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China's largest maker of medical equipment is Mindray Medical International Ltd. Based in Shenzhen, the company was founded in 1991 to serve Chinese hospitals, which, especially in rural areas, could not afford many basic medical devices. From its earliest years as a maker of in vitro diagnostic processes and patient monitoring and life-support systems, this Chinese business-to-business (B2B) enterprise strove for a basic level of acceptable quality and versatility, and a high level of innovation: The company has consistently reinvested about 10 percent of its revenue in R&D every year. As China's economy expanded in the 2000s, Mindray's ambitions grew accordingly; it competed with increasing success in the global medical devices market, rapidly gaining market share by offering monitoring and medical imaging systems at prices that were typically 40 percent lower than those of most incumbents.

In 2008, Mindray bought the patient monitoring division of the Datascope Corporation (based in New Jersey) for US$209 million. By 2010, the now-global enterprise had businesses in 140 countries, annual revenues of more than $700 million, and a portfolio of products approved by the U.S. Food and Drug Administration and other Western regulatory bodies. Mindray's expansion "is part of our long-term strategy to compete in the most sophisticated markets in the world," said Xu Hang, the company's chairman and co-CEO. Not bad for a company that began as a low-cost producer in an underserved Chinese B2B sector.

Another such company is Shanghai Electric Group, a maker of power generation, transmission, and distribution equipment, along with heavy machinery and public transportation vehicles. Founded in the 19th century, it established itself in the 2000s as a global player in the energy and construction equipment industry. Shanghai Electric's status as a state-owned company gave it access to China's domestic market, but the company also developed capabilities for producing reliable, low-priced equipment around the world. In 2010, for example, the company reached a $10 billion agreement to supply India's Reliance Power with coal-fired generators.

Mindray and Shanghai Electric are examples of a new type of industrial company emerging primarily in China. We call them mid-market innovators, after the burgeoning middle market of Chinese urban and rural businesses and government offices, which were their original core customers. Some mid-market innovators are privately held companies; others are state-owned. They are all in intense competition, often with one another, which forces them to be frugal, nimble, and responsive. They sell to customers who have many choices but who also have their own hypercompetitive pressures, and they are rapidly moving from their Chinese B2B context out into the global economic landscape.

A Challenge to Incumbents

The emergence of mid-market innovators is a game-changing disruptive force. They are rapidly reshaping the dynamics of many industries

— including agriculture, construction, healthcare, and transportation — but many competitors are still largely unaware that they exist. In aggregate, however, mid-market innovators represent the next stage in China's transition to becoming a global economic superpower — and a major potential threat to well-established global manufacturers, one that could jeopardize their existence. This may sound overdramatic, but the possibility is real. Incumbents in capital- and scale-intensive B2B industries, in which consumer branding isn't important, are particularly vulnerable.

Similar companies could conceivably emerge in other markets, such as India, Brazil, or Indonesia, but they haven't. They are, so far at least, largely Chinese. That's because of the unique characteristics of the Chinese business environment right now: the enormous size and complexity of its customer base, its fiercely competitive companies and rapid-fire innovation culture, its access to low-cost labor, its distinctive regulatory environment (balancing openness and control), and its explosive growth in infrastructure and public services. All of these combine to give mid-market innovators an immense platform for growth, protected from outside competitors, which don't have much access to that Chinese business environment or experience with it.

Thousands of new mid-market customers emerge every year in newly developed cities such as those in the Chinese interior or those formed on the edge of existing metropolitan regions. They tend to begin as domestic players, selling to Chinese industrial customers who are looking for goods and services that offer a fair level of functionality and quality at a relatively low price compared with most imports. As Ming Zeng and Peter J. Williamson point out in their book *Dragons at Your Door: How Chinese Cost Innovation Is Disrupting Global Competition* (Harvard Business School Press, 2007), the mid-market innovators are like many other Chinese companies, competing on price skillfully and relentlessly. But they also compete on innovation, by continually improving their products, processes, and business models, and closing the gap in reliability and performance between themselves and their established global competitors, sometimes with remarkable speed. At the same time, their products remain far lower in cost, and, just as importantly, are attuned to Chinese needs. For example, these companies do not target all parts of the country at once; instead, they recognize that different regions are developing at different rates, and they concentrate on the regions that are ready for their particular level of low-cost product.

Chinese innovators can start to encroach on turf that multinationals have long regarded as their own.

Some Chinese customers who buy from mid-market innovators today will eventually reach a point at which they can afford more reliable equipment with more features. Global companies will be eager to sell it to them. But by then the mid-market innovators will have built long-standing relationships with those Chinese customers — and their counterparts in India, Latin America, Indonesia, Africa, the Middle East, and other countries and regions around the world. Moreover, the financial crisis and resulting pressures on government spending have led to increased demand for low-priced, high-quality tools, devices, construction equipment, and machines of all kinds — making Chinese industrial products competitive even in established markets like Germany and the United States. With their seasoned knowledge of the middle market's priorities, the Chinese innovators can build scale, add capabilities, and start to encroach on turf that global multinationals have long regarded as their own.

