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Developing a Winning Strategy for the Air Conditioner Business in China

LG Electronics Tianjin Appliances Co.

First progress review

February 20,2001

MEETING OBJECTIVES

- Highlight China's air conditioner market development and opportunities for LG
- Review LG's current performance in the market and improvement opportunities
- Agree on key decisions to be made
- Agree on next steps and work plan for the second phase

AGENDA

- **Progress update**

- Market development
  - -Market demand
  - -Trade structure
  - -Competition
- LG's current performance and improvement opportunities
- Next steps
- Appendix
  - - Key assumptions of demand forecast model
  - - Profiles of consumer segmentation
  - - Profiles of top A/C competitors (including profitability analysis)

THE JOINT LG / MCKINSEY TEAM HAS COMPLETED FIRST PHASE OF THE PROJECT

completed

	Phase 1 Market diagnosis (completed)	Phase 2 Marketing and sales strategy definition	Phase 3 Implementation roadmap formulation
	5 weeks	5 weeks	2 weeks
Key activities:	• Forecast potential market by segment through refining market segmentation, understanding key growth driver, and modeling market growth. • Conduct internal data collection within LGE. • Develop sound understanding of value proposition based on available market research including branding customer segmentation. • Develop competitive assessment for air-con competitors. • Conduct interview with government agencies suppliers, distributors and retailers. • Assess current strength and weaknesses of marketing sales organization.	• Develop high level scenarios in a top management workshop based on inputs of Phase 1 • Select 2 to 3 potential strategies to foster growth and profitability • Develop scenarios based on these strategies • Define assessment criteria for scenarios • Evaluate scenarios against criteria to select best option for LG • Diagnose Bejing situation and current activities of pilot team • Plan activities to be tested to improve sales execution • Launch test actions	• Detail implementation plan • Put in place resources to ensure proper execution • Transfer methodology and tools to LG management
End Products:	• Market analysis and forecasts • Competitor analysis • Opportunity scan • Identify areas of strategic development	• Marketing plan to develop brand positioning to the desired target segment • Sales and distribution models to sustain the marketing strategy • Tested improvement ideas ready for implementation	• Implementation roadmap detailing key activities and milestones • LG project team identified to execute the recommendations

ALL AGREED-UPON END PRODUCTS HAVE BEEN COMPLETED

Modules	Key end products	Status	Responsible person: Mckinsey	Responsible person: LGETA
Branding / Marketing Segmentation	• Brand positioning status and recommendations • Consumer group segmentation	✓ ✓	Heidi Hu	Mr.Kim Mr.Mao
Market Demand/Forecast	• Market demand forecast by region, product type and customer group	✓	Steve Chen (Johanna Hainz)	Mr.Hong Mr.Wang
Channel Evolution	• Channel mix diagnosis • Channel KBF and channel recommendations • High level channel prioritization	✓ ✓ ✓	Frank Wang (Heidi Hu)	Mr.Wang
Competitor Profile	• Basic information, financials, product portfolio and expansion plans • Overall strategy, especially sales and marking strategy, including branding,pricing, channel mix and incentives, after-sales service practice • Value chain cost analysis • Strengths and weaknesses and the implications	✓ ✓ ✓ ✓	Steve Shan (Johanna Hainz)	Mr.Oh Mr.Qi
LGETA marketing, Sales and service organization	• Current organization's strengths and weaknesses • Current processes and incentive systems strengths and weaknesses • High level recommendation of change options	✓ ✓ ✓	Johanna Hainz	Mr.Choi

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FORECAST MODEL APPROACH

Define approach

- Define desired end products and level of detail
- Define key drivers for air-conditioner demand
- Decide on basis of starting point and historical data set
- Decide on benchmark markets suitable for China reference

Build model structure

- Translate drivers into model structure
- Decide on key assumptions driving demand
- Select appropiate methodology
- Build correlation between penetration and income per capita
- Build model curve and deviations

Forecast

Iterations

- Run forecast iterations
  - -Total demand
  - -By product type
  - -By market type (1st tier vs. 2nd tier)

KEY ASSUMPTIONS (1/2)

