. While the overall size of the market has grown, each firm

begins to confront slower revenue and profitability growth.

Rate of Change

In this current article, the rate of change refers to the extent to which product markets evolve in ways that are different from their predecessors. In many cases, change is gradual and evolutionary as product and process technologies slowly improve over time. Their impact on the market is predictable. In other situations, change can "disrupt" an entire industry's equilibrium, resulting in the creation of very different types of competitors using an entirely new means to compete. More often than not, the creation of a new core product idea or innovation opens up new avenues for firms to compete with entirely new product offerings or categories. Thus, a new product concept can destabilize an industry's pre-existing equilibrium. In general, however, fast-changing markets that are in a state of flux are likely to evince a large number of competitors jockeying with each other to serve customers that have emerging, or very different needs. On the other hand, markets that change more incrementally are likely to be quite stable, and customer needs are well understood. The combination of these two market drivers is shown in Fig. 1.

MODELING THE CHINESE BREWING INDUSTRY

Using this framework, we can begin to map out how different regional markets in China exhibit the characteristics highlighted in Fig. 1. Although China is a highly complex, geographically diverse country, we can detect some distinct patterns that are emerging.

Geographic Spread and Fragmentation

Until very recently, China's vast and diverse set of regional markets were geographically fragmented, especially in the largely

FIGURE 1 INDUSTRY PROFILE

		Rate of Change	
		Low	High
Lifecycle	Mature	<p>1. <u>Fast Growth</u></p> <ul style="list-style-type: none"> • Focus on developing core product concept • Rivals attempt to differentiate from one another • Emphasis on scalability, replicable business models • Value proposition seeks to build customer loyalty 	<p>2. <u>Ferment and Flux</u></p> <ul style="list-style-type: none"> • Market boundaries uncertain • Multiple competing customer needs and preferences • Numerous entrants from a wide number of industries • Value propositions in flux • Need to establish customer lock-in
	Growth	<p>3. <u>Steady Evolution</u></p> <ul style="list-style-type: none"> • Stable industry structure • Well-established competitors • Few opportunities for product differentiation • Scale and size important • Cost efficiency predominates • Knowledgeable customers 	<p>4. <u>Market Redefinition</u></p> <ul style="list-style-type: none"> • Rise of new product concepts • New rivals from other industries • New products reshape underlying value proposition • Established firms face market share loss

agricultural, rural provinces located in Central and Western China (e.g., Sichuan, Shanxi, Henan, Yunnan). The major domestic brands still generally dominated in their local areas. Poor infrastructure, returnable bottles, and tradition limited most brands' geographic reach. In 1995, there were over 800 breweries in China. Recently, this total has been reduced to 300 brewers, resulting in a substantial rationalization of total brewing capacity. Traditionally, all brands had very localized sales. It was difficult and expensive to ship beer across regional borders and break into protectionist regional markets. In the brewing industry, only Tsingtao is available almost nationally.

Supply-chain management in China has been a major problem, due to poor physical infrastructure (slow trains and limited road network) and lack of an efficient system linking manufacturer with wholesaler and retailer. Like many multinationals, brewers rely on

strong distribution channels to deliver their products reliably and also to educate their customers about the subtle advantages of their products. Efficient logistics and distribution are major problems in China. Multinational firms' potential advantages in supply-chain management are often rendered inefficient by the lack of competent local suppliers. These issues are among the major ones facing Anheuser-Busch according to David Renauld, vice president for the company in China.

Another problem for multinational brewers is their inability to reap economies of scale and spread high fixed costs because of the fragmentation of the Chinese market. Provincial trade barriers and protection of local enterprises by the government hinder global brewers. Anheuser-Busch, Heineken, and several other global brewers spent money on national and regional advertising campaigns only to find that it was impractical to supply large volumes of beer outside

the provinces in which it was brewed. They found that the fragmentation of their operations made smooth integration virtually impossible.

Transportation between many provinces remains slow and unreliable, although it is improving somewhat. For example, between Shanghai and Beijing, a distance of around 1,000 kilometers (621 miles), it took more than 31 hours to drive as recently as 1990, before modern highways were constructed. Today, driving time is around 14 hours. By 2008, China's goal is to have more than 82,000 kilometers (51,000 miles) of Interstate highways, compared with roughly 74,830 kilometers (46,500 miles) in the U.S., thus endowing China with one of the world's largest and most modern road network. To the extent that modern highways are beginning to connect major cities and span deep into the countryside, they are costly to use, since almost all of them are toll roads. Driving by car from Beijing to Shanghai can cost as much as 500 Rmb (Rmb is shorthand for Renminbi, the national currency of China. One U.S. dollar is approximately equal to 8.12 Rmb). Similarly, China expects to spend \$242 billion (USD) in repairing its railroad system by 2020. This is important, because if beer is exposed to extreme temperatures, its quality may be degraded. Specifically, very cold temperatures can cause beer to become cloudy. On the other hand, exposure to sunlight can accelerate the aging process and may cause the beer to taste "stale."

