Perspective

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Shan Zhai
A Chinese Phenomenon

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EXECUTIVE SUMMARY

Shan Zhai is becoming a widespread phenomenon in China. Originally used to describe a bandit stronghold outside government control, the term Shan Zhai today refers to businesses based on fake or pirated products. However, it does not stop there. Many businesses with humble Shan Zhai origins are now becoming formidable market disrupters and, in many cases, market leaders. The innovative nature of Chinese culture and the huge potential in the Chinese market create vast opportunities for Shan Zhai companies. The best of them are fast, flexible, innovative, and willing to take risks. As they achieve certain scale, they quickly move up the value chain and develop core competencies to differentiate themselves from the also-rans. The Shan Zhai phenomenon is not about low-cost fake products anymore; it is about how one type of Chinese company achieves success without following conventional wisdom and develops competitive advantage through innovation.

WHAT IS *SHAN ZHAI*?

Ms Yang, a Beijing office worker, shows off her new mobile phone to her co-workers. It boasts all the features of a "typical" handset: touchscreen, camera, MP3 and video players—but it offers a lot more besides. Shake it, and its wallpaper changes automatically. Dial in, and lights on the sides flash in sync with the most popular ringtones. But this is not a Nokia, a Motorola, or a Samsung. In fact, it has no brand name at all and costs just 480 yuan (US$70), about a fifth the price of similar "branded" products. This is what is called a *Shan Zhai* model in China.

The term *Shan Zhai*（山寨）is widespread in China. Originally used to refer to a bandit stronghold outside government control, it has today become shorthand for fake or pirated products, though it can also refer to anything improvised or homemade. From mobile phones to digital cameras, wine to medicine, New Year galas to movies, Chinese consumers encounter *Shan Zhai* in almost every corner of their daily lives. Nokir and Samsing Anycat mobiles, Pahetohic TVs, and Wetherm skin cream are just a few examples. *Shan Zhai* was even the subject of a heated debate at this year's National People's Congress held in Beijing in March, with some members deriding the vast number of *Shan Zhai* goods as low-quality counterfeits, while others advocated more tolerance given the benefits of *Shan Zhai* to Chinese society.

Perhaps the most impressive aspect of the phenomenon is the rise of a number of successful *Shan Zhai* companies. Often starting from scratch, *Shan Zhai* businesses can evolve with astonishing speed to challenge incumbent players in mature industries. Understanding how they function is important for foreign managers for two reasons: First, because they leave no room for complacency—today's backyard imitator might tomorrow be eating your lunch. Second, because the success or failure of *Shan Zhai* businesses is predicated almost uniquely on their ability to disrupt the status quo by inventing new and often ingenious business strategies tailored specifically to the local market. These can be illuminating for foreign managers looking for ways to improve their own business models.

Mobile phone maker Tianyu, for example, whose knockoff handsets target trendy but value-conscious buyers, has emerged from nowhere to become a major player in China. Not only did it take Tianyu just two years to overtake top domestic player Lenovo, but the company is now closing the gap on foreign giants such as Nokia, Samsung, and Motorola and moving aggressively into overseas markets. BYD, a local battery and automotive manufacturer, is another standout. After starting out making half-price imitations of best-selling Toyotas, the company has grown into one of China's most successful automotive manufacturers and today

Often starting from scratch, Shan Zhai businesses can evolve with astonishing speed to challenge incumbent players.

also ranks as a global leader in car-battery technology and dual-mode drive-train systems. Future Cola, once labeled a cheap copycat of Coca-Cola, has grown to become the third-largest player in the local carbonated soft drinks market, right after Pepsi. Finally, QQ, originally a *Shan Zhai* version of ICQ, has now become China's largest and most successful online instant-messaging platform, with nearly 380 million active users and more than 80 percent market share. These companies and others all form part of China's so-called *Shan Zhai* economy.

Although each *Shan Zhai* company is different, they often have common characteristics, such as tendencies to do the following:

- Focus on the domestic market (at least initially)
- Target mostly mass consumers
- Strive for very short cycle time on product introduction
- Focus on cost (but often offer lower quality too)
- Tailor product features and functions specifically to local requirements

Successful *Shan Zhai* companies may begin as counterfeiters or pirates but often evolve into legitimate businesses with their own intellectual property (IP) portfolios.

