

Bandit Handsets – Shanzhai Ji: The Pull of the Orient

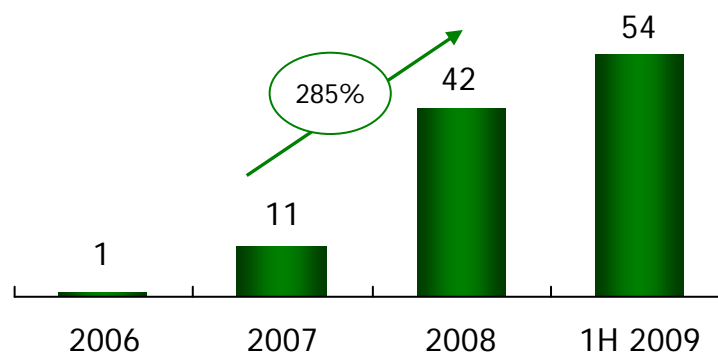
“Shanzhai” handsets (or “ji”), handsets which are made without a license and circumvent Chinese government regulations, have had a major impact over the past few years on the handset market in China – and more recently an increasing impact overseas. ‘Shanzhai’ is a terms with origins describing a mountain base from where bandits launch ambushes against the Imperial authorities. The term has now come to signify ‘copy, imitation, fake, or pirate’ and in so doing has become a new buzz word. A spirit of ‘Shanzhai’ is now something celebrated in popular culture in China. For example a ‘Shanzhai Star’ is an ordinary person who looks like a celebrity or a ‘Shanzhai Spring Festival Party’ is a party organized by private persons to rival CCTV’s annual television extravaganza.

BDA divides Shanzhai Ji into two categories: 1) ‘Minor brand’ handsets: Vendors’ own, but less well known, branded phones (those that have not passed MIIT tests) and 2) Refurbished or counterfeit phones. In a previous BDA Analyst Note, published on 25 August 2008, we attributed the spectacular growth of Shanzhai Ji to the lowering of entry barriers, a mature value chain and unmet market demand. BDA also pointed to an increasing trend for these phones to be exported and forecast that sales in China would level off due to fierce competition, declining margins and regulatory risks.

Now BDA’s predictions have come true. The year 2008 and 1H 2009 saw lackluster Shanzhai Ji sales growth in China but were marked by soaring export volumes. BDA estimates 42 million Shanzhai Ji were sold outside China in 2008, equating to a 282% YoY growth. The number continued to rise in 1H 2009, hitting the 54 million mark (see exhibit 1). By contrast BDA estimates Huawei has exported 31 million unit handsets and ZTE 32 million units in 2008. So if we take Shanzhai Ji vendors as a single handset manufacturer, they now constitute China’s biggest handset exporter.

Exhibit 1: Shanzhai Ji: Shipments Outside China (2006 -1H 2009)

Million units



Source: BDA estimates

Domestic Competition and Saturation: Booming Shanzhai Exports

Although the Chinese market still accounted for the bulk of Shanzhai Ji sales in 2008, this percentage is dropping rapidly due to intense competition and saturation of the addressable market. In order to guarantee their future survival, a growing number of Shanzhai Ji vendors are looking at opportunities outside China.

The addressable market for Shanzhai Ji in China lies in the RMB 400 to RMB 1,000 price band. In this segment global heavyweights, legitimate domestic vendors and, more importantly, nearly 1,000 Shanzhai Ji vendors are all busy battling it out for a slice of the market.

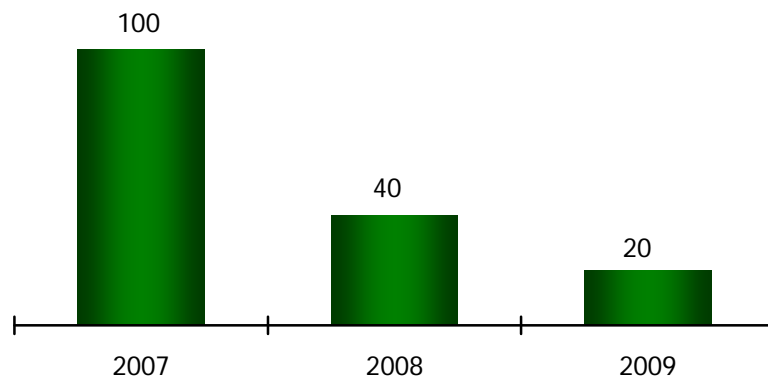
Most domestic and all Shanzhai Ji handsets are based on Taiwan's Mediatek (MTK) 'turn-key' solution. For vendors this acts as a double edged sword, radically shortening time-to-market but contributing to an explosion of undifferentiated handsets which compete not on features but merely in appearance and price. As a result there is always a constant downward pressure on the price/margin of handsets based on MTK solutions.