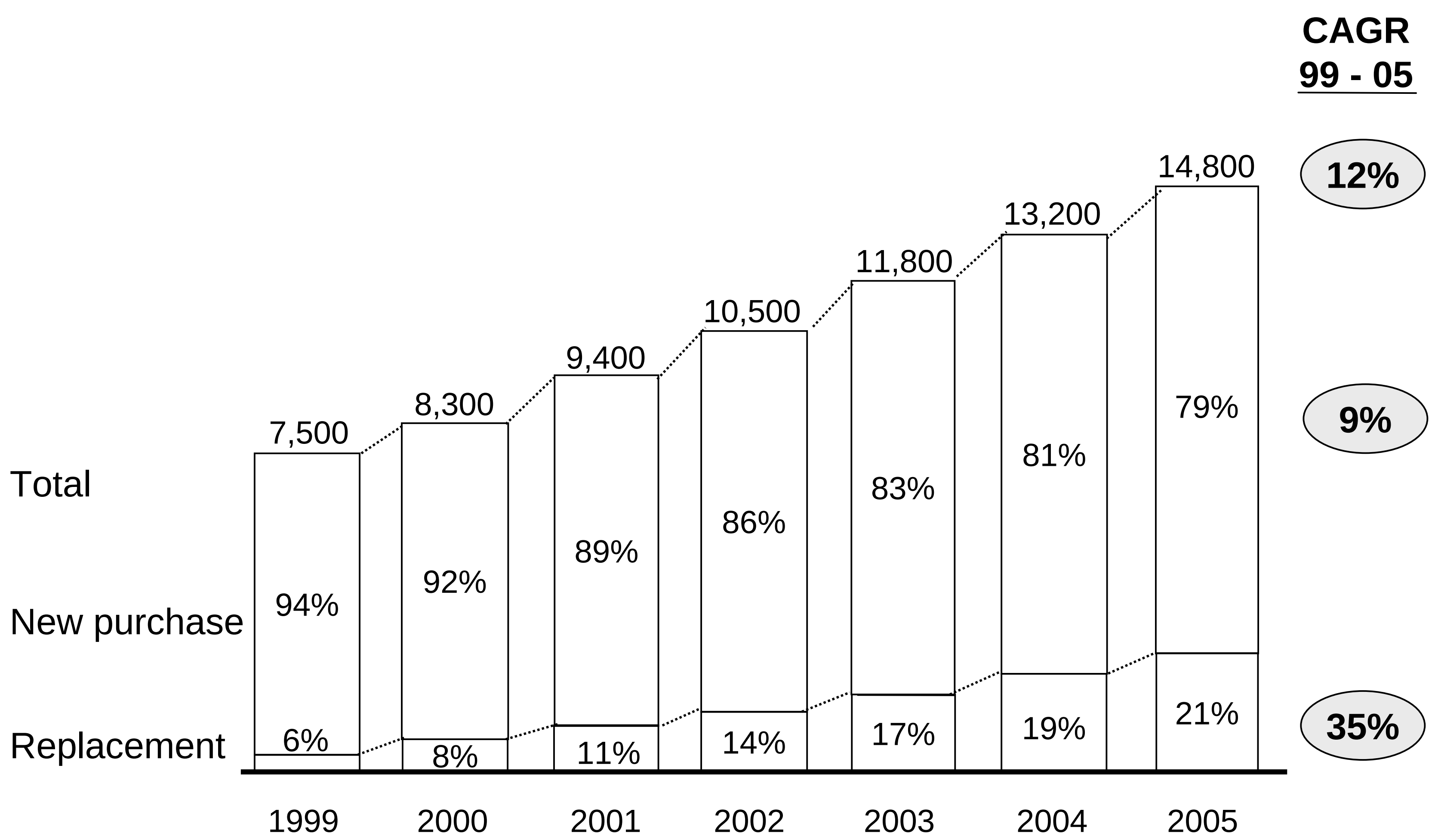
ITEM	ASSUMPTIONS	RATIONALE
Definition of regions	• First tier: Cities whose income per capita in 1999 was more than 9000 RMB per year, e.g., Shenzhen, Guangzhou, Shanghai, Beijing • Second tier: Cities whose income per capita in 1999 was between 5854 RMB (the national average income) and 9000 RMB per year, e.g., Wuhan, Jinan • Third tier: Cities and rural areas whose income per capita was less than 5854 RBM per year	Development grade per city compared to its income
Household growth rate	• Annual growth rate in urban areas from 2001-2005: 3.3% • Annual growth rate in rural areas from 2001-2005: 1.6%	Historical data
Household annual Income growth rate	• Compounded annual growth rate in urban areas from 2001-2005: 5.0% • Compounded annual growth rate in rural areas from 2001-2005: 4.5%	Historical data

KEY ASSUMPTIONS (2/2)

ITEM	ASSUMPTIONS	RATIONALE
Penetration rate of A/C	• 17% in urban area and 1% in rural area in 2000	Statistical yearbook
Average units per Household user	• Urban households: 1.2 units per household in 2000 and 1.3 units per household in 2005 • Rural households: 1.1 units per household in 2000 and 1.2 units per household in 2005	Benchmark from Taiwan: 1.7 units in 1996; Benchmark from Japan: 2.8 units In 2000 for urban households
Business users	• Business users captures 29% market share in urban areas and 40% in rural areas in 2000	Historical data
Demand of PAC	• Demand is driven by income increase and price decrease • The price of PAC decreases 10% per year until it hits the cost at 4000 RBM per unit • Household saturation at 30% of new product sales	Historical trend
Demand of WAC	• Share of WAC decrease from 17% to 12% market share in urban areas	Historical data
Demand of SAC	• The remaining share after WAC and PAC	