WHY DOES *SHAN ZHAI* MATTER?

Proponents of *Shan Zhai* companies believe they bring both social and economic benefits. By boosting the range of available products, *Shan Zhai* companies offer consumers more choice at lower price points—an important advantage in the current economic climate. In addition, supporters say *Shan Zhai* products can help break monopolies held by makers of more expensive products while simultaneously encouraging grassroots innovation at home. Opponents, however, say *Shan Zhai* companies generate a flood of substandard products that often openly flout other companies' IP rights. Others argue that the *Shan Zhai* culture fosters laziness and ignorance and impairs creativity and competitiveness.

Nonetheless, understanding how the *Shan Zhai* culture works is important for companies operating in China, especially foreign companies. While cheap copycat-type operators are generally short-lived, some of the best *Shan Zhai* companies have quickly evolved to become disruptors in their respective industries.

Three key questions are worth probing:

- What environments would encourage the emergence of *Shan Zhai* companies?
- How can we identify those *Shan Zhai* companies that will emerge as disruptors with sustainable businesses, as opposed to the vast majority that will fade away?
- What are the implications for companies that compete with *Shan Zhai* businesses, especially those from abroad?

HOW DID *SHAN ZHAI* CULTURE EMERGE?

The *Shan Zhai* phenomenon did not evolve spontaneously—it emerged as a result of both "soft" factors (Chinese culture, history, and the policymaking/regulatory context) and "hard" factors (market supply and demand) *(see Exhibit 1)*.

Culture, History and Regulation: Setting the Context

In terms of culture, Chinese people have a long history as "fearless experimenters". Going back to the days of China's ancient civilizations, evidence of *Shan Zhai* culture can be traced to Chinese classics such as *Journey to the West*（《西游记》） and *The Story of Shui Hu*（《水浒传》）, stories that have influenced the Chinese people for centuries. In *Journey to the West*, for example, Sun Wu Kong（孙悟空）, the "Monkey King", demonstrates his fearlessness and creativity in confronting challenges and fighting evil as he strives for justice against traditionally powerful authorities. In *Shui Hu*, the base where the heroes lived is called Liang Shan Bo, a literal *Shan Zhai* itself.

The mentality is also reflected in Chinese sayings such as "crossing the river by feeling the stones," and in recent times has been quickly adopted in Chinese business circles and even its major policymaking processes. For example, when economic reform was initiated on the Mainland about three decades ago, most local enterprises started at a very low level, with experience and resources far inferior to those of the global majors. Many, especially in the private sector, lacked both the institutional support enjoyed by state-owned rivals and the economies of scale of large foreign companies. Hard-pressed even to survive, they were forced to adopt creative and pragmatic solutions, often by emulating the strategies of foreign companies. *Shan Zhai* was part of the answer.

Chinese culture therefore provides a context for flexibility and creativity. In fact, the salient quality of modern-day Chinese entrepreneurs, including *Shan Zhai* practitioners, is not their "me-tooism" but their willingness to take chances and learn from their experiences. "Let's try it," they say. If an idea doesn't work, they abandon it and try something else. Speed is critical. The ability to experiment, replicate success and move rapidly up the learning curve has given many Chinese companies an advantage over some slower-moving foreign competitors. (See *China's Five Surprises* by Edward Tse, *strategy+business*, Winter 2005, provides more on "fearless experimenters").

In terms of policy, the Chinese government has for years gradually relaxed the regulatory environment in one industry after another. In the automotive sector, for instance, while authorities have tried to support growth at large stated-owned enterprises such as First Auto Works (FAW) and Shanghai Automobile Industrial Corporation (SAIC), nimble companies such as BYD and Chery have quickly grown into strong players. In the mobile handset-manufacturing sector, competition was for years stifled by licensing requirements imposed by the Ministry of Industry and Information Technology (MII). However, the lifting of this licensing barrier in October 2007 allowed the newly legitimized *Shan Zhai* enterprises to bring new vitality to the industry.

Of course, many *Shan Zhai* companies operate in breach of, or at least on the borderline of, China's IP laws. Foreign companies in particular continue to complain about poor IP rights protection in China. Lack of enforcement of patent legislation remains a key concern, as does the inability of the Chinese court system (with a few notable exceptions) to deal with complicated technological issues. Also, the lack of severe penalties for infringement does little to deter counterfeiting. Much more progress is needed in China's patent protection system before IP legislation can be enforced effectively.

