Pricing Strategies for Multinational Companies in China

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Zusammenfassung. *Die meisten multinationalen Unternehmen sehen China immer noch eher als Zentrum für Produktion oder Beschaffung anstatt als Konsumentenmarkt. Basierend auf unseren Erfahrungen mit den signifikant steigenden Absatzzahlen eines Markenproduktes eines multinationalen Unternehmens in China, argumentieren wir, dass dies nicht unbedingt der Fall sein muss. Erst wird eine Typologie verschiedener für den chinesischen Markt relevanter Ansätze für das Pricing dargestellt. Dann wird aufgezeigt, wie wertbasierten Pricingstrategien im chinesischen Kontext implementiert werden können. Es wird betont, dass die Implementierung von wertbasierten Pricingstrategien möglich ist und dass multinationale Unternehmen das Potential haben, signifikanten Umsatz in einem sehr wettbewerbsgeprägten Umfeld wie in China zu erreichen. Die Key Findings werden mit Case Studies von IKEA, Wal Mart und Starbucks in China untermauert. Dies sind Unternehmen, die die wichtigsten Prinzipien von wertbasiertem Pricing in ihre Pricing Strategie für den chinesischen Markt eingegliedert haben.*

1 Introduction

Measured at purchasing power parity China is already the largest economy in the world: it leads the world in the production of a large variety of consumer goods (like toys, apparel, shoes), equipment (like refrigerators, air conditioners, clocks), commodities (such as rice and wheat), has recently replaced the US as largest exporter of IT goods (Economist 2005) and is on the verge of becoming a powerful force in product categories formerly dominated by US or EU-based companies such as cars, semiconductors or mobile phones. From an economic perspective, China is a capitalist country

– with its own peculiarities: investments into most sectors are free (with the exception of the banking sector, the insurance sector, internet services and other industries considered „strategic" by State Authorities), markets are open and competition is intense. Politically, however, the country still operates under a One Party system and human rights are not as comprehensive as in other countries, with severe limits on free speech, political oppositions, and even access to information.

A vast number of **multinational companies** has rushed to China, staring the late 1970s and early 1980s and the rush to China has not slowed down. Large, multinational companies were the first to come to China: the examples of Volkswagen AG entering the market with its Chinese partner SAIC in 1985 or American Motors/Jeep with Beijing Automotive Group in 1984 are prominent examples here. Today, 25 years later China still continues to represent a huge opportunity – and a threat at the same time – for multinational companies (MNC's) of all sizes, countries, and industries.

MNC's wishing to establish a position in China can chose between any one of the following **options**: (1) China as a production hub, (2) China as a sourcing hub, (3) China as a market in its own right, (4) China as hub for other value-adding activities (HR, IT, R&D, etc.).

Large, multinational companies mostly operate under the **„full fledged" model**: they see China as a production & sourcing hub, they sell in China and tend to locate certain parts of their value adding activities (e.g. IT) in China as well. It should be noted that China as a market in its own right tends to be the most difficult part of the „full fledged" China strategy or the most difficult option among the four listed above. A number of smaller US or European companies thinks along these lines: „China for us is essentially a source for low-cost goods or raw materials, which we then sell under our own brand names in Europe or the US. Selling these products, either on our own or with a local partner, in the Chinese market would represent a huge challenge with uncertain returns; and these returns will not only be uncertain, but also low, given that prices in China are low and margins thin."

While this view may be true for specific companies or industries, our own experience shows that it is possible to implement a successful marketing strategy as MNC in China today. In this respect pricing strategies play a vital role. Furthermore, the way to China is littered with companies who initially failed, re-adapted and emerged stronger from a period of crisis. The case of Wal Mart (discussed in detail below), illustrates this point, where a globally successful strategy of lowest-possible prices was tried, did not succeed, was changed, and is now enabling Wal Mart to grow in China. With this in mind, we will outline in the following pages some particularities of the Chinese marketing environment; we will then present a typology of pricing strategies, and we will highlight how a MNC operating in China can develop/implement a marketing and pricing strategy on the Chinese market successfully.

2 Particularities of the Chinese Marketing Environment

The Chinese marketing environment can appear daunting to multinational executives. Local Chinese competitors are aggressive, fiercely competitive on price and seem determined not to allow multinationals any significant inroads into their markets. For example, Huiyuan in juices and Sanxiao in toothbrushes, for example, price their products more than 20 percent below those of the leading multinational brands and, as a result, dominate the mass market (Hsu & Hemerling 2003). Other markets, such as the market for passenger cars, are still dominated by multinationals and their Chinese joint venture partners, although local Chinese companies are making significant inroads into these markets as well.