CHINA'S A/C MARKET WILL MAINTAIN ROBUST GROWTH IN VOLUME, AND NEW PURCHASE WILL REMAIN THE LARGEST SHARE OF DEMAND

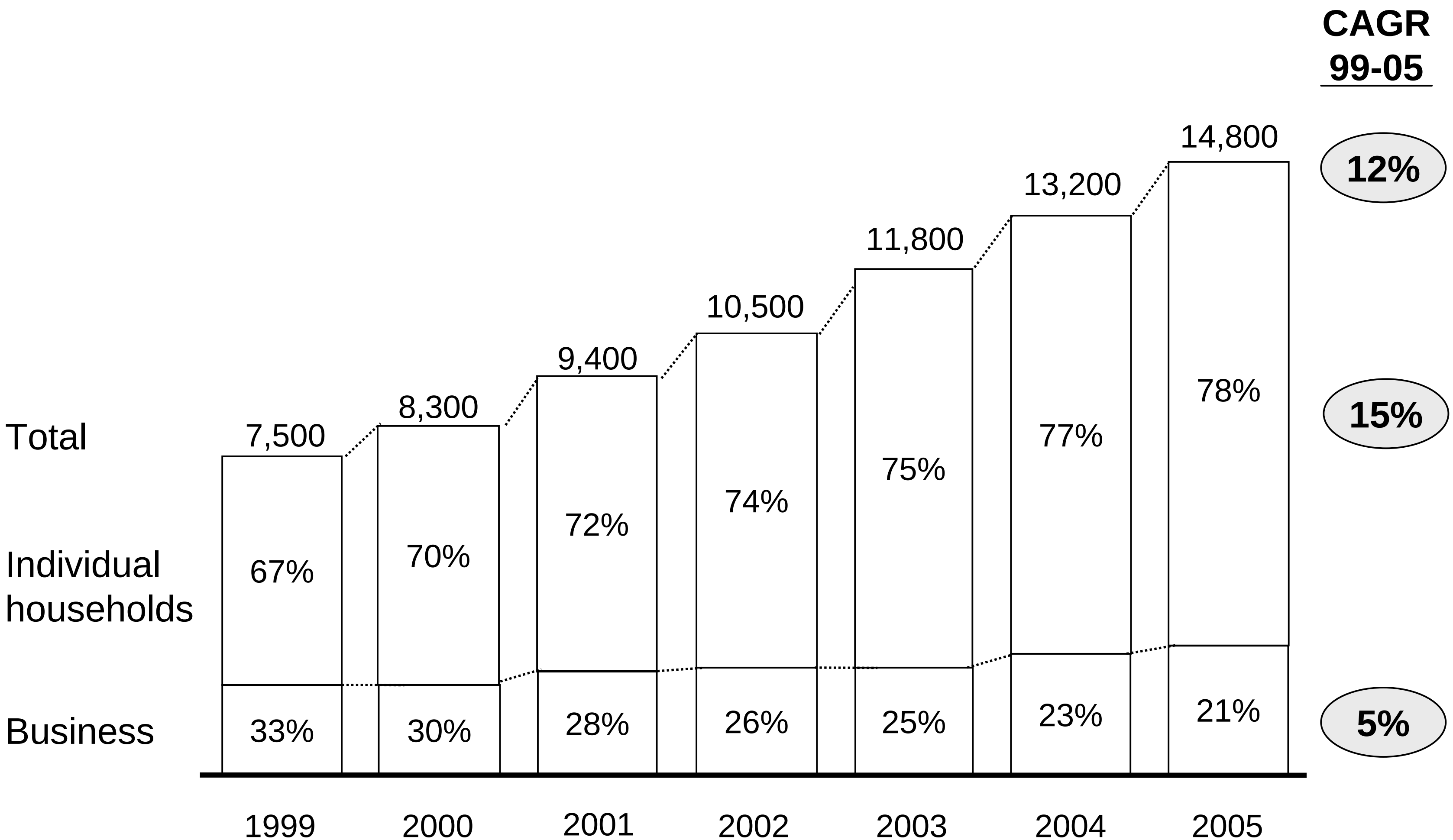
Thousand units; percent



Source: Mckinsey analysis

INDIVIDUAL CONSUMERS WILL CONTINUE TO ACCOUNT FOR THE MAJORITY OF DEMAND