A good example of the dynamic — and the threat — is the construction equipment sector. China's rapid expansion of buildings and infrastructure has involved widespread subcontracting, with work on all sizable projects shared among a chain of hundreds or even thousands of small businesses. Most of these Chinese construction subcontractors think in the short term. They want equipment that is good enough to do the immediate job, and that will then be written off after five years or less. They are not interested in expensive, feature-rich products with a long life span supported by service contracts.

This type of segment is hard to penetrate for non-Chinese heavy equipment manufacturers, such as Caterpillar (U.S.), Liebherr (Germany), and Komatsu (Japan). These manufacturers follow well-established business models with buyers who, supported by long-term financing, think on a 10- to 15-year time span. Equipment must both last a long time and have the service needed to keep it operating with as few interruptions as possible.

Meanwhile, upstart construction equipment manufacturers have emerged to serve China's fragmented construction industry. They sell low-cost machines that typically do not get expensive servicing, but are replaced when they wear out. The manufacturers focus on only a small range of related products, and keep their prices ultracompetitive by restricting investment only to functions and features that are strictly needed. Their versions of multinational products might not pass muster in Canada or Denmark, but they are considered superior in China.

Already, some of these mid-market construction equipment companies are becoming global powerhouses. For example, Sany Heavy Industry Company — founded in 1994 in Changsha, the capital city of Hunan province — became the world's largest concrete pump manufacturer in 2009; its total revenues in 2010 approached $8 billion. In 2012, Sany announced that it would acquire the second-largest producer, the German company Putzmeister, and it has built plants in the U.S., Brazil, India, and Germany, as well as a major R&D center near Cologne. Other construction equipment manufacturers expanding outside China include ZoomLion (also based in Changsha), XCMG (a state-owned company headquartered in Xuzhou), and Shandong Heavy Industry Group. They all got their start by selling to China's fragmented construction industry.

To a global organization headquartered in the U.S. or Europe, the emerging mid-market competitors are barely visible.

Three Challenging Strategies

Many large multinationals have been slow to recognize this threat. To a global organization headquartered in the U.S. or Europe receiving information through the filter of its local Chinese sales organization, the emerging mid-market competitors are barely visible. Many incumbents are also held back by their view of China's billions of new urban consumers as an increasingly important source of demand for their products. (See "Competing for the Global Middle Class," by Edward Tse, Bill Russo, and Ronald Haddock, *s+b*, Autumn 2011.) The mid-market innovators tend to avoid the consumer sectors, where competition is intense and profits are thin, even by their standards.

Even when global companies recognize the threat, many of them find it difficult to respond appropriately. They assume, incorrectly, that they have a great deal of time to adapt, and that their own products will hold steady as the Chinese market matures. Three of the most popular strategies for incumbents stem from this assumption, and these strategies have, by and large, led to poor results.

The first strategy is to ignore the risk and avoid competing in China altogether. But China's mid-market is large enough to allow local innovators to use it to gain proficiency — and rapidly bring their capabilities and low prices to the incumbents' traditional space, as Sany did.

The second popular strategy is to continue offering global products in China, waiting for emerging markets to catch up to premium demand. For example, a Western construction equipment maker might position itself to sell higher-priced vehicles in China — assuming that sooner or later, subcontractors there will gain scale and access to long-term financing, and start to buy more expensive, longer-lasting, higher-quality products. But that day is unlikely to come anytime soon. Even as China becomes a major luxury goods market, interest in "Mercedes quality" products will

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not extend to earthmovers, windmills, and medical devices, not even with the promise of greater durability. With its modest barriers to entry at the lower end of the price spectrum, China will always have a tendency toward excess capacity and price-based competition.

Finally, there's the "good enough" strategy, popularized by Bain & Company chairman Orit Gadiesh and her partners Philip Leung and Till Vestring. (See "The Battle for China's Good-Enough Market," *Harvard Business Review,* September 2007.) Companies that follow this strategy remain focused on the upper tier while producing a lower-priced brand considered "good enough" for mid-market customers. They reduce costs for the value brand by stripping out functions or features, being careful not to cannibalize the existing premium product line. In effect, this means running two distinct business models, each serving a different market segment. One straightforward way of doing this is to buy a local competitor or work in partnership with a local firm whose brand name can be used for lower-tier products.

For example, German truck manufacturer MAN SE (Maschinenfabrik Augsburg-Nürnberg), in a joint venture with China's Sinotruk, has maintained a two-tiered strategy since early 2011. Vehicles for the Chinese market are sold under the Shandeka brand name, and those for other emerging markets across Asia, Africa, and the Middle East are sold as Sitrak. This strategy allows MAN to sell two different vehicles at two different price points to two different markets, with separate business models.