The wholesale distribution sector is also fragmented in most regions, divided between state-owned cigarette and alcohol distribution companies, collective distributors (often owned by local townships), and individual wholesalers. The "quality" of wholesalers, in terms of their efficiency, service levels, and commitment to supporting marketing and brand-building programs varies widely. Their ownership status is not a good guide to their marketing capabilities. In the U.S., the average amount spent on advertising is 10 percent of sales by brewers and a similar amount by wholesalers. In China, brewers spend about 3 percent, and wholesalers spend less than 1

percent. Thus, wholesalers concentrate on particular geographic areas (although these are seldom exclusive). Some further specialize in a particular type of outlet (e.g., restaurant vs. off-premise retail, vs. bars). A brewer might typically deal with more than 20 wholesalers in each region in which it marketed its products. In many cases, the presence of second and third tier wholesalers further complicates distribution. These second- and third-tier distributors are often affiliates associated with wholesalers who serve smaller retail outlets that are costly or more distant from the wholesalers' larger primary accounts. Consequently, big geographic portions of the Chinese beer market display characteristics that are consistent with the conditions found in quadrant 2 of Fig. 1: *the market for beer in Chinese rural areas is in a state of ferment and flux.*

Fast Growth and Multinational Entry

Since the late 1990s, numerous multinational brewing companies have entered the Chinese market, seeking to ride the coattails of fast growth and the rising prosperity of many large Chinese cities. During the 1990s, China's beer output grew faster than anywhere else in the world. It reached more than 185 million hectoliters in 1997 (49 million hectogallons), second only to the United States. This represented around half the beer drunk in all of Asia at that time. Domestic and international predictions indicated that the country was set to overtake the United States as the world's biggest beer consumer by the year 2000. Yet consumption per capita remained low – in 1997 it was still not even half the world average – indicating that huge potential for growth in the industry still existed, especially if a large proportion of the Chinese population continued to develop a taste for beer.

Beer has not always been popular in China, especially among the 600 million people who live in the countryside. Its flavor was not much liked; it was viewed as less strong than spirits and relatively expensive. Rising affluence in China has pushed up consumption of

all alcoholic beverages, and beer is proving especially popular. In 1987, beer accounted for 45 percent by volume of all alcohol consumed in China; by 1993, this figure had risen to 60 percent. Today the average Chinese drinks almost 18.7 liters of beer (nearly 5 gallons), compared with 82 liters (nearly 21.5 gallons) in the United States, and 158 liters (41.7 gallons) in the Czech Republic. In urban areas, the figure is considerably higher: in the range of 27–30 liters (7.1–7.9 gallons) in Beijing, Shanghai, and Guangzhou. Consumption remains low in rural areas—production figures suggest rates of 6.3 liters per annum (1.7 gallons) in the Northwest and only 5 liters (1.3 gallons) per annum in the Southwest. Consumption is starting to rise, however, in the rural regions.

In the early 1990s, the Philippine-based San Miguel Corporation entered China through leasing the Guangzhou brewery to make beer for the Chinese mainland market. Major brewers from more than 10 countries and regions promptly followed suit, the result being one of the most intense marketing wars in Asia. Seeking rapid growth, foreign brewers poured into China, and between 2001 and 2004, deals with a value of around 73 billion Rmb (or roughly \$9 billion) had been struck.

Extracting a reliable profit from China's huge market has proved rather difficult. The massive onrush of foreign firms led to intense competition in key urban markets. Only very few companies, such as an Indonesian-backed company that licensed the German Beck's brand, were making money. Many others were losing millions of dollars. By 2005, the situation had developed into one of intense competition. Mounting financial losses for most companies required them to reevaluate and adapt their business strategies in order to remain in the market.

As late as 1995, China was still "the last frontier in brewing," according to the chief operating officer of the Asia division of Australia's Foster's Brewing Group, fifth largest brewer in the world. In 2005, China will sell 247.8 million barrels of beer, but low average prices mean the beer market is still relatively small in terms of value. China's beer market is worth around 196 billion Rmb (\$23.9 billion USD) in 2005. The market grew in the late 1990s at a rate of between 10 and 25 percent per annum. The segment for foreign beer is expected to grow 15–30 percent per year. Global consumption, by comparison, is growing at 1.2 percent per year. See [Table 1](#) for China beer market projections for major brewers.