The economic downturn has intensified the price war between Shanzhai Ji vendors and further eroded their profits in China. Millions of migrant workers, as well as other price sensitive low-income consumers, all significant client groups for Shanzhai Ji, have lost their jobs and cut spending on handset purchases and renewals. Shanzhai Ji sales growth in China has slowed markedly since 2H 2008.

Meanwhile, the advent of 3G in China has narrowed the scope for Shanzhai Ji (all of which are GSM). In 2009 all three Chinese operators have begun to actively promote 3G services with subsidized 3G handsets. Soon 3G handsets costing less than RMB 1,000 will become available, eating into previously lucrative Shanzhai Ji territory by attracting the customer of fashion-conscious young people, another major client group.

Both competition and the price war have dragged down dramatically sales prices and margins of Shanzhai Ji in China. Most Shanzhai Ji models are now priced in the RMB 400-700 band, while previously the bulk sold for between RMB 700 and 1,500. For example, one wristwatch model BDA found in Shenzhen was priced at RMB 700 last July but this has now fallen to RMB 500. One Shanzhai Ji vendor told BDA that his profit had been squeezed to RMB 10-30 per unit in China, down from RMB 100 in the heyday (see Exhibit 2). Meanwhile his shipments are only a fraction of what he used to supply, prompting this vendor to go abroad twice a year looking for new opportunities.

Exhibit 2: Shanzhai Ji: Average Gross Margin in China
RMB/Unit



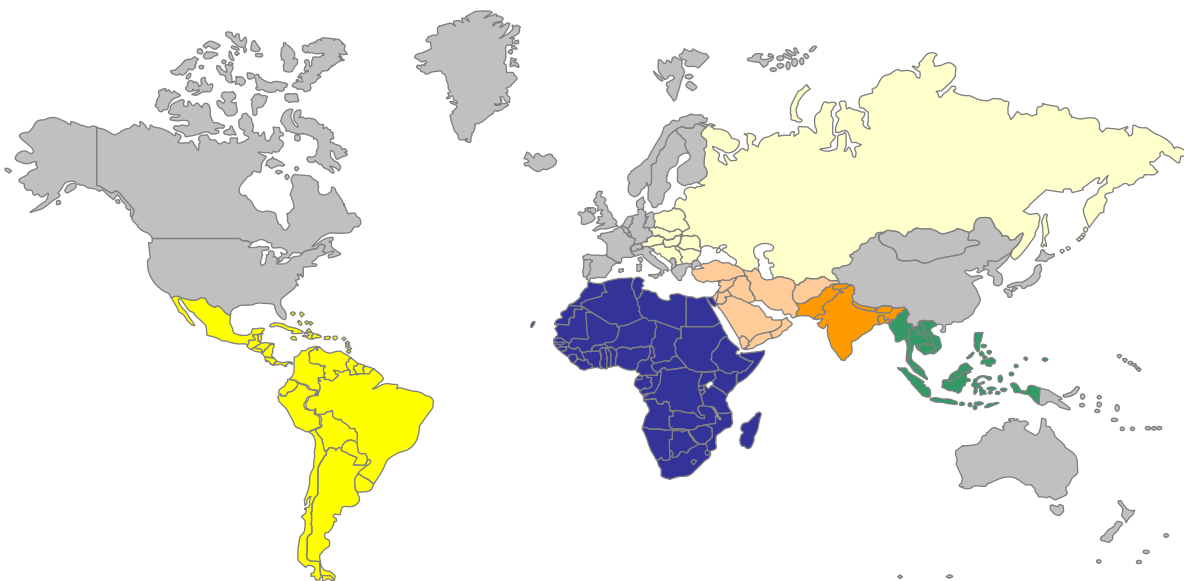
Source: BDA estimates

BDA estimates that Shanzhai Ji account for a greater than 70% share of the RMB 400-1,000 price band in China, in other words approaching saturation level. But overseas, especially in emerging markets like Brazil, Russia, India and countries in South East Asia, the Middle East and Africa still offer enormous scope for mobile subscriber growth and handset sales.

