Road of Strategic Transformation for Chinese OEM Enterprises: Issues and Countermeasures

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Abstract: The shift from OEM to ODM and OBM reflects the expansion of the scope of activity in the vertical value chain of the manufacturers, and is also an inexorable result of upgrading business and strengthening international competitiveness. This thesis explores the basic routes of strategic transformation of Chinese OEM enterprises and the major issues confronting them in the face of financial crisis based on integration of relevant theoretical views, and puts forth corresponding countermeasures and proposals.

Keyw Words: OEM; ODM; OBM; Strategic transformation

1 Introduction

OEM has played a significant role during the past thirty years of China’s rapid economic growth as a mode of business. Nevertheless, due to the accelerated transfer of the global value chain and the sharpened market competition, the comparative advantage of Chinese labor cost has gradually weakened. Conversely, the annual cost of raw materials, energy, land and environmental cost has increased, which together with the pressure incurred by the constant appreciation of RMB in recent years, has highlighted the shortcomings of OEM processing. The question of how to shift from the passive position to positive position, and to realize strategic transformation from OEM to the upstream ODM and downstream OBM in the value chain is key to the success or failure of Chinese enterprises in the new round of international market competition. Furthermore, it is an important subject for a country that is in the process of shifting from a massive manufacturing industry to that of a powerful manufacturing industry.

2 Review of Relevant Literature

The resource-based theory of Penrose (1959) contends that each manufacturer is a complex system of unique resources and capacities. That composition of the manufacturer’s resources and capacities is an important basis for selecting their respective business scope. Generally, the manufacturer will select different modes of business and integrate those resources and capacities of other manufacturers according to the current resources, capacities and conditions, and the characteristics of the product market confronting them. The continued investment on the proprietary assets in specific fields by the manufacturer may improve the competitiveness edges and conditions and form the core competence of the manufacturers (Prahalad & Hamel, 1990). The core skills formed through constant accumulation of the resources and capacities in certain fields will guide the manufacturers to carry out activities of a specific nature and position them to obtain higher levels of operational performance. However, this may also restrict the change of the manufacturer’s business scope and strategy application.

While analyzing the corporate behaviors and competitiveness edges, Porter put forth the renowned value chain theory (1985). The theory included three key points: (1) The various activities of the enterprises are an organic whole, and each activity contributes to value creation, while a kind of mutual connection lies between them, i.e. the system of “value chain.” (2) Different enterprises have different value chains, and the difference in value chain is embodied in the differences in the efficiency of various business activities, as well as in the differences in the organizational structure and business process of the enterprises. (3) Certain strategic links of higher value always exist in the multiple “value activities” of an enterprise. The advantages of the enterprise in competition, especially those that may be maintained for the long term, are the advantages of the enterprises in such strategic value links. Therefore, the enterprises shall intensively construct their own core capacities in such key links. Based
on the value chain theory of Porter, Gereffi (1999) contends that the global value chain is formed through the externalization of the internal value chain of the enterprises. Moreover, such a system may promote the flow of knowledge in the form of techniques and management experience between the client and the trustee, and transform OEM enterprises into entities capable of undertaking more valuable links in the global value chain. Humphrey and Schmitz (2002) adamantly put forward four types of modes of transformation at various levels centered on enterprises: process upgrading, product upgrading, functional upgrading and inter-sector upgrading.

3 Routes for Strategic Transformation of OEM Enterprises

Domestic and foreign scholars have reached a consensus on research related to the routes for strategic transformation of OEM enterprises, i.e. OEM-ODM-OBM. The corresponding thesis has summarized the routes of strategic transformation for OEM enterprises by referring to the dynamic evolution framework of enterprise growth and outsourcing system of value chain put forth by Hu Jun, Tao Feng and Chen Jianlin (2005):