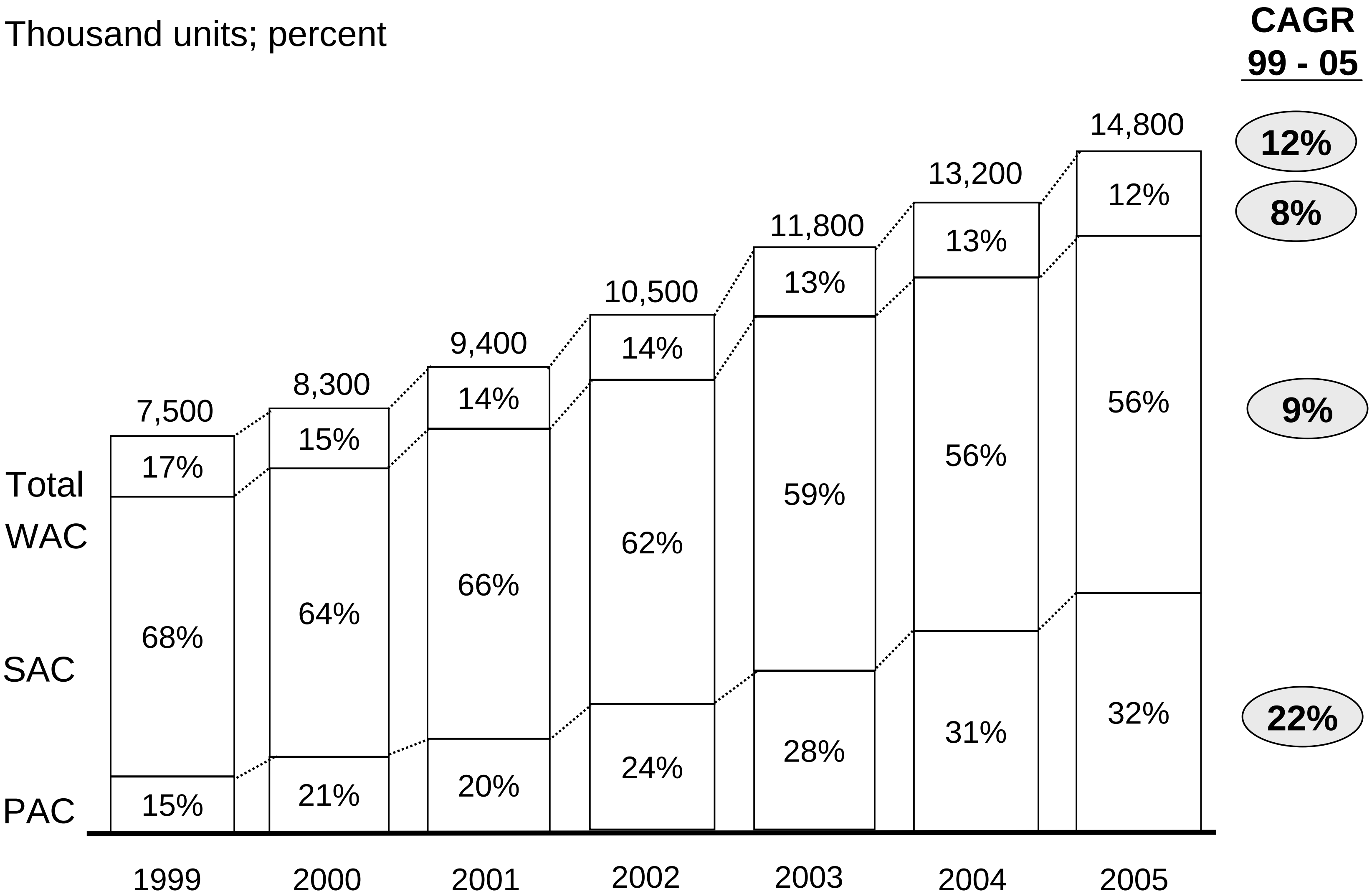
Thousand units; percent



Source: Mckinsey analysis

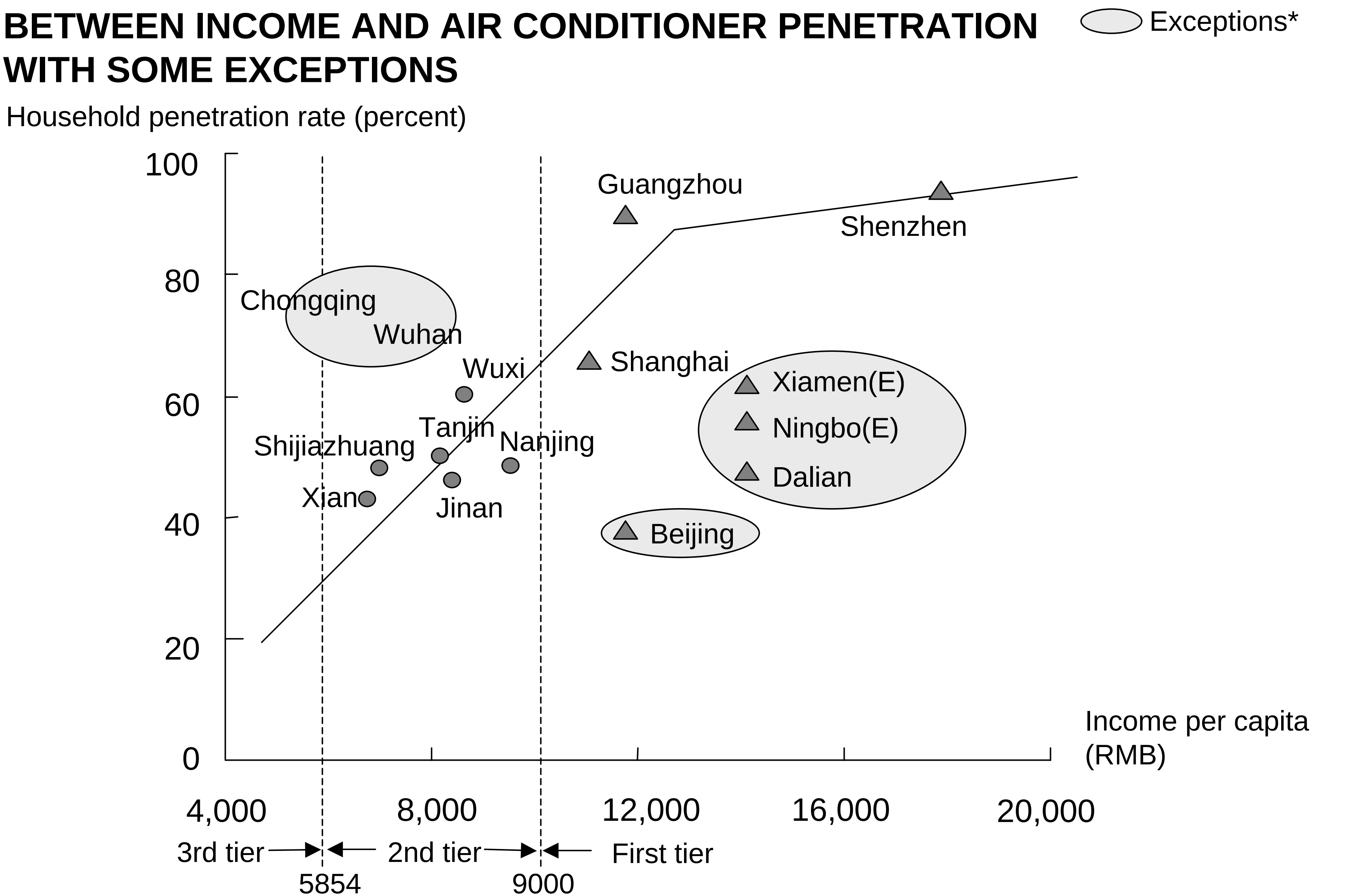
SAC WILL CONTINUE TO MAJOR SHARE IN AIR CONDITIONER MARKET BUT PAC WILL GROW SIGNIFICANTLY