TABLE 1 CHINA BEER MARKET PROJECTIONS, 2004–2014E

	2004	2014(EST.)
Total beer sales volume (million kiloliters)	267	424
Compounded average growth rate (percentage)		4.7
Averaging selling price (USD/hectoliters)	26.5	32.6
Compounded average growth rate (percentage)		2.4
Total beer sector revenue (million USD)	7,056	13,798
Market share		
<i>Tsingtao</i>	13.8	32
<i>CRB</i>	11.5	18.8
<i>Harbin</i>	4.6	18.2
<i>CRB-Harbin</i>	16.1	31.0
Estimated revenue (million USD)		
<i>Tsingtao</i>	973	4,473
<i>CRB</i>	813	2,597
<i>Harbin</i>	321	2,507
<i>CRB-Harbin</i>	1,134	5,104

Source: Companies, Smith Barney estimates, China Beer Sector March 19, 2005.

The urban markets of China have become the real drivers of beer consumption over the last decade. The urban markets are highly sophisticated, attract Westerners for business and pleasure, and now command the attention of all the leading multinational brewers. At the same time, the fast growth and demanding competitive requirements of Chinese urban markets mandate that multinational and domestic firms find some critical avenue to differentiate their products from those of their rivals. Unlike the Chinese rural market, the urban market evinces many of the characteristics found in quadrant 1 in [Fig. 1: the Chinese urban market is in a fast-growth mode](#).

The Specter of Consolidation

The transformation of the Chinese brewing industry, while still showing signs of fragmentation along provincial lines, began in earnest in 1990. After building their core businesses, domestic companies of significant size were emerging to become acquisition targets for multinationals eager to build national scale. At the same time, Chinese companies increasingly are looking for foreign investors to add capital and expertise to their business.

For the multinational firm, consolidation is necessary to stabilize a competitive position in many Chinese urban markets. Multinational firms, in particular, have attempted to build strong market shares in brewing and selling higher quality, premium beers at a higher price. In 1997, the chief executive officer (CEO) of Singapore-based Asia Pacific Breweries predicted a "bloodbath" in the China beer market. Almost a decade ago, the head of China operations for Philippine-based San Miguel commented on the overcrowded market: "We're all planning strategies like warlords, and everyone is confident they'll end up the winner."

Part of the impetus for consolidation among brewers has been that too many – more than 20 – foreign companies were targeting the same premium end of the market. With each firm hoping to capture a share of

around 15 percent, the figures clearly did not add up. Yet many of the foreign breweries resisted selling standard beer, which required a much lower price point. Instead, they spent even more heavily on advertising their premium brands. In 1995, for example, foreign companies more than doubled their advertising spending in Beijing, Shanghai, and Guangzhou alone. Yet by 1997, the international premium segment still only accounted for 5 percent of the volume of beer consumed. Nor was there any real brand loyalty among Chinese drinkers faced with the plethora of imports. "It is very, very difficult, particularly when you have lots of new beers being brewed in China, to differentiate one from the other," according to Rick Linck, chairman of Asia Pacific for Heineken.

In some parts of China, strong signs of consolidation are emerging, especially among the top-tier domestic firms that are rapidly becoming the preferred partners or acquisition targets of multinational firms. Where consolidation is occurring, it is likely to take on many of the characteristics portrayed in quadrant 3 of [Fig. 1](#).

CRAFTING AN EFFECTIVE COMPETITIVE STRATEGY

Many firms have learned that adaptation to the subtle undertones of serving the Chinese customer can be a tricky task. One common defining theme among all of China's markets: the persistent low price for most brands of domestically brewed beer. Retail prices varied considerably, from 1.5 Rmb for a quart bottle of standard, domestically produced beer, to 6–7.5 Rmb for international brands, and up to 19 Rmb for imported premium foreign beer. Ninety percent of the beer is sold for less than 4 Rmb. There is significant regional variation; beer prices are higher in the coastal and eastern regions and the major cities. In many markets, beer costs less than Coke. While multinational brewers might be more efficient and have more money to spend on sales and promotions, it is not easy to recover these costs. With prices so low,

companies find it difficult to pass costs on to consumers. The main price distinctions are between cheap “standard” brands (around 90 percent of the market) domestic premium brands (7–10 percent) and international premium brands (3–5 percent). As a rough indicator, the total international premium segment in China is about the same size as the Danish beer market.

