

German Mittelstand discovers BRIC

A Survey of Product Strategies of German 'Hidden Champions' in China and India

An empirical survey conducted at the Hamburg University of technology (TUHH) shows the BRIC markets are perceived to be of high and growing strategic importance by German "Hidden Champions". The survey suggests that many firms belonging to the German "Mittelstand" have just begun to realize the potentials of India as a strategic market. The survey reveals that such companies often try to target high-end, premium segments with products developed at the headquarters. An exclusive focus on affluent customers by firms enhances the risk of side-lining large customers groups that seek "affordable excellence". Ignoring them might turn into a high-risk strategy in the medium to long run as the economy grows.

An Indian Managing Director of a large German auto component supplier in Pune talking to one of the authors of this article a couple of years back summarized the credo to success in the local market with these words: "You need a product which costs 30% of the global price and offers 95% of the performance". Another Indian-origin R&D head of a global carmaker, very successful in India, corroborated this statement and stressed the role of aspirations of a young and ambitious generation faced with limited purchasing power. "It's about the aspirations of the youth in India", he said. "They want everything; they know everything; but they are not prepared to pay extra", suggested the man whose team has been credited with several successful innovations.¹ These statements, in the backdrop of coming from Indian-origin senior managers of MNCs, raised the question whether the firm headquarters located in developed countries fully appreciate the implications of such a challenge and whether this challenge gets duly reflected in the product strategy of the respective firm for the Indian market.

In the German context, too, headlines in the business sections of newspapers give reason to believe that especially mid-sized firms ("Mittelstand"), which constitute the backbone of German economy and account for the bulk of employment generation, have been slow to recognize and capitalize on such trends in the emerging economies. For example, daily newspaper "Die Welt" reported in April 2013 that German machines are being increasingly perceived as "too good to succeed" in the global market, winning innovation prizes but struggling with order books.²

This was the inspiration point for the authors at TUHH to conduct a survey to assess the present extent and the eventual need for enhanced local responsiveness in the face of growing and unsaturated markets of in the BRIC nations with a strong focus on China and India.³ Even though this questions is relevant for all MNCs independent of size and industry, its significance for mid-sized companies in an export-driven economy like Germany can be hardly overstated. A special role amongst the German Mittelstand can be attributed to firms known as "Hidden Champions". These are usually medium-sized companies with an annual turnover of up to €5 billion. They generally belong to the top-3 in the world market or are the number 1 on their home continent. These world market leaders are often active in the B2B area so that their products are frequently unfamiliar to the end-consumer.

Some of the Hidden Champions are, however, reported to have started losing relative market shares in the fast growing markets due to their often-exclusive focus on premium products and concentration of research and development (R&D) in the home country.

Research Question

Aim of this study was to analyse product-related innovation strategies of German Hidden Champions in the BRIC countries to take stock of the status-quo and to learn about their mid-term strategies. Three research questions were investigated:

- What is the strategic relevance of the BRIC markets for German Hidden Champions today and how is it expected to develop in the next 5 years?
- What are the market-segments that German Hidden Champions seek to serve in China and India?
- What innovation strategies are pursued by these firms in China and India in terms of product development and R&D locations?

For the purpose of this study, market segments in terms of the price/performance ratio were defined and three categories built:

1. Premium Segment: Broadly defined as the high-end category targeted at affluent and financially-strong customers, who demand the best possible quality, high reliability and a broad range of features including futuristic technology. Such products command a significant price premium.
2. Medium Price-Performance Segment: Characterized by relatively good quality of products whose performance and reliability well exceed the prevalent regulatory norms and comply with all relevant safety standards. The deliberate renunciation of the best possible quality combined with the concentration on the features really required leads to a significant lowering of the product price, making it attractive for a larger group of customers.
3. Low Price-Performance Segment: Products offered in this segment are generally characterized by their bare compliance of the safety & regulatory norms and in some cases even lack thereof. Often they rely on ripe, simple and/or partially outdated technologies. They usually offer only basic functionality leading to price-based competition in the market. Such products tend to have a short life-span owing to compromises made in terms of input factors.