Thousand units; percent



Source: Mckinsey analysis

REGIONAL ANALYSIS INDICATES STRONG CORRELATION BETWEEN INCOME AND AIR CONDITIONER PENETRATION WITH SOME EXCEPTIONS



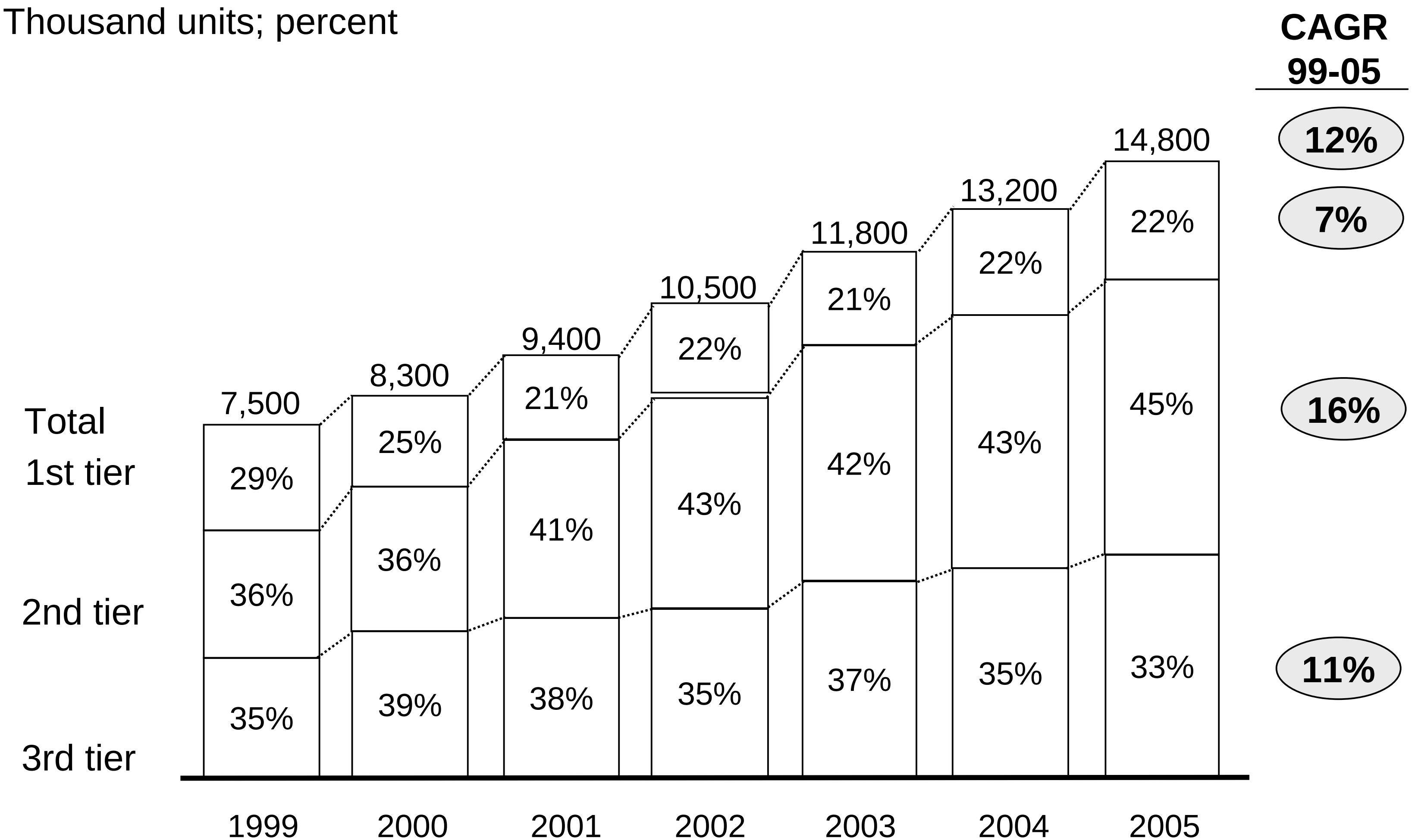
*Exception due to special regional weather conditions