Most of the beer sold through retail (“take-home” or “off-premise”) outlets is standard beer. People bring reusable glass bottles and fill them up. Most of the international brands are only available through “on-premise” channels like hotels, restaurants, bars, and karaoke bars. On-premise prices are considerably higher than off-premise retail, and indeed considerably higher than many Chinese consumers can afford. Among status-conscious buyers purchasing beer in hotels, bars, discotheques, and restaurants, however, demand is relatively price inelastic. Some customers are prepared to pay very high prices even by Western standards for the right brand, as a sign of status.

Confronting Fragmentation: Low-risk Entry Strategies

The beer market in China was a local provincial business with 100 breweries through the early 1980s. The Seventh Five-Year plan provided government loans and incentives for local governments to invest in building breweries. By the mid 1990s, there were an additional 650 breweries in China that had started production. The state-owned banks’ role was to fund local and provincial brewery operations. The operations were owned and managed by the local government. Much of the brewing equipment purchased was from failed U.S. regional brewers. Many of these breweries were operating at far below the break-even capacity required to be profitable but they supplied the country with numerous low-end brands. This overcapacity led to capacity consolidation through the late 1990s. In the beginning of the 1990s, capacity utilization was at 55

percent, which increased to 75 percent by the late 1990s.

This phase satiated the nation with many local brands and breweries that were identified with the town or city in which they were brewed, such as Guilin beer. Because of the persistently weak transportation infrastructure, it still remains cost efficient in many areas to brew and distribute in a restricted geographical region. Consolidation of brewing to ship across regions is not economically feasible until the transportation costs are lowered. For this reason, many local breweries that were created during this phase are still making money in China.

Most foreign brewers had imported their brands to China before producing them domestically. Multinational brewers had spent large sums on advertising, especially in the bigger hotels and restaurants where prices were already high. In order to secure access to higher-paying customers who were frequenting these restaurants and hotels, larger beer companies paid an extra concession fee to sell on these premises, thus furthering raising the final price of the beer. As a result, many local Chinese beers were being pushed out with foreign beers often sold at twice the price of local ones. Overseas brewers then began to import brands rather than products by finding cooperative partners in China: the world’s top 10 brewers had all entered the market in this way.

Fast Growth: Partnering to Differentiate Oneself

The combination of rising consumption and weak local competition led major breweries to invest heavily during the past decade. Almost 50 partnerships were formed between Chinese and foreign brewers by the late 1990s. For most foreign investors, the idea was to tie up with a local partner, improve quality and efficiency, and then use the brewery to start making and selling their own global brands. The advantage of a joint venture was that the local brewery would already have an established market. The disadvantages were that the partners often had

different priorities; their equipment was old and of poor quality; and they were heavily over-staffed. It was not easy for the foreign partner to maintain control, even with representatives on site. During the early phase of this entry strategy, the beer market still evinced high fragmentation, especially in the nonurban areas. The top three brands represented only 14 percent of volume. By comparison, the top three brands represent nearly 70 percent of the volume in the U.S.

In 1994, Anheuser-Busch, the world's biggest brewer, paid \$135 million (Rmb) for a 5 percent stake in Tsingtao, one of China's two largest breweries, followed by \$1,148 billion (Rmb) for an 80 percent share in the Wuhan Brewery in Hubei province, a major brewery in eastern China, from which it began to produce Budweiser. By 2005, Anheuser-Busch owned nearly 28 percent of Tsingtao. Heineken used its joint venture with Singapore's Fraser and Neave, Asia Pacific Breweries, to become a major force in Shanghai, to compete with Australia's Foster's. In 1996, the world's number-three brewer, Miller, joined forces with Shuanghesheng Five Star, one of China's oldest and most famous brands, paying \$820 million (Rmb) for a 20 percent share of the Beijing market. The world's number 4 brewer, Kirin of Japan, launched a major campaign to win a large share of the market in China's Northern provinces. By the late 1990s, all the world's major beer companies were involved in China to some degree.

In addition to the major international brands, a number of strong national players have also entered the Chinese market. These include South African Breweries (SAB), involved in a large joint venture with China Resources (a major government-backed, Chinese conglomerate listed in Hong Kong), and Lion Nathan (the dominant brewer in New Zealand, with large interests in Australia and the U.K. and now 45 percent owned by Kirin of Japan). While both of these companies promote brands (e.g., "Snowflake" in the case of the SAB joint venture and "Rheineck" in the case of Lion Nathan), their strategy focuses on rapidly building volume with

competitive pricing in the mainstream market rather than building a premium brand with heavy advertising.