Foreign companies operating in China essentially face two disadvantages compared to their local Chinese competitors: first, a disadvantage in knowledge about markets and customers and, second, a disadvantage in costs. To overcome the first inherent disadvantage a sound understanding of the Chinese business environment, cultural background, socio-economic trends, and consumer psychology is absolutely essential. While it is impossible to give a complete outline of some of the issues facing Chinese business or individual customers today, we summarize salient points worth to be explored in detail. We also need to remember the inherent complexities and contradictions in the soul of the Chinese consumer and in the Chinese landscape. As one consultant has put it: „Everything is true somewhere in China"

- high importance given to traditions,
- high importance of family,
- patriotism,
- high importance of personal relationships,
- high importance of harmony,
- high work ethic,
- high saving rates,
- high symbolic value ascribed to brands,

- rapid accumulation of wealth over the past decades: high ambitions,
- high expectations towards the future,
- marketing as relatively recent discipline.

We will not discuss these elements in detail, but will limit our discussion to the most salient elements affecting marketing strategies in China. In one instance, marketing in China is still a young discipline. Marketing matters, after all, only if there is choice. China's economy did not allow private property until 1978, a ban on ads was lifted in 1979, and only since then did marketing as a practice and marketing as a discipline develop in China. Many consumers in the West tend to be jaded, cynical and suspicious of marketing. Having grown up in an environment where they are inundated with thousands of TV ads, print ads, internet spam, and other hard-sell tactics, they tend to view marketing in a negative light. They are hard to impress, hard to reach through traditional marketing channels, and tend not to respond well to traditional marketing tactics, unless they are so creative, so impressive and so unusual that these tactics truly stand out – the campaign BMW Films may be a good case in this respect (see: Moon 2005). Not so Chinese consumers. In an environment, where marketing is still young, it is also able to retain part of its traditional efficacy of helping to create demand, to communicate values, to reflect on the products' owners, and to touch and move people.

The importance of traditional family values, traditions, harmony, and patriotism also affects marketing strategies. High saving rates – at 30% of GDP among the highest in the world (Lieberthal/Lieberthal 2003) – also mean that Chinese consumers can be more cost conscious than some of their Western counterparts. Finally, working ethics in China is extremely high. Long hours, a dedication to work, and high aspirations for the future are common elements for a generation which as seen its wealth double every 6-7 years in the past. „People in China have dreams, while people in the West have expectations", is the way one CEO summarized this point in personal discussions.

3 Overview of Pricing Approaches Available to MNC's Operating in China

On a general level we can distinguish three different pricing practices suitable for operating in China. These practices differ regarding the use of information on costs, competitors, and customer value respectively:

- **cost based pricing approaches**. Here pricing decisions are influenced primarily by accounting data with the objective of getting a certain return on investment or a certain mark-up on costs. Typical examples of cost-based pricing approaches are cost-plus pricing, target return pricing, mark-up pricing or breakeven pricing. In all these instances the first step in pricing decisions is an analysis of a company's costs and its cost structure (variable costs, fixed costs, contribution margins) which then leads to set prices in function of pre-defined mark-ups or a target return on investment (e.g. minimum gross margin of 50% or target return on sales of 15% for new launches). Main weakness of cost-based pricing approaches is that aspects related to demand (willingness to pay, price elasticity) and competition (competitive price levels) are ignored. Main advantage of this approach is that the necessary data to set prices are usually readily available.

- **competition-based pricing approaches**. As the name implies, this approach uses data on competitive price levels or on average prevailing market prices as primary source to determine appropriate price levels. Typical variants of competition-based pricing approaches are parity pricing (where prices are set at the same level as competitive prices), parallel pricing (where a pricing approach of a dominant firm is closely matched), umbrella pricing (where a dominant firm sets a price level which is followed by other firms) and penetration/skim pricing (where a certain discount or mark-up is applied to competitive price levels). Main advantage of these approaches is that the competitive situation is taken into account; main disadvantage is that aspects related to the demand function are again ignored. In addition, a strong competitive focus in setting prices can exacerbate the risks of price wars: the domestic car industry in the United States is probably the best example, although similar developments have occurred in the airline industry, again in the United States. The motivation to use competition-based pricing approaches is frequently justified with the reasoning that price is one of the most important purchase criteria for customers. We should note that this reasoning is correct only in rare instances.