¹ See, Tiwari, R. and C. Herstatt (2014): Aiming Big with Small Cars: Emergence of a Lead Market in India, Heidelberg, Springer.

² For deliberations on these aspects, see: Tiwari, R. and C. Herstatt (2013). "Too good" to succeed? Why not just try "good enough"! Some deliberations on the prospects of frugal innovations, Working paper No. 76, Hamburg, Institute for Technology and Innovation Management, Hamburg University of Technology

³ An extended version of the survey results may be found in a conference paper by the authors, titled "Global Innovation Strategies of German Hidden Champions in Key Emerging Markets". This paper (Working Paper No. 85) may be downloaded from www.global-innovation.net without any charges.

As a next step, 3 product development strategies were defined for the target markets in question:

1. Global Products: These are standardized products with largely identical features and are sold globally without any significant local market adaptation (e.g. most electronic consumer devices).
2. Adapted products: These are products in a firm's portfolio which were originally developed for a specific target market. They are subsequently modified or adapted to meet the local demand conditions of some other sales region while retaining the core functionality. They can have additional, modified or reduced functions and/or it may be composed of different materials.
3. Exclusive Products: These products are exclusively developed for a specific sales region/market to cater to the differing needs and preferences of a strategically important market.

The survey questions included the perceived current and mid-term strategic importance of the BRIC countries as well as the targeted market segments. The respondents of this online survey - mainly R&D directors and heads of international sales & marketing divisions - were also questioned about the locations at which significant value creation activity (R&D and production) takes place.

Findings

So far, 53 valid responses from the targeted group of German Hidden Champions have been received. The respondents came from branches as diverse as electrical engineering, pharmaceuticals, medical devices, automotive components, construction, and mechanical and plant engineering. Companies from the mechanical & plant engineering sector make up the largest group of survey participants (nearly 50%). On an average, responding firms had a 90-year company tradition and employed 2,250 staff worldwide, while almost all generated a turnover of €1 billion or more. The survey discovered that Hidden Champions operate on a global scale. Most participating firms maintain basic and applied research as well as important parts of product development at headquarters in Germany. There is a high concentration

Country/Region	Basic/Applied Research	Product Development/Adaption	Production
Germany	50	50	51
Western Europe (without Germany)	12	20	28
Eastern Europe (without Russia)	0	10	19
North America	14	27	33
South America (without Brazil)	3	5	18
Japan	2	7	10
Brazil	4	7	19
Russia	1	1	10
India	2	8	15
China	4	15	32
Rest Asia	4	7	12

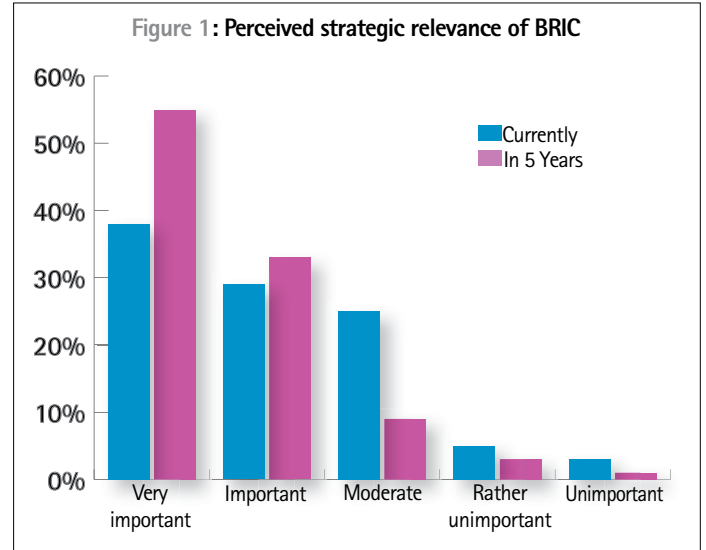
of R&D capabilities in North America and Western Europe. Primary production bases for the surveyed companies are found in Germany, North America, China and Western Europe, as can be seen in Table 1.

As can be seen in Table 1, India, on level of individual countries, plays an important role in the production and product development/adaptation strategies of some firms. The extent of China's involvement is however much greater.