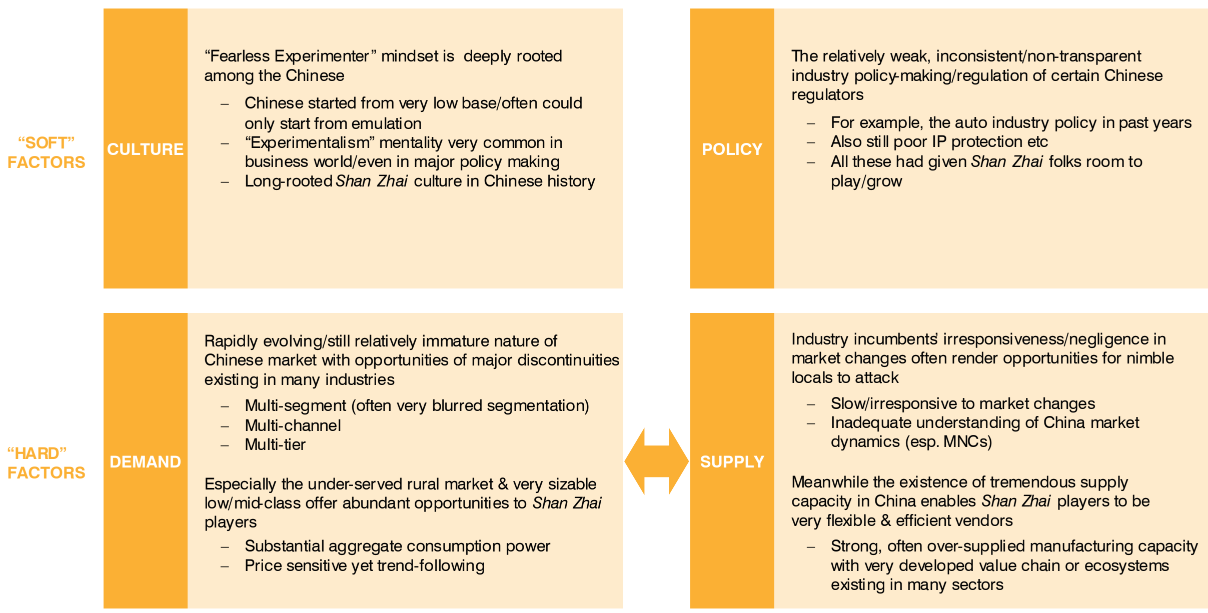
Supply and Demand Dynamics Drive Opportunities

Perhaps more important than the "soft" factors detailed above, the emergence of the *Shan Zhai* phenomenon has been driven by the supply and demand (ie, "hard") characteristics of the Chinese market.

On the demand side, the rapidly evolving and still relatively immature nature of China's markets offers opportunities to exploit possibilities across a number of dimensions, including customer segments, channels, and geographies. *Shan Zhai* companies often target less developed markets, such as those in lower-tier cities and the countryside—a logical choice given that more than 60 percent of China's 1.3 billion people live in rural areas. Although individual incomes in these less developed markets are lower, aggregate consumer purchasing power can still be significant. In particular, younger rural consumers tend to follow urban consumption trends. Likewise, in more developed markets, lower- and mass-market consumers often yield tremendous aggregate consumption power for many products and services.

Tianyu's breakthrough in making *Shan Zhai* handsets is a good example.

Exhibit 1
Key Factors for Shan Zhai Phenomena in China



Source: Booz & Company analysis

The company started out by focusing on previously neglected low-end handset users in China's overlooked Tier 3 and Tier 4 cities, aggressively rolling out a channel strategy (again, one overlooked by majors such as Motorola and Nokia) targeting "last-mile" sales. This involved development of a streamlined distribution model that offered products mostly at points of sale at retail chain stores or supermarket electronics counters and paid generous sales commissions directly to retail sales forces. A critical turning point came when Taiwan's cell phone chip solution company MediaTek launched a new chip solution that featured all-in-one functionality. Taking advantage of MediaTek's simple, integrated motherboard and easily changeable user interface, Tianyu then focused its efforts on developing and adding popular features, building on its in-depth understanding of local customer needs and its ability to reach them effectively.