1. Technical route transforming OEM to ODM, i.e. OEM enterprises acquire the advanced techniques and management knowledge from the client via favorable outsourcing relationships of value chain, and constantly improve their own capacity of R&D and design, quality management, and the capacity of controlling technological process. These will place the entity in a favorable position as they strive for the ODM orders from renowned domestic and foreign manufacturers and intermediaries. Conversely, the client will gradually increase the responsibility of the trustee in the division of labor, and let go of partial control of the functions such as component purchase, technological design and after-sales service, which are all closely related to the production and assembly of OEM enterprises. Meanwhile, due to the improvement in the strengths of the OEM enterprises and the implementation of the “streamlining” plan of international companies, OEM enterprises will gradually participate in R&D and design work of the client so as to share the product development information and technical knowledge, and to learn the successful experience of the counterpart in standard control, quality management, product design, market exploration, and the purchase of raw materials and components.

2. Brand route transforming OEM/ODM to OBM, i.e. OEM enterprises have a more complete understanding of the market, products and the requirements of the client, and are capable of completing work in each link such as product R&D and design, technological arrangement, market exploration, brand promotion and sales service or putting the work in each aforementioned link under their control. This may be divided into direct transformation and indirect transformation. Direct transformation refers
to those enterprises that strive to carry out channel building and brand promotion through conscientious learning and investment completely on their own when undertaking OEM, and become manufacturers of their own brands. Indirect transformation refers to those seeking opportunities during the undertaking of OEM through some indirect measures, and realizing establishment of their own brands by means of external forces, including purchase, joint venture and brand licensing.

3. Taking pluralistic routes and entering into industries of greater potential for appreciation: an enterprise may avoid excessive order concentration on some or a type of client through horizontal spanning of the value chain. As a result, this would lower the business risks during outsourcing and prevents the enterprise from losing the game thoroughly in case of industrial depression of a certain product. More importantly, the enterprises have the ability to stride over a low-profit value chain of dim prospects to another highly profitable and promising value chain when involved in multiple industrial value chains. In addition, rich product lines may lay a solid foundation of product mix for the enterprises to create their own brands.

This thesis explores the major issues confronting Chinese OEM enterprises and how to adopt corresponding countermeasures according to their own resources, capacities and conditions during transformation of their own brands mainly through referring to the second and third routes of transformation.

4 Major Issues Confronting Chinese OEM Enterprises During Strategic Transformation

4.1 Negligence of R&D and lack of core competitiveness
From the perspective of the pattern of labor division within the international value chain, Chinese OEM enterprises usually are at the lowest level of labor division in the entire industrial chain. They are typically involved in a vicious cycle of constant product R&D and unfavorable brand promotion due to standard and “modularized” development of manufacturing technology.
Due to lack of core technology and renowned brands, Chinese OEM enterprises at the lowest depths of the “smiling curve” are rather weak in bargaining with their counterparts located above and below them. Worse still, the more incapable such enterprises are in increasing investment on R&D and brand promotion due to a lower added value, the less the differentiated competitive edges there will be. In addition, due to lack of non-price competition, the enterprises are increasingly inclined to resort to price cuts as the major means of competition, which is the road many Chinese OEM enterprises are currently taking.

4.2 Passive position and lack of initiative in business
The renowned foreign manufacturers typically sign OEM cooperation agreements with Chinese manufacturers out of consideration of global “comparative advantages” and favor for the extraordinary manufacturing conditions of China. In the event the comparative advantages in the manufacturing conditions of China decline, the foreign businessmen will naturally “leave when the going is good” or “leave right away.” Meanwhile, the clients often select from several OEM enterprises according to fluctuations of the exchanges rates in various countries and for the purpose of maintaining the elasticity in decision making during production on commission. They will also constantly seek the suppliers with better cost effectiveness, quality and delivery speed. In addition, the client may also frequently adjust the quantity, varieties, prices and date of delivery of the goods to be ordered according to the transient market demands, causing extremely unstable business of the OEM enterprises. In other words, the risk of undertaking OEM lies in the difficulty in determining the quantity of orders, and mastering the initiative.