Despite the growth in the Chinese market, losses mounted rapidly as the brewing industry matured. Investments were scaled back or delayed, prices lowered and alliances reconsidered among the over-stretched foreign brewers. "Unless you're damned lucky and started with a small investment, China will continue to be a strain for a few years more," commented the head of China operations for San Miguel, whose company reported a \$25 million (USD) loss from international operations in 1996, mainly due to costs incurred in marketing and new investments in China. Singapore-based Asia Pacific Breweries announced half-year losses in China of \$20 million (USD) during 1997, and Australian giant Foster's lost \$114 million (Rmb) in China for the year ending June 1997. "There are still a lot of local breweries coming in. The competition can only get worse," commented Rick Linck of Heineken.

Among the joint ventures there was criticism of complacency, with marketing, quality control and management often leaving much to be desired. Most foreign companies continued to produce domestic brands with their joint venture partners while introducing their own brands. In some cases, domestic brands were upgraded and relaunched, and new domestic brands developed. The major breweries have invested heavily in increasing output, quality, and packaging. Most brewers claimed to have spent millions to improve marketing and distribution, but failed to realize the problems of reaching consumers in such a vast country.

For example, San Miguel, which had invested \$2.4 billion (Rmb) in three Chinese breweries, kept capacity expansion low as losses mounted. Others, such as Lone Star (owned by U.S. based Stroh's Brewery) and Foster's, with a new plant in Shanghai—also slowed down their expansion of brewing and packaging capacity. Some even considered sharing capacity with other foreign joint ventures, a move which would never have been entertained previously.

Consolidating to Build National Brands

By the early 2000s, there had been considerable domestic consolidation of brewing capacity among a set of vibrant, domestic competitors. These domestic firms had begun to set the stage to begin national brand consolidation and even national brand building. The top three brands in each of the leading 17 provinces held a minimum 60 percent market share and as high as 91 percent. Some joint ventures were becoming profitable, with average net margin of 4 percent in the industry in 2003.

Chongqing, Shanghai, and Beijing are the largest cities in China, with over 15 million citizens each. Shijiazhuang, Fuzhou, Hefei, and Ningbo are the cities that have over 70 percent urban populations. These consumers are served beer brands by a channel that begins with regional and local brewers and hundreds of local distributors reaching thousands of “mom and pop” retail outlets.

Chinese beer producers need to take advantage of new technology, improve quality and packaging and embark upon advertising campaigns to meet the foreign challenge. Some analysts felt that foreign beer could never capture the Chinese market fully, as Chinese beers still sold well in small towns and the countryside. Local beer quality is improving: in 1993, 55 percent of breweries reportedly failed a quality test, but recently this had fallen to 15 percent. Analysts expected to see a greater trend of small brewers joining forces in a given province. The Chinese government had a policy of favoring larger brewers (defined as those producing over 300,000 hectoliters annually; approximately 79,250 gallons) which handicapped small operations, and had toughened up its grain policy, setting a ceiling of 180 kilograms (397 pounds) of grain to produce each ton of beer. These tactics put pressure on those breweries that lacked economies of scale. Potential new entrants were also beginning to emerge as domestic spirits distillers considered moving into lower alcohol drinks, such as beer and wine. In China, about 300

breweries went out of business in 2004, according to Rick Linck of Heineken.

After building their businesses, domestic Chinese companies of significant size have emerged to become the preferred acquisition targets for multinationals eager to build nationwide scale. At the same time, Chinese companies increasingly are looking for foreign investors to add capital and expertise to their business. In May 2004, SABMiller’s bid for Harbin came days after Anheuser-Busch revealed it had agreed to buy a 29 percent stake in Harbin for \$1,107 billion (Rmb). Anheuser’s purchase was a shot across the bow of SABMiller, which has owned an equivalent stake in Harbin. SABMiller reported its fiscal full-year net profit more than doubled, helped by growth in its regions. The brewer said net profit in the year ended March 31 climbed to \$5.289 billion (Rmb) from \$2.427 billion (Rmb) a year earlier. Sales rose 39 percent to \$1.390 billion (Rmb). The company said the most recent year’s figures included only nine months of contributions from Miller, the U.S. beer brand it bought in 2002, skewing the direct comparison. “Everyone who wants to play on the international stage needs China,” says SABMiller’s Asia chief, Andre Parker. “Now is the time to build up positions while the market is in a consolidation mode.”

The Harbin battle highlights many of the difficulties facing foreign acquirers in China. The Chinese government owns a part of many Chinese companies, making deals complicated to construct, slow to close, and full of potential pitfalls. In the case of Harbin Brewery, the Harbin city government in March sold its 29 percent stake in the brewery to a British Virgin Islands-registered company whose owners aren’t publicly known. But it wasn’t until May 2004 that Anheuser-Busch was able to confirm that the initial sale of the stake, which it has now bought, had been approved by higher government bodies.