Meanwhile, on the supply side, the often slow and occasionally negligent responsiveness of industry incumbents in reacting to market changes has created opportunities for nimble local competitors. Typical mistakes include these:

- Failure to respond quickly to evolving markets or adapt to changing consumer preferences

- Inadequate understanding of local market dynamics (for foreign companies) or a persistent reluctance to implement change (for large Chinese state-owned enterprises)

One example is the car rental industry. Hertz, the world's largest car rental company, entered China as early as 2002. But despite its first-mover advantage and years of industry experience, Hertz's Chinese operations were slow to develop, as were those of Avis, the number two global brand. One reason was that both companies tried to apply their US operating models to China, a strategy that left the door open for a domestic player, eHi Car Rental, to develop its own, localized business model. Realizing that the Hertz/Avis self-drive approach neither suited the needs of busy and often stressed local executives nor worked well in China's heavy traffic and rapidly-evolving road systems, eHi began offering chauffeur-driven services—a move that turned out to be both profitable and viable. As a result, eHi has grown quickly to become China's only profitable large car-rental company.

BYD's breakthrough as a major Chinese vehicle manufacturer in an industry formerly dominated by large state-owned enterprises is another good example of *Shan Zhai* in action. BYD started its car business by making copies of Toyotas. However, just as many local vehicle manufacturers began focusing on cutting costs and developing smaller cars in response to a deteriorating economy, BYD chose instead to develop its own technology. After making a significant breakthrough in car battery design, the company incorporated its new technology into China's first electric hybrid car. The company is now working on an all-electric vehicle that BYD claims can travel 300 kilometers on a single charge.

Another major supply-side advantage is China's imposing manufacturing capacity and capabilities. Most *Shan Zhai* mobile phones, for example, are developed in Shenzhen, where a well-developed ecosystem has evolved. Clustered within a few kilometers of Shenzhen's Hua Qiang Bei Road, more than 27 large markets sell all kinds of electronic goods, ranging from basic components to complete handsets. In fact, in Shenzhen today there are over 30,000 companies collaborating across the entire mobile phone value chain, including design/product solutions, sourcing, assembly/production, testing, packaging, distribution, and after-sales services. Over the past several years, this critical mass of businesses has morphed into a virtual organization. This means that for *Shan Zhai* companies, just one or a few firms (such as MediaTek) perform the majority of chipset-level R&D, the costs of which are then shared among a large number of manufacturers. For companies such as Nokia or Motorola, however, each business must pay for its own R&D and recoup its costs through large volume sales. As a result, R&D costs for each *Shan Zhai* mobile phone chip are normally $8 to $10 cheaper than for a traditional mobile chip. While Nokia or Motorola must sell nearly a million units to break even, a *Shan Zhai* company can reach breakeven on sales of just 10,000 phones.

HOW TO TELL THE DISRUPTORS FROM THE ALSO-RANS

While many *Shan Zhai* companies are short-lived, some go on to become very successful. These winners often share similar traits, particularly three kinds *(see Exhibit 2, page 8)*:

An ability to break into a market and establish a significant position quickly. They do this by:

- Developing an in-depth understanding of local needs, then moving quickly to capture emerging opportunities overlooked or underserved by incumbents.

- Developing a very responsive and resilient business model, often featuring:

1. Rapid/frequent launches of new products and services that fit well with the latest market trends or consumer preferences
2. Very flexible and localized operations that are both low-cost and resilient
3. Innovative channel/sales strategies that maximize reach to target customers
4. Most important, an creating an "experiment-learn-adapt" virtuous cycle

- Scaling up quickly while simultaneously creating barriers to entry and developing strategic core competences. A common modus operandi involves targeting lower-end mass segments in order to build scale and market share via large-volume sales, then raising entry barriers by developing further advantages in areas such as cost control, pricing, and supply chain stickiness, or by building cohesive ecosystems with industry partners.

An ability to upgrade core capabilities and migrate up the value chain

- Upgrading core capabilities. After starting out as copycats, successful *Shan Zhai* proponents acquire key know-how, especially in R&D and new product design, and then begin developing value-added services or differentiated products to solidify or expand their customer base.