Surveyed Firms' Activities in the BRIC Countries

An overwhelming number of the responding firms (87%) were already active in the BRIC countries selling their products, with Russia and China being the top-most host-nations. The firms on an average had long experience in the BRIC countries. Close to 62% of the respondents had been active in at least one BRIC country for more than 10 years; in another 24% cases it was between 5 and 10 years. China and Russia were again countries with the largest share of companies with 10+ years of engagement, with a share of 69% and 64% respectively. In contrast, about 50% of firms in India had been there for less than 10 years.

The BRIC countries are perceived as strategically "important" or even "very important" by two-thirds of the respondents. This share increases to 88%, when the respondents are asked about the strategic importance of the BRIC markets for their firm in the coming five years (see Figure 1).



Amongst the individual BRIC countries, China plays a clearly leading role with 87% considering it currently either a "very important" (62%) or "important" (25%) market. Brazil and Russia both score around 65% (market is "important" or "very important"), while India lags behind in their assessment of its present importance to firm's business. Nearly half (47%) of the respondents rate the second-most populous country as a strategically "very important" or "important" market at present. The relative moderate importance of the Indian market at the present time could be explained in part by its low share in the company turnover currently. Participants estimated it as only 3.1% of their global turnover on average, compared with an average of 11.5 % for China (see Table 2). Some firms stated to generate as much as 50% of their annual turnover in one BRIC country.

Table 2 : Level of the respondents' engagement in the BRIC nations

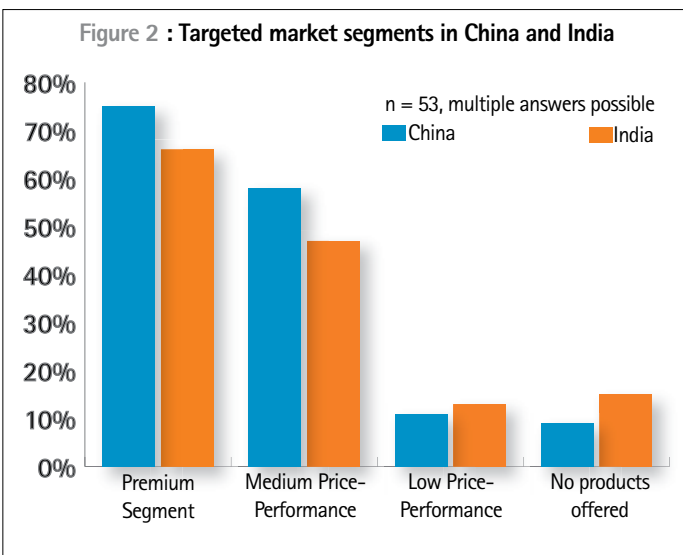
Country	Share of Turnover	Number of Associates
Brazil	4.8%	30
Russia	6.5%	25
India	3.1%	36
China	11.5%	160

As expected, the strategic relevance of the BRIC countries is expected to increase further in future. The significance of China in five years' time is rated as "very important" by 74% of all responding companies (97% when the "important" rating is also included). The significance of the other countries could also increase greatly. This is especially true of the Indian market, whose future strategic relevance is rated as "very important" by 44% of the survey respondents and as "important" by a further 45% (together accounting for 89%). Participating Hidden Champions estimated the Indian market to be strategically more important than the Russian (81% cumulative) or Brazilian (74% cumulative) markets.

Targeted Market Segments in China and India

Forty-eight of the 53 responding firms were offering products in China, and 45 in India. The firms were primarily engaged in the premium segments of the two countries followed by the medium price-performance segment (see Figure 2). The low price-performance sector did not see any major presence of the firms participating in the survey. Only few companies had no products on offer in the respective markets.