These hurdles make hostile takeovers particularly tough to pull off in China, even in Hong Kong, where the Harbin brewery battle is being played out. Hong Kong is where the company’s stock is traded, and regulations

and corporate practices are close to international standards. Despite the difficulties of acquiring companies in China, global brewers have little choice but to persist, because the potential profit is so great. In the beer industry, for instance, China is one of the few major markets where sales are still growing.

Anheuser-Busch is particularly under pressure to take the offensive in China. Unlike SABMiller and Heineken, which have bought up brewers around the world, Anheuser-Busch has made only a few investments in a handful of brewers. Anheuser-Busch had already made inroads into China. Not only has it established a successful business there, but it also owns a significant stake in Tsingtao Brewery Co., the country's largest brewer, with a goal of increasing its ownership to 27 percent by 2010. SABMiller is already well established in the region, both through its existing stake in Harbin and its 49 percent stake in China Resources Breweries Ltd., the country's second-largest brewery.

There are several challenges that face the beer brand-building plan, according to Y. R. Cheng, principal and general manager for Budweiser Shanghai. First, beer-brand building will be extremely treacherous in the short run because Chinese treat beer as they treat noodles, vegetables, and meats. They view these as nonbranded products. Branding beer might be a waste of money. With so many foreign beer brands in China, companies have to work hard to establish their product as more desirable than that of the competition. Subtlety is generally not effective. The Budweiser advertising campaign of "Born on date" in the U.S. to insure freshness of the beer has not caught on in China. Usually, a link with wealth and status, often by using gold in the packaging, is the preferred marketing tactic. Tennants ("T" in China) spent millions creating a quality image for its China launch, and packaged the beer in a gold can. Suntory launched Suntory Gold in Shanghai in 1996, and premium Chinese brands also emphasized quality over price—for example, Tsingtao's "Gold Label" beer. But cheap brands remain

dominant, and in the countryside in particular, price remains the bottom line: inexpensive local brands do not have to work too hard at capturing the market. According to Linck of Heineken, "Beer is essentially a commodity. It's all about distribution and branding. In the next decade we expect volume growth of beer in China to be 5.5 percent per annum. Growth by mergers and acquisitions has peaked. The remaining profit drivers are average selling price and margin."

Morgan Stanley Dean Witter & Co., a leading investment banking firm in the U.S., noted that the China beer market resembles the U.S. beer market at the end of prohibition. At that time, the U.S. market had close to 750 breweries. After years of intense competition, the U.S. brewing industry has winnowed down to about 20 major brewers, not including small microbreweries. Philip Morris created the first true U.S. national brand by bringing a large advertising campaign to a developed market and strong consumer income levels. Philip Morris was able to look at beer as a growth market and invest in its future. The Miller Lite brand was introduced by Philip Morris creating a category and brand that over 20 years later is still a market leader. Miller Brewing was sold to SAB of South Africa as Philip Morris restructured its numerous lines of business. Regional brewers, like Adolph Coors (which recently merged with Canada's Molson), were late to national advertising but reacted quickly enough to ride the national wave. Many local and regional brewers disappeared (e.g., Ballentine, Pearl, Falstaff, Jax, Blatz, Stroh, and Heileman), as they could not compete with the domestic light beers' branding success. With improved market conditions, China will likely follow this path, given the influence of the same global players as in the U.S. market.

Opportunities for Market Redefinition

As the many of the largest domestic and multinational firms seek to strengthen their

hold on the Chinese market, beneath the surface of this industry are the seeds for potential change. The beer market in China in the late 1990s remained dominated by lagers, but there was evidence of growing interest in different beers. In 1996, the Irish theme pub arrived in Shanghai, together with Guinness original stout and Kilkenny, a red beer, to be possibly replicated elsewhere in China. The "Guinness is good for you" slogan was being revived in China to appeal to Chinese health consciousness. Volumes, however, were still low.

There are few microbreweries in China, although this is a growing niche as interest in different beers develops. Maintaining equipment for draught beer proved a problem in the rural areas where a constant source of electric power is problematic. Climate extremes and old equipment make it more difficult to maintain correct brewing and storage temperatures.

Perhaps most important, the largest Chinese domestic players are now targeting the export market to become potential global players in their own right. For example, Tsingtao, China's most famous global brand, had expanded its production. In 1994, it purchased the Yangzhou Brewery entering into a joint venture with a local brewery in Xian, a city in the Shanxi province. The company aimed to become a modern transnational corporation building on its fame in the international market. Zhujiang Brewery in southern China had set up branch companies to market its beer, and had purchased breweries in Hefei, north of the Yangtze River, and in another city south of the Yangtze to increase production.