Exhibit 2
Growth Pattern of Successful Shan Zhai Companies

OBJECTIVES

From "Copycat" to "Innovator"
From "Disruptive" to "Sustainable"
From "Marginal" to "Mainstream"

	1 Break through in *Shan Zhai* Way			2 Upgrade Core Capabilities		3 Invest for Future
	In-depth understanding of local needs/capturing window opportunities	Developing a responsive and resilient business model	Scaling up quickly/raising the barriers of entry	Upgrading core capabilities (esp. product design/R&D)	Further moving up in the value chain	Exploring next -wave growth opportunities
	– Identify underserved /overlooked market segments by incumbents – Understand real sources of competitive advantages	– Rapid, flexible/ localized products & operations – Innovative channel/ sales strategies – Experiment-learn-adapt virtuous cycle	– Often start with lower-end/mass segment to build up scale – Then raise entry barriers through advantages such as cost/pricing/supply chain stickiness (or building up cohesive ecosystems)	– After initial emulation stage, start to invest or acquire key know-how especially R&D/ new product design – Move away from cheap copycat strategy to be more value-added or differentiated	– Enhance brand building efforts – Move away from *Shan Zhai* image – Even target to become industry trendsetters	– Identify new growth opportunities with potential to duplicate or exceed past *Shan Zhai* success – Invest to build the foundation – Enter in right stage in the S-curve
Tianyu	– Target value-conscious yet trend-followers	– 100+ new models/year with large varieties	– Quickly became #1 Chinese handset maker	– Invested in product design and R&D	– Initiated brand building/increased marketing $	– Invested in 3G products
BYD	– F3 emulating Toyota Corolla but at half price	– Streamlined/ localized production lines	– Built from scratch to 200+K units in 2008	– Invested heavily in R&D with 5000+ staff in research team	– Buffet's $ made BYD more as a "real" major league player	– New energy - plug-in F6 & fully electrical crossover E6
Future Cola	– Copied Coca - Cola's packaging design – Target rural market	– Vast distribution network – Tailored marketing	– Quickly became the third largest player in China Carbonated Soft Drinks market	– Upgraded products/brand image	– Started to enter Tier 1 and 2 markets	– Entered Vitamin-C drink, Sports drink markets

Source: Booz & Company analysis

- Moving up the value chain, upgrading their brand image, and actually moving away from their *Shan Zhai* beginnings. Some have even emerged as industry trendsetters, leading a new wave of product or technology development.

Investment in the future:

- Many *Shan Zhai* companies target markets that have reached maturity on the S-curve, after which basic entry barriers are lower, market demand has grown to allow more participants, and they are able to apply their "disruptive" tactics to attack incumbents.
- That said, the very best *Shan Zhai* players are constantly looking for the next "blue ocean" opportunity—one that can offer new growth before their current market comes to the end of its life cycle.

In Tianyu's case, the company's first move was to target lower-end customers by leveraging the simplified but disruptive MediaTek technology platform to offer value-for-money handsets with practical but trendsetting features. In addition, it developed a very responsive operation capable of fast turnarounds. Launching more than a hundred tailored models within a year, Tianyu created a wide spectrum of product choice for its channel partners and ultimately its customers. Crucially, its nimble and efficient team, together with a distributor network motivated by a proper profit-sharing scheme, allowed costs to be effectively managed. The resulting high sales volume led to rapidly growing market share, and the company soon became China's top domestic handset manufacturer, whose sales are now closing in on market leaders Nokia, Samsung, and Motorola. But Tianyu hasn't stopped there. The company has now started investing in 3G products, aiming at the next phase of China's telecom development. Following a

The very best Shan Zhai players are constantly looking for the next "blue ocean" opportunity.

recent agreement with Qualcomm, a leading developer of CDMA wireless technologies, Tianyu will soon be able to develop, manufacture, and sell its popular K-Touch range on a platform compatible with China's upcoming 3G networks. Today, Tianyu is a mainstream player virtually unrecognizable from its *Shan Zhai* beginning, thanks largely to increased efforts in R&D and brand building.

There are more than a few similarities between these various *Shan Zhai* success stories and what Harvard Business School Professor Clayton Christensen has described as the "innovator's dilemma": New entrants such as Tianyu have adopted a disruptive business model (MediaTek in Tianyu's case) to attack and even topple incumbent industry leaders that had generally focused on incremental improvements and sustaining established business territories. This template has been boosted by the fearless experimenter mind-set, which has further propelled already nimble *Shan Zhai* companies to become ever more responsive and adaptable to market changes.