Market Demand and High Margins in Emerging Markets Pull In Shanzhai Ji

Around the world there are 2.4 billion people yet to enjoy the benefits of a mobile phone and most of them live in developing countries in Africa, Eastern Europe, Latin America, the Middle East, and South and Southeast Asia. These are precisely the areas where Shanzhai Ji exports are mostly directed (see exhibit 3).

Exhibit 3: Shanzhai Ji's Main Export Destinations



Source: BDA interview

Shanzhai Ji players have been nimble in identifying demand in these markets by bringing cost-effective products, careful customization and extensive distribution networks. An ordinary Shanzhai Ji model supporting MMS/FM/WAP/Bluetooth/Java with MP3/3GP/MP4 plus a camera is 30%-50% cheaper than branded handsets with similar features. Therefore these cheap 'Made in China' phones have begun to make real inroads into these markets. For example, in India, BDA estimates that more than one million Shanzhai Ji have been sold each month this year. According to the Indian Cellular Association (ICA), the total number of Shanzhai Ji users in India hit 25 million in 2008. In Ghana, over 50% of models sold are Chinese-made Shanzhai Ji. The most popular models are those featuring analog TV, something that is regarded as the height of fashion by young Ghanaians.

Importantly Shanzhai Ji models have been carefully customized for local markets. Besides the dozens of languages supported (Exhibit 4) and features such as analog TV mentioned above, the rapid reaction to local trends is impressive. For example, only half a year after the US launch of the iPhone, a Shanzhai Ji version, the Hiphone, made its appearance on the market. An 'Obama phone' has proved popular in the African market, especially Kenya, and a fake Blackberry with an Obama image has also sold well there. A sword-shaped handset customized for the Middle East market has also proved a great sales success (Exhibit 5). Although these efforts are sneezed at by legitimate handset vendors, they do provide Shanzhai Ji vendors with significant revenue.

Exhibit 4: Some Languages Supported by Shanzhai Ji



Exhibit 5: Some Models Customized For Overseas Markets



Obama phone

A fake BlackBerry with Obama image

Sword-shaped model

In addition, Shanzhai Ji's distribution networks are gradually becoming more developed, facilitating the flow of Shanzhai Ji into overseas markets. Firstly a number of Shanzhai Ji vendors are actively building their own distribution channels in many counties. These vendors usually visit target counties to set up cooperation with local distributors and ascertain local preferences for future product design. One medium-sized Shanzhai Ji vendor told BDA that he had already traveled abroad twice in the first half of this year in order to check out new cooperation opportunities.

Secondly, a growing number of international distributors are coming to the Shanzhai Ji trading market in China, looking to make deals with Chinese distributors or even directly with Shanzhai Ji vendors (Exhibit 6). Some big international distributors have set up their own offices in China and have learnt fluent Chinese in order to bargain with vendors. For example one big African distributor, who has an office in Shenzhen, selects a number of models from different vendors, and then ships them back to Africa; yearly shipments have totaled over 500,000 units. The profit earned by these distributors is always over 50%, and possibly even 100% per unit. Such huge profits encourage more international distributors to join in, all of which helps Shanzhai Ji capture market share in emerging countries.

Exhibit 6: International Shanzhai Ji Distributors in China



The deals Shanzhai Ji vendors make with overseas traders are characterized by higher margins and

larger shipment quantities than for domestic business. The average profit on exported phones is about RMB 50 per unit, higher than the RMB 20 achieved in China. If vendors establish the trust of these distributors, each shipment can involve over 5,000 units, much larger than the deals for hundreds of units normal in China.

Outlook: Overseas Market Continues to Drive Growth

Looking forward, BDA thinks Shanzhai Ji export will continue fast growth in the next three years due to push and pull factors mentioned above. The overseas market will replace China as the growth engine for Shanzhai Ji sales.

But as in China, regulatory risks are never far away from Shanzhai Ji. In this June, citing concerns that terrorist groups use handsets without IMEI (International Mobile Equipment Identity) and it is hard for the police to track them, India Indian government said it would prohibit the sales of handsets without IMEI or with shared IMEI from July. Although it has proved not true later, this new caused considerable alarm in the Chinese Shanzhai Ji industry.

Product quality and after-sale service are vital to Shanzhai Ji's sustainable growth in overseas market. If improperly coped with, these problems will ease the current pull of the bandit handsets from the Orient.

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