In 1996, the China National Council on Light Industry established the local beer industry as one of the priority industries during the Ninth Five-Year Plan from 1996 to 2000. Focus was to be placed on technology improvement aimed at companies with annual output of over 500,000 hectoliters, developing specialized production, launching new products, and utilizing large-scale packaging equipment. The government granted a package of preferential loans and

tax incentives to the 10 biggest domestic brewers to help them compete while remaining independent. It also stated that big domestic brewers should not engage in joint ventures with foreigners. Beijing indicated it favored the expansion – in capacity and geographic penetration – of the top 10 or so domestic brewers to give them a 40 percent market share within a decade, which would represent a dramatic rise.

The fastest growing domestic producer was Yanjing Brewery, majority owned by the Beijing Municipal Government. Yanjing had increased its market share in Beijing from 55 percent in 1994 to over 80 percent recently. Over the same period it had increased its production capacity from 4.5 million hectoliters (1.2 million hectogallons) up to 7 million hectoliters (1.8 million hectogallons), with plans to increase its capacity still further to exceed 12 million hectoliters by the year 2008.

STRATEGIC FOCUS: HEINEKEN'S COMPETITIVE STRATEGY

Strong competitive advantages depend on building on a key source of distinction that the firm offers its customers. A competitive advantage is something an organization can do that its rivals cannot match. Frequently, competitive advantage emanates a firm's ability to continuously lower its costs, or to provide a point of distinction that is not easily imitated, such as product differentiation. Demand-driven advantages enable the firm to gain access to customers because of higher switching costs, buying habits, or distribution channels. Cost advantages are almost always achieved through technological, organizational, and/or human resource management (e.g., training) advances. Regardless of the tactics chosen to achieve sustainable advantage, firms must be able to execute a strategy and build barriers to imitation from competitors. As each company crafts its specific competitive strategy according to its own internal capabilities and value

proposition, it must identify ways to sustain its sources of distinction that enable it to thrive even in the wake of severe competition. Thus, competitive advantage is developed when a firm can aggregate one or more activities in its value chain to achieve a stronger market position than its competitors.

Heineken's strategy in China is to differentiate itself from others by offering beer with a high degree of product quality. Product quality refers to ensuring not only that every beer tastes good, but also that it exceeds customers' expectations. The way Heineken accomplishes this is through local brand building. That is, Heineken buys the local market share leader and then adds a premium and super-premium Heineken brand to the local market. It has done this successfully in Henan, Shanghai, Guangdong and Shenzhen where it has acquired local breweries.

Heineken is equipped with sophisticated marketing and brand-building competencies that far exceed the capacity of local Chinese marketing companies, many of whom are still trying to distinguish between marketing and sales. But in order to exploit their expertise, Heineken needs specialized inputs like detailed market research that are often unavailable or poorly supplied in China. Good market-research companies are scarce outside the major cities. So, Heineken either has to make do with inadequate inputs or perform these functions in-house, even when they lack the requisite skills.

A fragmented advertising market poses two problems for Heineken. First, there is no independent research on the effectiveness of

advertising through various media outlets, such as TV, newspapers, fliers, billboards, and the like. Therefore, resources are probably wasted because breweries cannot measure the impact of their advertising dollars on various advertising modes. Second, since most Chinese brewery managers are generally inexperienced in managing advertising and branding resources, Heineken needs to spend considerable resources educating managers on advertising strategies. Consumers are not accustomed to emotional pull advertising that has worked for Heineken and other brand-driven firms (e.g., Coca-Cola Co., Procter & Gamble Co. among others) that emphasize image, styling, and other brand-conscience elements.

Successfully competing in China mandates that Heineken sustain higher economic performance than its local Chinese beer rivals. This requires establishing a superior market position. This is a challenging task. We noted that most of the beer sold in China sells for less than 4 Rmb per bottle. Therefore, it is uncertain whether Chinese consumers who did not grow up watching and reacting to consumer ads will respond to advertising campaigns to drive sales of high-priced products. The sophistication of China's advertising system is very fragmented, making it difficult to reach 600 million consumers who do not live in major urban areas.

Heineken's biggest threat emanates from other global beer companies. The top three brewers (SABMiller, Anheuser-Busch, and Interbrew) control more than 35 percent of the Chinese market. Table 2 illustrates the top beer brands in key cities and provinces.