4.3 Poor reputation and difficulty in winning the trust of international consumers
Goods “made in China” enjoy a poor reputation within the international market in the long term, and it is difficult to win the trust of international consumers, which is mainly due to three reasons: (1) China is still an underdeveloped country, therefore more often than not, the consumers of developed countries do
not believe that China with GDP per capita of about 2,000 USD has the ability to enjoy high-quality brands. (2) The competitive pressure of long-term OEM has forced Chinese enterprises to adopt low-price strategies, and fail to pay sufficient attention to non-price competitive methods, thus leaving an impression of “fine quality and low price” for Chinese products on foreign consumers. (3) There are a lot of fake and shoddy products “made in China”, which has lead to poor reputation of goods “made in China” within the international market. As a result, there has been much trouble in the strategic upgrading of Chinese OEM enterprises.

4.4. Excessive competition and serious product homogeneousness
Due to a low threshold to undertaking OEM, the number of enterprises manufacturing the same type of products has soared. This has led to serious homogeneousness among products and inevitably excessive competition. Such enterprises are generally engaged in vicious price competition to win the orders from clients, while the foreign businessmen profit from this competition. Meanwhile, some foreign businessmen have taken advantage of the urgent psychology of domestic enterprises in finding a way out of difficulties and have made use of such domestic enterprises to counterfeit internationally renowned brands. As a result, they have not only produced a huge illegal profit and have thrown some domestic enterprises into the mire of disputes over international business infringement.

4.5. Anxious for success, lacking strategic awareness of brand management
In recent years, many Chinese OEM enterprises have realized the importance of international brand marketing and have consciously conducted brand management. Nevertheless, due to deviation in brand recognition, they generally lack a complete mode of brand management. For example, the purpose of some OEM in creating brands is to seek “self-improvement” and honor. As a result, they are anxious for success and neglect sustainable development. Some enterprises contend that their products have powerful brand forces once their trademarks have been certified or appraised to be “renowned brands” or “famous brands”. In fact, brand management is a long-term, complex and scientific process, which demands a definite development strategies and a complete mode of management, comprehensive overall planning from the perspectives of marketing research, market selection, brand orientation and marketing mix, as well as meticulous efforts with strict methods and pragmatic spirit, which is a process involving long-term efforts.

4.6. Neglect of international demands and trans-cultural obstruction to brand identification
Shift from OEM/ODM to OBM typically involves trans-cultural obstruction in brand identification system (including name, mark, color and slogan.). For example, the needs of future market internationalization are neglected at the beginning of the establishment of many brands in China, and a brand name rich in local cultural colors will usually be selected instead, or only the Chinese Pinyin of the Chinese name is adopted. Thus, such brands may be relatively successful within the domestic market, which, nevertheless, may be adverse for the brands in effectively communicating information to foreign consumers upon entry into the international market. Similarly, some brands are excessively nationalized and localized in marks and color design and fail to arouse consonance among foreign consumers. In addition, some brands bear excessively strong national colors in interpretation of the spiritual consonance, and are unable to tolerate the more extensive demands of the international market, or even conflict with some national or regional cultures. For example, “Changchun,” a renowned domestic electrical appliance brand, once took “regarding thriving national industry as its own task” as the spiritual consonance and slogan of its brand, which has won the favor form many domestic consumers in certain period, and meanwhile has caused huge obstruction to brand internationalization.

5 Countermeasures for Strategic Transformation by Chinese OEM Enterprises

5.1. Recognizing differences in business modes, cultivating new core competitiveness
Fundamental changes will take place to the business modes of the enterprises during the shift from OEM to OBM. Such a change may be summarized into three basic aspects: (1) Enterprises undertaking OEM
business are confronted with business market, and such business belongs to Blob operational mode. Conversely, carrying out OBM business involves consumer market, which belongs to Bloc operational mode. (2) The key to undertaking OEM business lies in meeting the demands of individual organizational clients. Conversely, carrying out OBM business requires the enterprises to make great efforts to understand the different cultures of various countries or regions, and study the different social customs and modes of marketing as well as make timely adjustment to the different reactions of the consumers. (3) The emphasis in undertaking OEM business lies in improvement of internal production efficiency of the factories, and “production capacity” or “product capacity” is the primary activity creating value in the value chain of the enterprises. Conversely, in carrying out OBM business lies in reaching the efficiency of the external market, and “marketing capacity” is the primary activity creating value in the value chain of the enterprises. Overall, strategic transformation of OEM means expanding the scope of activity and operational functions of the manufacturers in the vertical industrial value chain, which requires the enterprises to carry out constant “proprietary” investment in the new functional fields (market investigation, channel building, brand promotion and technical service.) to the best of their abilities so as to from a brand-new energy and capacity structure.

