

Beijing-based Xiaomi is fast emerging as the Apple rival to watch

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It wasn't long ago that everybody wondered whether Apple Inc. could effectively compete against a tough bunch of homegrown smartphone makers in China.

Then came the company's blowout earnings report last week, which included a stunning 70 percent year-over-year increase in its China region revenue, driven by its new iPhones.

That answered the question in the affirmative - but it doesn't mean Apple can breathe easy. Chinese smartphone makers are growing fast, led by an aggressive company hardly anyone in the U.S. had heard of until recently: Xiaomi.

Based in Beijing, Xiaomi is fast emerging as the Apple rival to watch - not just in China, but around the world. Last year it sold 61 million smartphones, more than three times its 2013 total. A few weeks ago, the 5-year-old company raised \$1.1 billion in new funding at a valuation of \$45 billion.

"The trend over the last couple of years has been for local vendors, plus Samsung, to dominate the market and make it hard for others," said Chris Jones, principal analyst on the mobile team at research firm Canalys. "They've been driving down the prices of smartphones and driving up the screen sizes and quality."

Xiaomi sells smartphones at about half the cost of the iPhone. That's a big deal in a country such as China, where average incomes are a fraction of those in the U.S.

Besides selling relatively inexpensive phones, Xiaomi's strategy has been to primarily sell its phones online, which boosts profit margins by taking expensive real estate out of the equation.

It also uses a savvy "pre-order" system, manufacturing the phone after an order is placed and paid for by the user; with the price of smartphone components constantly declining, Xiaomi ends up benefiting because the cost to produce the phone ends up being cheaper than when the phone first went on sale, said Wang Jun of Analysys International in Beijing.

Xiaomi's chief executive, Lei Jun, has often been called "China's Steve Jobs," although he protests the comparison. The company has won over millions of Chinese consumers, and, like Apple, enjoys strong brand loyalty among its fans.

"I have three Xiaomi phones," said Hao Ran, a sales manager at a Beijing theater. "The iPhone is just too expensive and isn't worth the money."

In a way, that serves both companies well, because each appeals to a different segment of the market: Premium shoppers for Apple and price-conscious ones for Xiaomi.

"Xiaomi's user base doesn't really overlap with iPhone users that much, especially with loyal Xiaomi and Apple fans who would never buy a smartphone from a different brand," Wang Jun said.

For some Chinese consumers, there's more than just the price consideration. Ran, 27, also said he worried about his privacy being

compromised by Apple and Samsung.

"I trust Chinese smartphone makers more," he said.

In recent months, the Chinese government has been ramping up its restrictions on foreign hardware and software makers as well as Internet giants. U.S. companies have complained of a protectionist regime, saying such rules stifle innovation and make it increasingly difficult to do business in China.

So far, that hasn't seemed to hamper Apple.

Revenue in the company's "Greater China" region - encompassing China, Taiwan and Hong Kong - totaled \$16.1 billion for the October-December quarter. The 70 percent increase was by far the biggest percentage jump by region for Apple; in comparison, its Americas revenue rose 23 percent compared with a year earlier.

Apple's success in China was largely due to the iPhone 6 and 6 Plus, which finally gave Chinese consumers what they know and love: large-screen smartphones.

Many Chinese consumers use their phones as their primary - and oftentimes only - Internet-connected device, so big screen sizes are a huge draw.

There are also socioeconomic factors in play. As millions of Chinese become more affluent and join the swelling middle class, status and brands have become more important - and Apple fits right into that, said Murillo Campello, a professor of management and finance at Cornell University.

"You get a cachet: Made in California," he said. "With Xiaomi, you get

the functionality of having a smartphone, but it's just not as impressive."

That sentiment was echoed by Gan Yu, 20, who lives in Beijing.

"When the iPhone 6 Plus was released, I immediately got one," she said.

"People around me told me nice things about the Xiaomi phones. They sounded like a good bargain. ... But for myself, almost all my friends are using iPhones. So if I own a Chinese-brand phone like Xiaomi, I'll be too embarrassed to take it out."

The frenzy for new iPhones was so pronounced that year-over-year iPhone sales doubled last quarter in mainland China. Apple didn't specify how many units were sold there.

In a call with analysts, Chief Executive Tim Cook called the growth "absolutely stunning."

"The local competition was obviously there this quarter and it has been there for many quarters," Cook said. "I think we did really well."

As a result, the Cupertino, Calif., company - which just one quarter earlier had been in seventh place among smartphone vendors in China - rocketed to No. 1 for smartphone shipments during the last three months of last year, a first for the company, according to Canalys.

Xiaomi was No. 2, followed by Samsung and Huawei.

"This is an amazing result," Canalys said in its report. "While Chinese smartphone vendors are quickly gaining ground internationally, Apple has turned the tables on them in their home market."

By mid-2016, Apple plans to more than double its number of greater China retail locations, to 40 in all. It already opened two stores in the

region this month. To get the stores up and running, Apple has reportedly been wooing store employees to relocate to China.

Apple may be on top right now, but China is a volatile, relatively young market. To stay ahead, the company will have to constantly innovate while maintaining its status as the desirable "it" brand - not only in China, but in other emerging markets where price is a strong consideration.

In the meantime, other major tech players will continue to jostle for position, and analysts say they expect big fluctuations in the months to come.

"The market share between the top vendors is pretty close, so if the winds blow in the right direction, any one of them can move into the leadership position," Canalys' Jones said. "Xiaomi, Samsung, Lenovo, Huawei, Apple - they're all in there."

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