- **customer value-driven pricing approaches**. Customer value-driven pricing answers the fundamental question „What is our product's value to the customer and how can we communicate that value as part of the price?" The subjective, but quantified value of a purchase offering to actual and potential customers is the primary driver in setting prices. A variant of customer value driven pricing is customer-needs driven pricing. We will give a comprehensive definition below.

For the moment we should note that „value pricing" is sometimes used (for example by retailers like Wal Mart in the slogan „great value") as a synonym for low prices: according to our classification scheme, „value pricing" is thus a form of competition-driven pricing approach characterized by the intent of being perceived as low price category leader. Customer value-based pricing approaches, in contrast, are driven by a deep understanding of customer needs, of customer perceptions of value and of customers' willingness to pay: these approaches recognize that there are different market segments with markedly different perceptions of value in all markets and that there is, thus, a potential for offering a range of value proposals at different price points in order to maximize value capture.

The advantage of customer value-driven pricing approaches is their direct link to the needs of the one constituency paying for the respective goods or services: to customer needs. One disadvantage of these approaches is the fact that data on customer preferences, willingness to pay, price elasticity, and size of different market segments is usually far more difficult to obtain and to interpret than data on cost structures, for example. Furthermore, we need to keep in mind that customer value-based pricing approaches may lead to relatively high prices, especially for unique products: while this may be optimal in the short-run, this clearly may spur market entry by new entrants or create a risk free zone for competitors offering comparable products at slightly lower prices. Finally it is important to note that it is an error to assume that customers will immediately recognize and pay for a truly innovative and superior product: It is the task of marketing to educate customers and communicate superior value to customers before linking price to value: if customers do not recognize a product or service as superior it is useless to ask them to pay higher prices.

We summarize the main approaches to set prices, their strengths and limitations in the table below. In the following paragraph we will discuss in detail the concept of customer value-based pricing, since this is the approach which has received relatively little attention from practicing managers, although it is generally recognized as the most sophisticated approach to pricing.

Over the past 20 years a wide number of publications has examined the question to which degree these approaches have been adopted in different countries and industries, worldwide (see, for example: Avolnitis/Indounas

Table 1. Comparison of Pricing Approaches

	Cost-based pricing	**Competition-based pricing**	**Customer value-based pricing**
Main features	Prices are set in function of unit costs	Prices are set in function of competitor price levels	Prices are set in function of customer perceived value
Examples	Cost-plus pricing, mark-up pricing	Parallel pricing, umbrella pricing, penetration/skim pricing, „value pricing" (price leader pricing)	Customer needs-based pricing
Key inputs	Finance, accounting: data on costs, margins and target returns	Sales, marketing: data on competitors and average market prices	Marketing, general management: data on customers, customer needs, price elasticity and size of different market segments
Main strengths	Data are readily available	Data are readily available	Does take customer perspective into account
Main weaknesses	Does not take into account competitor and customer perspective	Does not take into account customer perspective Increased likelihood that competition-driven pricing will lead to price wars	Data are difficult to obtain and to interpret Customer value-driven pricing approach may lead to relatively high prices – need to take long-term profitability into account Customer value is not a given, but needs to be communicated
Overall evaluation	Overall weakest approach	Second best approach	Overall best approach, direct link to customer needs

2006; Chia/Noble 1999, Forman/Lancioni 2002, Noble/Gruca 1999). Based on these studies and based on HINTERHUBER & PARTNERS consulting projects in the area of pricing we estimate that today approx. 50% of companies use primarily cost-driven pricing approaches, that 35% of companies use competition-based pricing approaches, and that, finally, only 15% of companies use customer value-based pricing approaches as dominant approach to new product pricing.

While generalizations are difficult on the similarities and differences between pricing/marketing strategies of local versus MNC's in China – there is a lack of empirical studies on this specific question – even a superficial look at product positioning and pricing strategies of local and multinational brands seems to allow to conclude that local, Chinese companies generally compete on the low-price end of the market, while multinational brands generally compete on the mid- or high-price end. This conclusion is not inconsistent with the inherent cost advantages which many local companies enjoy.

This allows us to conclude: for multinational brands/companies to compete successfully in China, they must learn how to provide enough value to customers to be able to compete on the mid/high end of the market. Reversely: competing with Chinese companies on the basis of costs is thus a recipe disaster in most cases.