5.2 Implementing dual-track system to avoid loss of orders
A dual-track system is typically adopted by the enterprises undertaking international operations, i.e. retaining part of OEM/ODM business while carrying out strategic transformation to OBM so as to share the production capacity and “learn by doing” constantly as well as cover the huge expenses to be invested on brand marketing with the profit from undertaking OEM/ODM. In this case, the enterprises shall try to avoid head-on conflicts between “OEM” and “brand establishment” if at all possible. In the event this does not happen the international brand dealers will confront them with the threat of withdrawing orders. Therefore, two major strategies may be adopted: (1) The products of their own brands must differ from the OEM products in orientation. For example, one of the secrets for “becoming prosperous” of Galanz is to maintain their own R&D investment based on a great many OEM orders in order to gradually strengthen their own value-added functions at corresponding nodes of the value chain, develop differentiated products of their own core techniques and then enter into the downstream brand marketing. (2) Adopt OEM or brand marketing strategies according to various geographical regions. In fact, due to financial restriction, enterprises are unable to carry out brand marketing in extensive international market at the very beginning, and they shall first select the regions. For example, America and West Europe are the major markets of many Chinese OEM enterprises. Competing with clients with their own brands too early will necessarily lead to a loss of orders. Therefore, the enterprises shall start with the countries and regions without sales by OEM clients and then gradually expand into other areas. For example, the products of Qingdao DoubleStar Group exported to America usually adopt the mode of OEM, and the products exported to South Africa, Russia and Singapore bear the brand of “DOUBLESTAR.” The former way has the ability to recover funds as quickly as possible and open the international market rapidly with low market risk, while the latter is beneficial to expanding the popularity of the own products of the enterprises, and will lay a foundation for creating globally renowned brands.

5.3. Diluting the effects of place of origin, creating the image of international brands
At present, we shall rationally realize that the image of place of origin of Chinese brands has certain negative influences on the international marketing of the enterprises and such influences may not necessarily disappear soon. Therefore, it is necessary for Chinese OEM enterprises to adopt a series of measures to avoid or reduce the adverse influences caused when marching toward doing business within the international market with their own brands. They must pay close attention to the following three points: (1) Dilute the sense of place of origin. In the past, the products of traditional Asian industries have been looked at negatively in the international market due to the quality guarantee by its technical capacities. Therefore, Asian manufacturers, including Japan, will generally not emphasize the place of origin of the brands when promoting in the market overseas. Instead, they will focus on creating the image of international brands. (2) Obscure the place of origin. Many manufacturers deliberately make
the brand name and marks sound or look like “foreign goods” of a prestige image of the place of origin when determining brands for the products to cater to the psychology of international consumers. For example, TCL color TV and SOVA air-conditioner of Guangdong Province have taken the route of creating an international image. (3) Cooperating with renowned foreign intermediaries or manufacturers. The reputation and image of the intermediaries are important clues to assessing the quality and prices of the commodities sold by them. Therefore, cooperation with reputable retailers is an effective way of creating brand image. For example, the trading companies of Haier in America place the emphasis of marketing strategy on forging an alliance with national and regional retail chain shops such as Wal-Mart Stores. This helps to make up for the shortcomings in the image of the place of origin with the good reputation of the latter. Cooperation between Haier and Sanyo has not only weakened the unfavorable influences of the image of the place of origin, but has also rapidly entered into the Japanese market and has enjoyed unique market affinity.