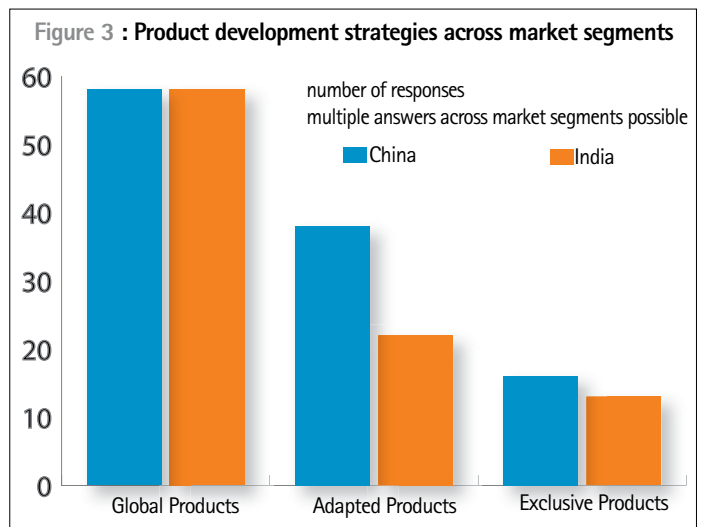
An interesting finding was that 16 firms in China and 19 in India offered products exclusively in the premium segment. While 6 firms in each country only had medium price-performance products on offer, there was one firm that stated to be solely offering products in the low price-performance segment in India. On the other hand, 20 firms in China and 13 in India offered products in both premium and medium price-performance segments. Only 3 firms in both markets offered products in the whole range across all the three segments. Three firms in India and two in China were engaged only in the medium and low price-performance segments.



Most of the products which are available in these two markets are manufactured in cooperation between the German headquarters and local production sites in China or India. Furthermore, the results indicate that most Hidden Champions concentrate the production of their premium products at their home-base. Products belonging to the medium price-performance segment are mostly manufactured in cooperation between the headquarters and the host country for goods offered in China, whereas such products when sold in India witness a greater share of overseas production. In the low price-performance segment, the firms mostly manufacture exclusively in China while catering to the local market. For serving India's low price-performance segment the respondent firms stated to usually choose a cooperative production strategy between the headquarters and the local subsidiary.

Product development strategies in China and India

Survey participants were asked what products (global, adapted or exclusive) they were offering in the Chinese and Indian markets in the three market segments described earlier. Seen across all market segments global products dominated the product portfolio of the surveyed firms, followed by products adapted for these markets. The share of products developed exclusively for the respective local market was relatively low, see Figure 3.



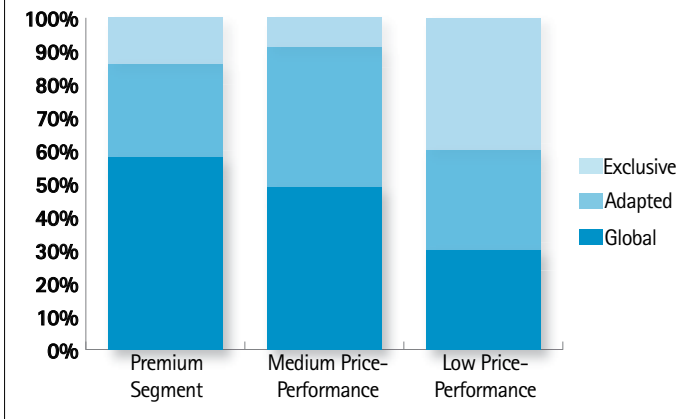
Composition of company product portfolios in China

Differentiated across market segments, perhaps not surprisingly, was the premium segment in China that was dominated by global products. Increasing pressure for price reduction tended to increase the level of local adaptation in China. Lower price-performance requirements caused many companies to develop products exclusively for the Chinese market, see Figure 4.

Composition of company product portfolios in India

Similar to the company portfolios in China, also the Indian market was supplied predominantly by global products, however, on an even stronger scale, see Figure 5. The surveyed Hidden Champions relied heavily on their global and adapted products to serve the Indian market, which together accounted for somewhere between 67% and 90% of all products across the three market segments.

Figure 4 : Composition of company product portfolios in China



This substantial reliance on global products might be explained by India's still low share in firm's global revenues (3.1%), limiting firms' motivation for developing/adapting products specific to market needs in India. An interesting question here however is whether India's low share in company turnover is not rather caused by a lack of right products that better suit the market specific needs and preferences.