Source: Mckinsey analysis

LG NEEDS TO IMPROVE ITS SALES IN THE LARGE AND FAST GROWING 2nd AND 3rd TIER REGIONS

ESTIMATE

Thousand units; percent



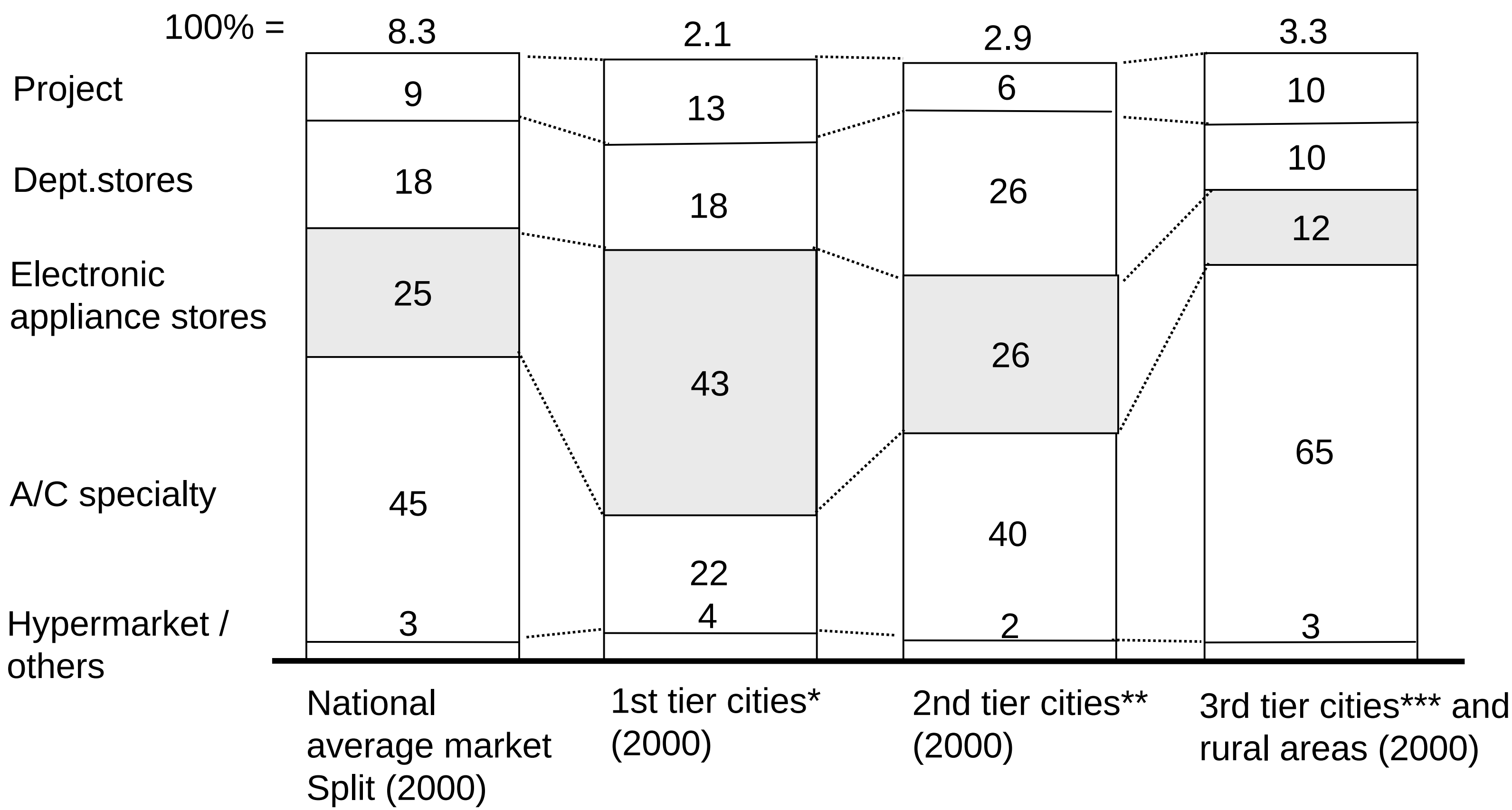
Source: Mckinsey analysis

A/C MANUFACTURERS NEED TO ADAPT THEIR SALES APPROACH TOWANDS THE RAPIDLY EVOLVING TRADE STRUCTURE

Key issues	Key challenges for manufacturers
• Large electronic appliance stores are going to replace A/C specialty stores and other traditional retail formats, especially in first and second tier cities, as main distribution format	• These formats are going to have different key buying factors and manufactures will need to adapt sales approach to ensure continued impact at retail level
• large electronic appliance chain stores like GuoMei and purchasing groups such as Suning are expected to grow sharply	• Manufacturers will have to establish key account management to serve them effectively, which could lead to direct sales connection over time
• Project sales account for significant portion of the market, but it is practically dominated by the top 5 manufacturers	• Manufacturers need to build strong project sales capabilities in order to serve this volume market profitably
• First tier, second tier and third tier cities have different distribution channel structure	• Manufacturers have to build tailored distribution models for each type of market

ELECTRONICS APPLIANCE STORES HAVE BECOME THE MAIN DISTRIBUTION CHANNEL IN FIRST MARKETS, WHILE A/C SPECIALTY STORES REMAIN THE MAIN CHANNEL IN 3rd TIER MARKETS