BYD is another example of a *Shan Zhai* imitator that was transformed after applying a similar migration pattern. BYD was originally known for churning out copies of Toyota cars—particularly its F3 model, a half-price Toyota Corolla imitation that became profitable within just three months of product launch. In order to minimize costs, BYD deployed a semiautomatic manufacturing system featuring low fixed investment and high labor content that leveraged China's still low labor costs. In addition, it developed a unique backward-vertical integration model by streamlining its production line and developing key high-cost parts (including chassis, air-conditioning, and engine) in-house. In 2006, BYD's sales reached some 60,000 units, up from just 11,000 in 2005. By expanding market reach and continuing to leverage scale to cut costs, the company has seen sales mushroom further. In 2008, it sold a remarkable 200,000 cars, while in the first two months of 2009, sales grew a further 140 percent year-on-year. The company is now targeting 2009 sales of 400,000 cars, doubling turnover in a single year.

Today, Tianyu is a mainstream player virtually unrecognizable from its Shan Zhai beginnings, thanks largely to increased efforts in R&D and brand building.

As impressive as this is, it is just the start of the BYD dream. Since the company began manufacturing cars about five years ago, it has invested in and built a layered and integrated R&D organization, quickly transforming technology and experience into reality. It has also invested huge amount in talent development. One of BYD's most significant achievements has been its grasp of core technology and manufacturing know-how in car battery and dual-mode drive-train systems. If its efforts in these areas prove as successful as the company currently claims, BYD will have created a key platform to tackle the lucrative new-energy auto market. Warren Buffett's proposed investment in the company (which is still awaiting Chinese government approval) is a further indicator of the company's potential. Today, therefore, BYD is well on its way to becoming a major-league player and innovator in the automotive market.

A final example of a *Shan Zhai* success story is Future Cola. Its humble beginnings saw it launching a product that copied Coca-Cola's packaging design but whose flavor was tailored for the Chinese palate. Unlike Coca-Cola, which began largely by targeting major cities, Future Cola sought out overlooked consumers in rural areas. It imported state-of-the-art equipment and quickly localized production facilities, allowing it to offer products at significantly lower price points. In addition, the company managed to develop a vast sales and distribution network in rural areas, partly by leveraging the resources of its parent company, Wahaha Group. More important, it launched an aggressive but very focused marketing campaign to build a brand image as "the Chinese people's own cola." By 2006, Future Cola had grown into the third-largest player in China's carbonated soft drinks market, with a particularly strong position in rural areas. In an effort to expand market share further, Future Cola now has plans to branch into Tier 1 and 2 markets in major cities, in direct competition with Coca-Cola and Pepsi.

STUDY THE *SHAN ZHAI* AS THEY STUDY YOU

Foreign and local companies alike are often frustrated by China's *Shan Zhai* phenomenon. *Shan Zhai* companies' modus operandi usually involves such careful study and adaptation of an existing business model that they are perceived to be taking something belonging to an incumbent whether they are acting in breach of its IP rights or not. At the same time, *Shan Zhai* companies can offer instructive insights into how local markets work and in particular how existing strategies can be adapted to work more efficiently in a Chinese context. This is especially true for foreign companies, which are often unfamiliar with China's sometimes unusual operating environment.

Key takeaways include these:

- Underestimate low-cost competitors at your peril. With the right business model and strategy, some *Shan Zhai* companies can and do evolve into major-league players.

- Always drive change instead of being driven by change. Companies need to be "constructive destructors" and game changers. Do not just react to market change; change the market.

- Get out of your comfort zone. Learn from the *Shan Zhai* players and become a fearless experimenter —you will find opportunities that would otherwise never occur to you.

Companies that are able to work successfully in China must first develop a clear understanding of its complex markets, appreciate the diversity of the local customer base, and come to terms with relatively poor IP rights protection. Those who can come to terms with the subtleties of China's multi-tier customer segments, understand their tastes and preferences, and create distinctive products that meet local needs will benefit from the *Shan Zhai* mind-set when serving China's emerging breed of consumers. On one hand, *Shan Zhai* companies can be formidable competitors. On the other hand, they could become potential business partners or even acquisition candidates. The key is to keep an open and humble mind.

Get out of your comfort zone. Learn from the Shan Zhai players. Become a fearless experimenter.

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