Role of China and India in Product Development

The survey revealed that the headquarters played an overwhelming role in the product development for all segments of the two markets surveyed here. Especially in the premium segment the headquarters was solely responsible for product development in 75% of the cases in China and in 80% of the cases in India. In another 17.5% cases (China) and 11.4% cases (India) it was involved in co-development of products. With increasing price sensitivity and decreasing demand for prime quality the involvement of local subsidiaries tended to increase.

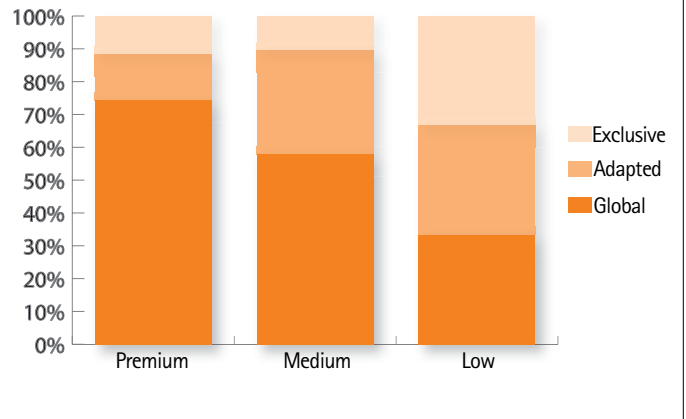
The survey also showed a greater role of the Chinese subsidiaries in product development and adaptation, especially in the medium and low price-performance segments, in comparison to India. A possible explanation for this might lie in the longer presence of the surveyed companies in China.

Contribution/ Practical implications

The survey results above show that German Hidden Champions increasingly recognize the growing strategic importance of the BRIC nations, especially China and India, both for sales and also for other important value chain activities such as production; but lesser so for R&D. In keeping with their traditional product and marketing strategies, the majority of the companies surveyed focused essentially on the premium market segment. However, many customers in such markets are either unable or unwilling to pay for high-priced goods manufactured by Hidden Champions when competing against a comparable, "good enough" solution from local manufacturers or from other nations such as China.

Customers in the emerging economies are increasingly looking for products whose range of offered features meet the purchaser's actual needs while culminating in substantial reduction in the total cost of ownership ("affordable excellence"). Companies offering frugal products can win large market shares as long as they understand that frugal innovations, even though targeted at price-sensitive customers, clearly

Figure 5 : Composition of company product portfolios in India



differentiate from products at the low price-performance segment. Frugal products do not make compromises on the quality, reliability and safety standards in order to lower the price point. They rather make use of R&D, state-of-the-art technologies, product analogies and open global innovation networks to achieve cost reductions.

What does this mean for German Hidden Champions that have been the object of investigation in this paper? It can be observed that many companies, for a variety of reasons, continue to focus singularly on the profit-rich premium segment. They often ignore market segments that might have thin profit margins but large volumes. Such strategies run the risk of forfeiting competitiveness to established or new competitors that target above-average economies of scale. With appropriate product and innovation strategies befitting the market requirements they can participate in the enormously growing market segments. Competitors can use their profits to consolidate and upgrade to new and better technologies and intensify R&D efforts to reach out to more markets and further enhance economies of scale. By achieving an even more favourable cost structure and upgrade their product range they could then also reach out to premium market segments.

At the end it may be interesting to quote the technology head of an Indian producer of generic drugs. Talking to the authors he stated: "Germans are innovative but they also need to understand the market requirements and cater to multiple segments through a multi-tier product approach and only this will enable them to re-establish the market they have lost to the competitors from the East".

About the authors

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for Technology and Innovation Management of the Hamburg University of Technology (TUHH). They jointly lead the research programme "Global Innovation" and have a long track-record of working with Indo-German bilateral business. Together with Prof. Cornelius Herstatt they have co-founded a Center for Frugal Innovation at TUHH that seeks to



Dr. Stephan Buse

conduct and promote research, consulting, and education in the field of affordable and sustainable innovations.