5.4. Cultivating the capacity of innovation, occupying the commanding point in market competition
From the perspective of the development course of renowned international brands, possession of desirable capacity of technical innovation by the manufacturers is not only the prerequisite condition for shifting from OEM to ODM, but also the important basis for the brands to leap onto the international stage. Through technical innovation an enterprise may win their own intellectual property rights to realize a high degree of “differentiation” in competition, and then enable the brands to occupy the commanding point in market competition. Therefore, we shall specifically pay attention to the following issues: (1) Strengthen the cooperative relationship with the client during undertaking of OEM business, and constantly learn and accumulate knowledge in product innovation and improve the capacity of undertaking ODM business; (2) Set aside a certain proportion of the profit acquired through undertaking OEM business for investment on R&D, and divert the limited resources to the key link of cultivating technical innovation and ensure that the product quality and functional indexes will be listed in the fore in the same trade; (3) In the event that the conditions permit, establish R&D organs in foreign countries in order to track and master the latest technical trends at any given time. For example, ASUS computer was founded in 1990, and master board production was the only business during the company’s first eight years in business. Thanks to its unremitting efforts in R&D, the average selling price of the master board is higher than that of other similar products by an astounding 30%. ASUS then came out with the notebook computer in 1998 and mobile phones in 2003. Thus, the company has built itself up through the process of components for renowned international manufacturers, and has constantly cultivated “the capacity of managing internal affairs” and participated in various international exchanges on quality, R&D and design. They have gradually transferred their reputation accumulated in industrial market to the end-consumer market and have established a favorable example for Chinese enterprises to create international brands.

5.5. Making definite brand strategies, and organizational promotion from up to down
OEM enterprises shall carry out top to bottom organizational promotion to implement strategic transformation. Firstly, guidance by the top management must take place. The upper level of management of the enterprise, especially the founders of the company or CEO, shall have determination and confidence in creating their own brands, and must be willing to launch a “brand creation campaign” from top to bottom within the enterprise. For OEM enterprises that have been operating solely for the benefit of others for some time, implementing their own brand strategy is similar to the internal “business revolution” inside the enterprise, and will influence the overall task and mission, corporate culture and the state of mind of each employee of the respective enterprise. Secondly, powerful promotion by the brand teams must occur. It is necessary for an enterprise to establish a special brand promotion group to guarantee the effective implementation of own brand business, whose major duties are to establish and promote the brand identification system. Thirdly, participation must be from all members of the enterprise. Brand construction is an all-member activity of the enterprise, and it is necessary to create a powerful brand image in external market through brand communication and
constantly carry out communication and education on brand spirit to internal employees through brand culture construction.

5.6. Planning brand framework, establishing identity system of international brands

An enterprise shall carry out brand-new planning and integration of brand identity system from the perspective of a more extensive international market while planning to create an international brand. This not only involves a series of brand factors (generally, including improvement or redesign of the brand name, brand symbol, brand character, brand slogan and brand jingle.), but also the reselection or reorientation of brand strategy. Furthermore, an enterprise’s brand name is the most fundamental factor in the brand identity system, and is the content that may be directly expressed through language in the brand. Brand symbol is the part of the brand that may be identified, but cannot be expressed with language. For example, the tick-like symbol of Nike, and the tire man of MICHELIN tire. Brand character is a special brand symbol representing the features of humanity or real life. For example, Ronald McDonald, Marlboro Cowboy etc.; Brand slogan is the short description or persuasive sentences in the dialogues between the enterprises and consumers. This is an impactful weapon for strengthening brand orientation and highlighting differentiation. For example, the “Just Do It” of Nike, and ASUS’ “ASUS’ quality is as hard as a rock.” A brand jingle is a brief piece of musical information centered on the brand, and it is a slogan for expressing the brand character and emotions through indirect and abstract manners, such as the “den-den-den-den” of Intel. All in all, the brand is symbolic of comprehensive cultures, and the establishment of the identity system shall be centered on the brand value and focuses on the mutual coordination and cooperation between various brand factors. Only in this way may a uniform and unique brand image be created and conveyed in a more impactful and concise manner.

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