TABLE 2 TOP BEER BRANDS IN KEY CITIES AND PROVINCES

CITY/PROVINCE	GDP PER CAPITA (USD)	TOP THREE BEERS	TOP THREE MARKET SHARE (PERCENTAGE)
China overall	1,092	Tsingtao, Yanjing Hapi	14
Shanghai	4,625	Suntory, Reeb, Bass	56
Beijing	3,051	Yanjing, Five Star, Tsingtao	77
Guangdong	2,058	Zhuijiang, San Miguel, Tsingtao	73
Shandong	1,645	Tsingtao, Laoshan Budweiser	81
Hubei	1,267	Xingyinge, Jiniong Quan, Tsingtao	71
Henan	879	Baoji, Hansa, Tsingtao	68

Anheuser-Busch has a joint investment with Tsingtao in over 50 breweries. The brewery in Wuhan can deliver enough beer to cover almost the entire East Coast of China. These 50 breweries enable it to command a market share of 19 percent, compared with Heineken's two-percent share.

Heineken's strategy has been to continue building local and regional profitable businesses by investing in strong local brands and adding Tiger and Heineken brands to its distribution system. The Heineken brand is brewed and marketed in the primary regions of Shanghai, Guangdong, and Henan. In Shanghai, it has a 5 percent market share with its international premium beers of Heineken and Tiger; in Shanghai, its Reeb beer is number two; in Guangdong, its Kingway beer is number three, and in Henan, its Anchor and Aoke beers have enabled Heineken to be the market leader. Both Tiger and Heineken are sold in all three markets and priced above the market leaders in each market. For Heineken, this multi-pronged approach to serving a regional market will help erect stronger barriers to entry. In a restricted market, such as Shanghai, economies of scale for new entrants are usually more difficult to capture because of high fixed costs. Heineken's presence in the major cities limits its advertising and supply-chain management costs.

In an attempt to meet the standard, premium, and super-premium market segments, Heineken has developed a range of products by engaging in joint ventures in local breweries to achieve sustainable regional dominance. For instance, in 2005, Heineken raised its ownership stake in Kingway, located in Guangdong's major city of Shenzhen, currently one of the richest areas in China. Kingway's net margins continue to be in the 15–17 percent range, whereas the entire China beer market is less than 6 percent. Its flagship beer, Heineken, is targeted to the high-end of the super-premium market (16–18 Rmb). Tiger beer is targeted to the premium beer market (6–8 Rmb) and Reeb is focused on the standard market segment (3 Rmb). Although the China beer market

remains geared to the standard market, Heineken hopes that its efforts to increase both the quality and its brands name will generate growth in the premium category. The strategy of joint ventures with local breweries to minimize shipping costs and maximize the scale of operations appears to be sound. Economies of scale are critical for Heineken because of lower advertising and distribution costs.

One of the keys to Heineken's strategy is to differentiate its product from its competitors. China's beer drinkers do not view differences in beer taste as a significant differentiator. They differentiate beer by price. Heineken sells at a four-time multiple of standard brands in China. This multiple gap is a disincentive for consumers to buy a more expensive beer because the price gap is too great. Therefore, according to Rick Linck, Heineken's China strategy needs to focus on buying or forming joint ventures with local brewers and using those local brands for the standard segment of the market in which price is the key differentiator. This will enable Heineken to gain scale and entry for the distribution of its premium beer. In order to drive sales of all of its brands, Heineken needs to create positive brand imagery campaigns, possibly by coupling advertising campaigns with well-known or popular actors, actresses or other public figures.

SUMMARY

We have highlighted how the structure of the China brewing industry affects the nature of competition within that industry. A typology of four configurations was presented, along with the key industry characteristics of each. We argue that because China is such a vast country, competing in China requires that organizations view China as consisting of distinct arenas in which to operate. Organizations competing in rural China require different competencies from those competing in large metropolitan areas. In their continuing search for greater economies of scale, brewers in the China beer market are striving

to achieve a high degree of product and process standardization because they face high fixed costs. Brewing is a mature industry where large firms, such as Anheuser-Busch and SABMiller, enjoy significant market shares. While opportunities for differentiation still exist, they are difficult to pursue because buyers are knowledgeable about competing products and costs. Heineken has chosen to achieve sustainable dominance in various regions by adopting local strate-

gies that lower supply-chain management costs and increase its ability to capture local customers. To pursue this strategy, Heineken has acquired local brewers in order to gain a stronger bargaining power over its suppliers, lower its operational costs, and gain market share.



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The article by D. Lei and J. Slocum, "Strategic and Organizational Requirements for Competitive Advantage," *Academy of Management Executive*, 2005, 19, 31–45, provided the framework for our discussion on the characteristics of an industry. The book by R. Pitts and D. Lei, *Strategic Management: Building and Sustaining Competitive Advantage* (Cincinnati, OH: South-Western Publishing Company, 2006) and the article by B. Greenwald and J. Kahn, "All Strategy is Local," *Harvard Business Review*, September 2005, 94–107, also provided intellectual guidance for the development of this typology.

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