Millions



*Beijing, Shanghai, Guangzhou as representative cities
**Use Tianjin, Wuhan, Nanjing as representative cities
***Use Hebei as representative cities
Source: LGETA; Interviews with LG staff; Team analysis

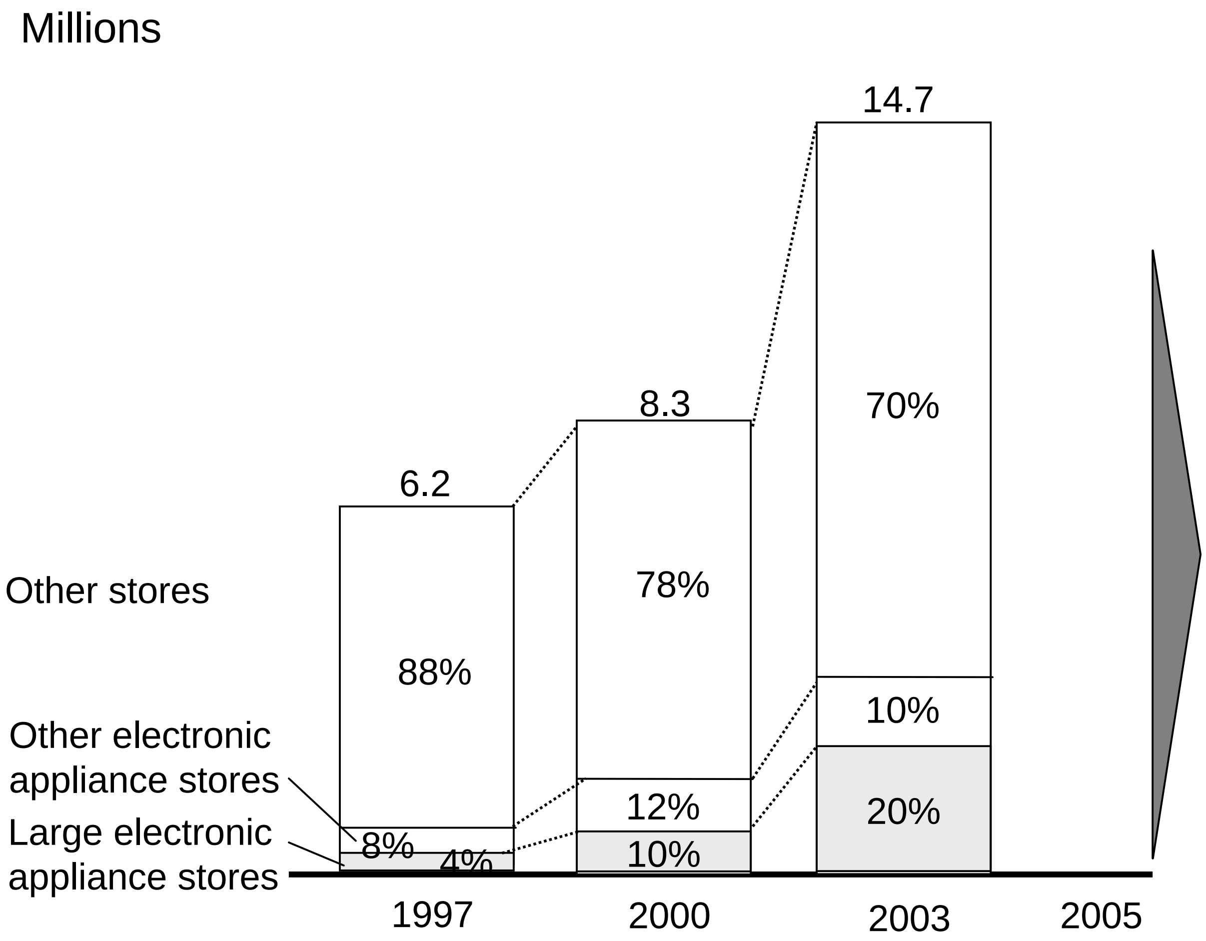
DIFFERENT FORMATS HAVE DIFFERENT KEY-BUYING FACTORS AND SERVICE LEVEL REQUIREMENTS

Format	Service requirements
Department store	• Strong brands • High quality product • Good service support • Promotional sales person and events • Requires same price as wholesaler and prefers to work with manufacturers
Electronic appliance store	• More rebate based on sales volume • Good quality product and service support • Promotional sales person and events • Requires same price as wholesaler and prefers to work with manufacturers directly
A/C specialty store	• Low price • High product quality and service support • On-time product delivery
Hypermarket	• Requires least service support • Needs to provide models for lower-end customers • Standard warranty is sufficient • Mainly window markets is requiring no delivery

Source: Consumer survey, team analysis

IN THE FUTURE, LARGE ELECTRONIC APPLIANCE STORE FORMAT IS LIKELY TO GROW IN MARKET SHARE AND WILL HAVE SIGNIFICANT IMPACT ON LG'S CHANNEL MANAGEMENT