The two-tiered strategy, with separate but parallel business models, can be effective; it is certainly better than ignoring the mid-market entirely, and it enables companies to compete in mid-markets where they otherwise could not. But it is extremely difficult to get right. Marketing two brands is inherently more complex and expensive than marketing one; it can lead companies to duplicate resources and to create an incoherent web of joint ventures and other partnerships, which may be difficult to unravel later.

Moreover, it is not a trivial task for many global producers of industrial equipment to build the capabilities needed to sell effectively to mid-market customers in China. They must invest in Chinese (or equivalent) R&D and product development, simultaneously integrating their new operations with their old and managing intellectual property challenges. They also lack the home advantages that Chinese mid-market innovators possess: the knowledge of their market niche, access to low-cost production resources, and a deep understanding of the regulatory and operational environment. Joint ventures such as MAN's can help, but they also add to complexity and incoherence.

For global players, there are no easy solutions to competition from mid-market innovators.

For global players, there are no easy solutions to the problem of competition from mid-market innovators. Instead of competing as they are, incumbents facing this existential crisis will have to reshape their entire business model, while remaining true to their own identity.

Integrated Capabilities

A small number of global companies, seeing the challenge of mid-market innovators facing them, have taken on this kind of comprehensive approach to change. They are focusing on developing low-price, as opposed to low-cost, products. They do this by creating an integrated capabilities system that approaches Chinese mid-market customers and Western higher-end customers as one market, with one group of products. This cannot be done overnight; it requires a relentless focus on improving operations and product development together with regional integration.

For example, a company might migrate more parts of its value chain and innovation practice to China and other lower-cost countries — with the intent not of saving labor costs, but of gaining distinctive production capabilities that can be put in place around the world. These new efforts can specifically target the country's mid-market and use local engineers and research staff accustomed to frugal ways of thinking. It may not be obvious at first how particular product lines will be affected, but the new efforts can act as springboards for the kinds of ventures that lead to global mid-market prowess.

Honeywell International Inc. has adopted this strategy; its active R&D centers in China are geared not just to products for the Chinese market, but to an integrated product line that can be sold worldwide. The company's revenues from product innovations originating in China have grown at an average annual rate of more than 40 percent in recent years. General Motors Company has a similar approach, with 11 joint ventures, two wholly owned foreign enterprises, and more than 35,000 employees in China. Working closely with the SAIC Motor Corporation, a Chinese automaker, GM has successfully positioned its brands to suit the diverse needs of the Chinese passenger vehicle market.

If a company takes this type of approach, rather than offering products that are just good enough for particular markets, its goal is to create great products sold everywhere — with the right features, better durability, more rapid innovation, and lower prices. Such a company will develop a capabilities system that, in its sector, can create products with Mercedes-level quality and attractiveness, Toyota-level durability and margins, and Skoda-level prices. That might seem an unrealistic goal, but if incumbent multinationals don't take it on now, they may find themselves facing former Chinese mid-market competitors who have learned how to do it successfully.

Global multinationals can tap strengths that their local upstart competitors don't have. For example, incumbents already have the means to take products developed in China to other emerging markets. Distribution and marketing are other areas of competitive advantage. Most Chinese manufacturers remain centered on production; multinationals can harness their global experience in promotion and delivery to offset the better local knowledge of their domestic competitors. Finally, global incumbents can use their expertise in alliances and M&A to forge partnerships with other companies, in China and elsewhere, that make the most of their combined capabilities and aspirations in creating a single line of products.

The goal is Mercedes-level quality and attractiveness, Toyota-level durability and margins, and Skoda-level prices.

Siemens AG is noteworthy for the way it integrates its Chinese and global operations. It employs 29,000 people in China, where it has 65 operating companies selling industrial, transport, energy, and healthcare equipment, with 16 R&D centers. It has managed data centers for the Ministry of Railways, supplied high-voltage direct-current power transmission systems in Guangdong province, furnished gear motors for a bridge at Rizhao port in Shandong province, and built the baggage handling systems at Beijing Capital International Airport. Siemens's sales in China were $8.5 billion in fiscal year 2011.

Global companies are also more experienced with localization, adapting global products to meet the varying needs of different markets. Sometimes this can result in simple products of the "good enough" variety. But many companies have learned that value in adaptation need not come from stripping out functionality. Rather, the key is offering market-relevant features at a lower price. A footprint with local innovation can allow companies to tailor product development "in country, for country"; they can use global resources when appropriate, but design products to meet local conditions and delight local customers.

To many global incumbents, the threat of mid-market innovators seems remote. But if the trends continue in a plausible fashion, they could move to center stage. If and when that happens, global incumbents will be forced to rethink their product portfolios, business models, staff skills, and ingrained mind-sets. They will have to stop thinking about what they can bring to China from elsewhere, and start focusing on what China's mid-market can offer them. On the upside, this would allow major global companies to tap into the same large customer base, and to develop the same kind of entrepreneurial zeal that mid-market innovators are using right now to fuel their growth. ✚

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