This means that multinationals wishing to compete successfully in China need to master the following disciplines of value-based pricing strategies: (1) value creation, (2) aligning prices with value created, (3) market segmentation, and (4) price controlling. The next chapters will be devoted to discuss each of these aspects in detail. Based on our experience of successfully expanding sales of a branded, multinational product in a heavily contested market in China, we will illustrate each of these disciplines with appropriate case studies.

4 Implementing Value-Based Pricing Strategies in China: The Role of Value Creation

Given that competing on cost is not a viable alternative for most, if not all multinationals competing in China, the question all of them must face is superior value creation. How is value defined? According to one school of thought (see: Zeithaml 1998), customer value is the difference between perceived benefits and sacrifices. In microeconomic terms, customer value is seen here as the difference between the consumer's willingness to pay and the actual price paid, customer value is thus equal to the ''consumer surplus,'' the excess value retained by the consumer.

A second line of thought (see, for example, Forbis/Mehta 1983; Nagle/Holden 2002) defines customer value in a broader way. Nagle and Holden define customer value as the maximum amount a customer would pay to obtain a given product, that is, the price that would leave the customer indifferent between the purchase and foregoing the purchase. Customer value in this sense is equal to the microeconomic concept of a customer's 'reservation price'' and the use value of goods.

The difficulty of the former approach of defining economic value lies in the fact that price is part of the definition: Each time alternative approaches to pricing strategy are considered, economic value for the customer will necessarily change. As the objective here is the conceptual exploration of alternative pricing strategies, a definition of value is required, which is independent from price.

The following definition of customer value is thus best suited for pricing purposes (Nagle/Holden 2002): A product's economic value is the price of the customer's best alternative („reference value") plus the value of whatever differentiates the offering from the alternative („differentiation value").

Once value is understood, efforts are needed to create value: value creation essentially means to increase the positive differentiation value (or reduce the negative differentiation value) between the customer's best

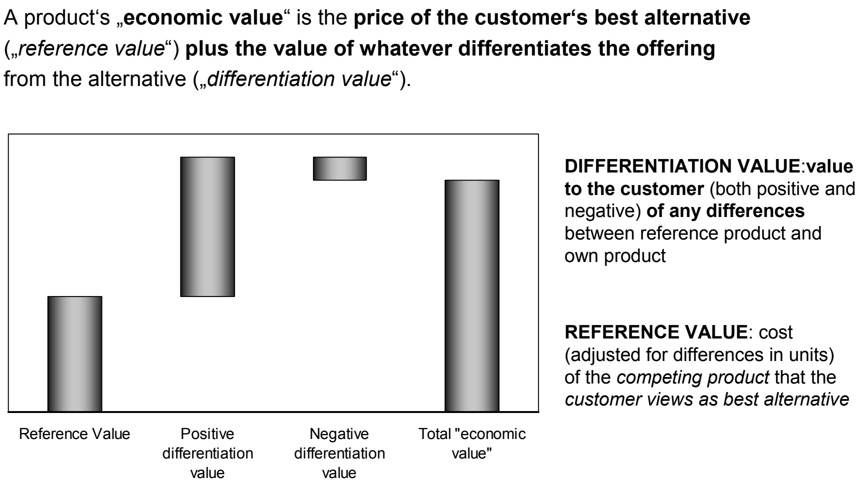

Fig. 1. A Definition of Customer Value
Source: Nagle & Holden 2002.

available alternative and the company's product in order to justify higher prices. Value can be created at least along the following four dimensions:

- **improvement in the product itself**: improved reliability, efficacy, quality, environmental benefits, etc.
- **improvements in collateral services:** warranties, repair, maintenance services, repair & spare part services, etc.
- **improvements in the relationship dimension:** ease of doing business, accessibility, simplification on the customer side of ordering, purchasing, receiving, and disposing of goods, etc.
- **improvements in the emotional dimension**: providing prestige, uniqueness, perceived benefits for consumer personality, self-esteem, providing „meaning of life" (see: BBDO, 2001), etc.

Companies can and should improve their offerings along all these dimensions. The success of Starbucks in China, for example, can be largely explained by its ability to provide superior customer value along the emotional dimension where customers enjoy the intangible benefits of a superior emotional experience; this allows the company to charge prices 5 or 10 times the price of comparable products. The high prices Starbucks charges even have a positive connotation for Chinese customers: they signal to their friends, acquaintances, and even themselves that they are „worth it" and that they belong to a group of selected few who can engage in conspicuous consumption.

