Watch Out, Coke and Pepsi -- Here Comes Wahaha

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Wahaha, whose main products are milk drinks, bottled water and mixed congee, is the number one beverage company in China, with revenues of 11.4 billion yuan ($1.37 billion) and profits of 1.35 billion yuan ($162.7 million) in 2004. The company was started in 1987 by Zong Qinghou, its 60-year-old chairman and CEO.

Up until the year 2000, Wahaha was 100% state owned. That year, Zong bought out 55% of the government's shares, kept 30% for himself, and allotted 20% to employees and 5% to senior management.

As a young man, Zong spent 15 years on a farm before starting the company with two retired school teachers. Initially he made money by selling beverages and ice cream. Then in 1989 he founded the Wahaha Nutritional Food Factory in Hangzhou. Its main product - "Wahaha nutritional liquid" - was an instant success. In 1991, Wahaha Nutritional Food Factory and its 100 employees merged with a state-owned enterprise called Hangzhou Canning Factory. The company in 1996 set up five subsidiaries with the French giant Danone Group, a joint venture that attracted $45 million in foreign investment, but allowed Wahaha to retain all managerial and operating rights as well as the brand name Wahaha. In the last eight years, the company has established 40 subsidiaries in more than 16 provinces in China, and in 1998 launched its own brand, "Future Cola," to compete against Coke and Pepsi. In 2002, Wahaha entered the children's garment market.

Qinghou Zong recently talked with Wharton marketing professor Z. John Zhang at Wahaha headquarters in Hangzhou. Philip Wu, president of the Wharton Club of Shanghai, was also present at the interview.

Later, people started to question the quality of those medicines, especially if they contained hormones. Meanwhile, I found that Chinese children -- who usually don't have any siblings due to the single-child policy -- are too picky about their food. I wanted to develop a kind of oral medicine that could help stimulate their appetite. We invited a professor to do the research and development, and asked experts from around the country to offer advice. At that time, there was no health product specifically aimed at this market, even though China had more than 300 million children. I felt the potential was huge. It turns out that our strategy of focusing our products on children was right. Our Wahaha products sold very well in the market, and we made a lot of money -- more than 7 million yuan in profit in the third year, and more than 20 million yuan in the fourth year.

Once we opened the market to the Wahaha products, we could hardly produce enough to meet demand. Competitors came in, and we realized that we would have to expand our production scale. In 1990, when we were still considered a small factory, we spent more than 80 million yuan acquiring a money-losing, state-owned enterprise. At that time, some people were criticizing us for overthrowing the state-owned economy. But we assured our managers that we would run a good business and keep people employed.

We expanded the Wahaha product offerings to include a kind of milk mixed with juice, which has become very popular with kids. Then we became a one-billion-yuan enterprise, with 200 million yuan in profit.

Back then, it was five factories of ours -- not the entire corporation -- that were co-operating with Danone. The rate of return was high, with the investment recouped within two to two and a half years. As a result, Danone has wanted to expand its investment in us every year. Now we have more than 30 factories in which Danone has a stake, and they represent one third of the profits. The state-owned stake now is less than one third.

Initially, Danone also wanted to join us in managing the company, but there is a lack of understanding on their part about the market in China. Some foreign management styles are not applicable in China. They thought things should be done this way, but I thought things should be done that way. I understand the market, and I didn't listen to them. For example, we initially had two pure-water production lines. I told them we should add seven more, but they said only two more were needed. In the end, we made a lot of money with the seven new lines. That made the foreigners happy. After a few more instances like this, they realized that our understanding of the market is more accurate and that we do things honestly. The key to both a human being and a business is credibility. After witnessing how well we have managed the business, Danone decided not to interfere. For a shareholder, what matters most is return on investment.

Zhang: Has Danone helped Wahaha expand into the European markets?

We have been focused on our primary business for more than a decade. We have started to diversify gradually only during these two years. We won't diversify until we become competitive and until opportunities emerge. I think diversification depends on market demand, competitiveness and opportunities. Meanwhile, after a company reaches a certain level, it may have to diversify. At present, Wahaha has 16% of the market. It's difficult for a 10-billion-yuan beverage company to expand further.

There are two problems facing the beverage industry right now: First, the consumption level is low in rural areas; secondly, Chinese people have different consumption habits (than do foreigners). People drink a lot of beverages in the summer, while Westerners drink them all the time - with meals or when they are at home. When Chinese people go back home, they drink tea and they make tea for guests. And they have soup with meals. During these two years, the supply in the market has grown faster than the demand, leading to a glut. So there is intense competition in the industry.

Other Wahaha products were sold in the urban markets first, followed by the rural markets. But it has cost a lot in recent years to put our products on the shelves in supermarkets. The investment is big, while the return is small. For retailers who really want to do business with us, it requires them to put in three to four times their capital. For every one million yuan in sales, there's four to five million yuan worth of investment beyond it. That has limited our ability to expand sales. Gradually, we are losing the urban markets to our competitors. But that doesn't mean our products don't sell in the city.

In 1996, when Wahaha teamed up with Danone, there was still more than 20 million yuan in bad accounts even though our products saw more demand than supply. To solve the problem, we established joint products. Because there was more demand than supply and retailers competed for our business, we asked the retailers to pay us first. At the same time, we offered them interest rates that were higher than the

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rates offered by banks. As a result, we secured capital and eliminated bad accounts. After a few years, retailers developed trust in us, and came to know that we have the capability and don't lie.

First and foremost, it takes honesty and credibility to do business. You have to be honest with the retailers in order to have a lasting co-operation. They get their share of the profits at the end of each year. Incentives also helped me establish relationships with retailers. If they can make more money by doing business with you, they will be more willing to do business.

Speaking of the extension of the brand, initially the popular view was that Wahaha was a children's brand. Now the brand is expanding, regardless of the product. Some people didn't think it was a name suitable for bottled water, but now bottled water ranks number one in the country. Today the general feeling about the Wahaha brand is: It conveys credibility, quality and affordability. Even children's clothing can be named Wahaha.

All the branch managers are selected from within. Once they prove to be reliable, their main responsibility is to supervise production. It would be difficult to find a lot of qualified managers to be in charge of a company's entire operations.

In addition, there is a sales department in each province, a branch manager in each district, and a client representative for each client. All orders have to be returned to the headquarters.

Zong: State-owned enterprises have to be reformed. Otherwise, they will fail. Managers at state-owned enterprises are appointed by the government, and the relationship with government officials often is the key. There has been some improvement in recent years, due to concerns about profits. But all in all, there is no link between government-appointed managers and profits. There are no well-managed state-owned enterprises even in capitalist countries. The notion that state-owned enterprises can be run well in China is against economic logic.

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