5 Implementing Value-based Pricing Strategies in China: Pricing to Reflect Value

Once superior value has been created, it is essential to set prices at a level which reflect this value. In other words, superior value deserves premium prices. Charging less would mean leaving value untapped, charging more than is justified by the value created would make meaningful sales impossible. The relation ship between prices and value can best be illustrated by Figure 2.

An excellent example of a company who had to learn how to align prices with value delivered is IKEA in China. The company is known all over the world for a pragmatic, do-it-yourself style and low prices. When to company came to China, it offered its range of furniture at low prices –

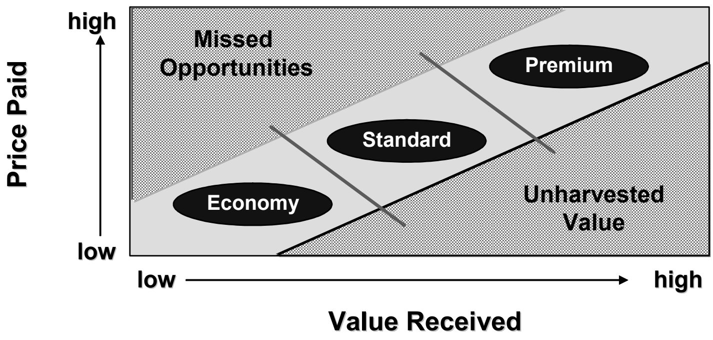

Fig. 2: A definition of customer value
Source: Strategic Pricing Group 2001

compared to the prices of other countries where IKEA operated. When compared to the available alternatives of customers in China, the prices of IKEA actually were very high. Customer reference values were low and the positive differentiation value the company's products offered was in no way sufficient to justify the company's prices. In such a competitive environment, the company had no other choice than to lower its prices. With prices on main products reduced by up to 40% over the past 3-4 years, IKEA is now a strong and growing competitor to a number of local furniture retailers. The case of IKEA not only illustrates the relationship between price and value very well, it also reminds executives seeking to expand their business in China of the need to take a truly customer-centric perspective, when evaluating pricing strategies. Chinese consumers justifiably did not care if the prices IKEA charged were lower than anywhere else in the world, as long as the value IKEA delivered was low – given customer's low reference values resulting from intense local competition.

6 Implementing Value-Based Pricing Strategies in China: Market Segmentation

The process of creating and estimating customer value goes hand in hand with the process of market segmentation. Significant differences in economic value arise from the way in which customers use and value the product and from how they value their respective reference products. These differences result from differences in incremental value, which in turn usually result from distinctive characteristics of the customer, the usage of the product, or environmental factors.

A company with a broad, fragmented product line, limited physical space for inventory and rapid response times will assign a higher value to just-in-time delivery than a company with only one product line and ample space for inventories. This explains why those companies most adept at implementing value-based pricing decisions – think of software or pharmaceutical companies – know that there is no other way of gaining insight into sources of customer value than through observation and intense field-research into customer habits and requirements. Microsoft, for example, is known for handing out beta-versions of its latest enterprise software products to particularly knowledgeable companies and customer segments. This form of free customer feedback is used to determine which features add most value and to gain a deep understanding on how different customer segments use and value the product.

In order to segment markets effectively, a deep understanding of customer needs is essential. While marketing theory (e.g. Kotler/Armstrong 2001) proposes a wide number of segmentation approaches – geographic, demographic, financial, behavioral, needs-based – there is one approach which is superior to other approaches for the purposes of value-based pricing: customer-needs based segmentation. A needs-based segmentation helps to identify the size of various customer clusters: it is especially useful in identifying the size of the price conscious market segment – a market segment whose size is frequently overestimated by many executives doing business in China.

Empirical research, however, shows that the size of the pure price-driven customer segment is much smaller than most executives assume, since customers generally value product quality, safety, reputation, delivery reliability, after-sales services at least as much as low prices. Note that all these differentiating factors are categories where multinational companies can excel.

The effectiveness of this approach is highlighted by a case study of a company wishing to expand its Chinese operations – a Fortune 500 electrical component manufacturer – which we will call WORLDTRONIC. Its Executive Board believed to be operating in a commodity market in China: their customers, the assumption went, could just as easily adopt one supplier's components as another's. This assumption was grounded not only on gut feeling, but also on the repeated threat of some of the company's key accounts to switch suppliers should WORLDTRONIC's price not match prices of smaller local competitors. This gave the company not much leverage in its negotiations with customers. In addition, profitability of Chinese operations was significantly below peer level and, at commodity-like levels, seemed to reinforce the core assumption of the Executive Board, i.e.

that the company was in fact producing and selling commodities in China. We conducted in-depth analyses with all key accounts of the company in China, interviewed also a number of smaller customers and also involved former customers who had recently switched to competitors. We discovered that 70 percent of the purchasing decision was based not on price but on quality, service, and technical competence. By undertaking both a conjoint analysis as well as one-on-one interviews with main customers we decomposed customer needs and purchase criteria and discovered the existence of four separate customer segments with widely different purchase criteria and price/value expectations. Only one segment (20% of customers) cared primarily about price and one-time delivery („low-price segment”), the other segments („product driven”; „service oriented”; „technically sophisticated”) mostly cared, respectively, about inherent, differentiated product attributes, speed/quality of technical support services and the breath/depth of the company's product range coupled with requests for customized offerings.

We then re-configured WORLDTRONIC's product portfolio to specifically meet the diverse set of needs of its customer base; the economic value of its offerings for these segments was quantified and, via sophisticated communication campaigns, communicated to customers. In a last step, we set up a system to encourage sales personnel to sell on value and to reward price maintenance; also discounting authority was linked to customer segment, so that unnecessary discounting to performance/service seeking customers was reduced. As a result, revenues and profitability of WORLDTRONIC grew significantly. Fig. 3 illustrates the benefits of our market segmentation approach.

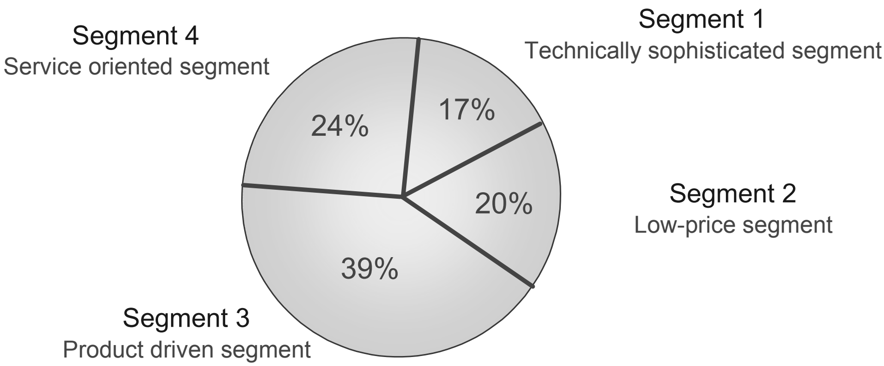

Fig. 3. Strategic Pricing and Benefits of Market Segmentation
Source: Worldtronic

7 Implementing Value-Based Pricing Strategies in China: Price Controlling

Monitoring and controlling target prices is especially important for multinational companies which need to give their local Chinese sales and account executives the necessary degrees of freedom to operate successfully. Nothing, in fact, can destroy a company's quest to achieve leadership in the premium price segment faster than excessive discounting at the field lever. Tight discount policies are essential. Strict monitoring of sales representative discounting behavior is a must. Linking sales representative bonuses with account profitability (and not realized turnover) is key to focus the attention on selling on value, not on price. Finally, attracting and rewarding sales representative and account manager whose behavior is in line with company strategy may also mean sometimes to let go of field officers whose discounting and deal-making abilities can not be brought up to the expected standards.

8 Conclusions

„Marketing in China is a high-risk, high-return game", says Tom Doctoroff, Greater China CEO of the advertising agency J Walter Thompson. Success and failure in China are illustrated by Wal Mart, a company which tried to impose its strategy of everyday low prices – which has been tremendously successful in a number of major countries worldwide – to China. It failed. Wal Mart had to admit that its lowest-price positioning was not feasible in a country which has myriads of corner stores, street vendors, and improvised markets selling already every available good on Earth at the lowest possible price. The organization was then forced to adopt a new strategy, positioning itself as a differentiated, comfortable, branded alternative to China's open air markets at higher prices.

We have shown that the challenges and risks multinational companies face in China when approaching the issue of setting and implementing prices can be significantly reduced by following a set of proven practices. First, understand the Chinese marketing environment and its complexities and contradictions. Second, successful pricing strategies in China are necessarily value-based pricing strategies in the medium or high end of market prices. Third, value creation, pricing to reflect value, market segmentation, and price controlling are necessary steps in the process of strategic pricing especially relevant in the Chinese context. Case studies, from Wal Mart's initially failed approach to IKEA have illustrated some of the difficulties and successes multinational companies have encountered. Perseverance and an ability to learn from mistakes are essential.

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