ESTIMATE



Implications for LG

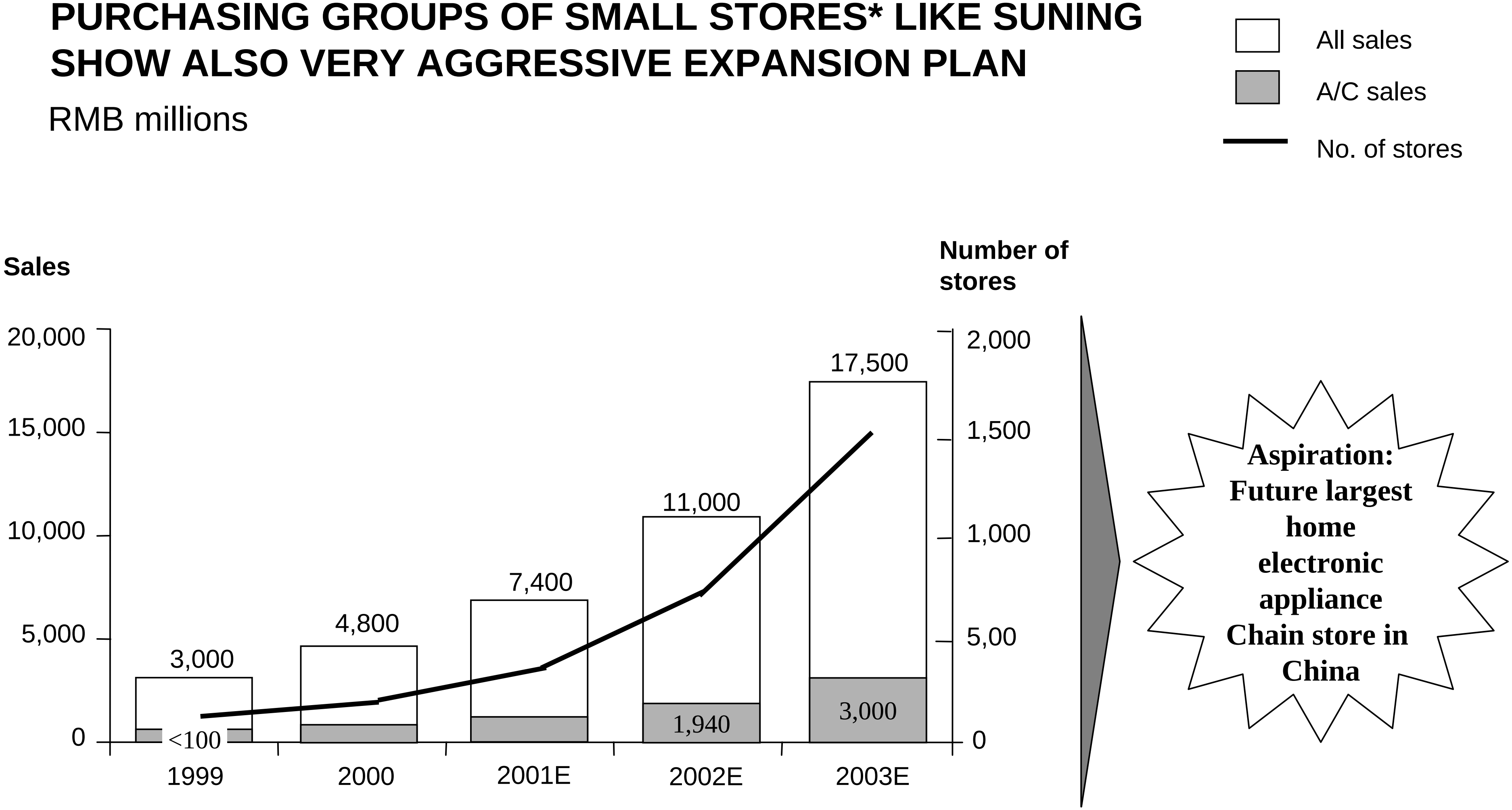
- LG needs to build Key Account Management (KAM)
- LG may over time, need to distribute to them directly by passing distributors
- LG needs to manage potential channel conflicts and impact on its pricing

*Include Guomei,Guotong, Suning, Sanlian, Shanghai BizCenter, and Yongle

Source: Interview, team analysis

PURCHASING GROUPS OF SMALL STORES* LIKE SUNING SHOW ALSO VERY AGGRESSIVE EXPANSION PLAN

RMB millions



* Purchasing groups defined as number of connected small stores, merging its purchase volumes to increase purchasing power for better discount, etc.

Source: Interview, team analysis

NUMBER OF HYPERMARKETS WILL DOUBLE IN 2005, LED BY RAPID EXPANSION OF INTERNATIONAL CHAINS

Hypermarket	Number of Stores (1999)	Expansion plan (new stores/year)	Number of Stores (2005)
Carrefour	23	5-7	53-56
Wal-mart	6	1-2	12-18
Lotus	4	3-4	22-28
Metro*	6*	N/A	6
Auchan	1	N/A	1
Makro	4	N/A	4
Others**	~6	N/A	~6
Total	**~50**		**104-128**

* Cash and Carry
**Trust Mart, Vanguard and others

Source: Literature search

PROJECT-BASED GROUP SELLING ACCOUNTS FOR A SIGNIFICANT PORTION OF SALES BUT LG CURRENTILY DOESN’T SERVE THIS MARKET WELL

A/C makers	**Project based group A/C sales** Percent
Gree	20
Kelon	20
Chunlan	20
Haier	15-20
Midea	15
Matsushita	2
LG	5

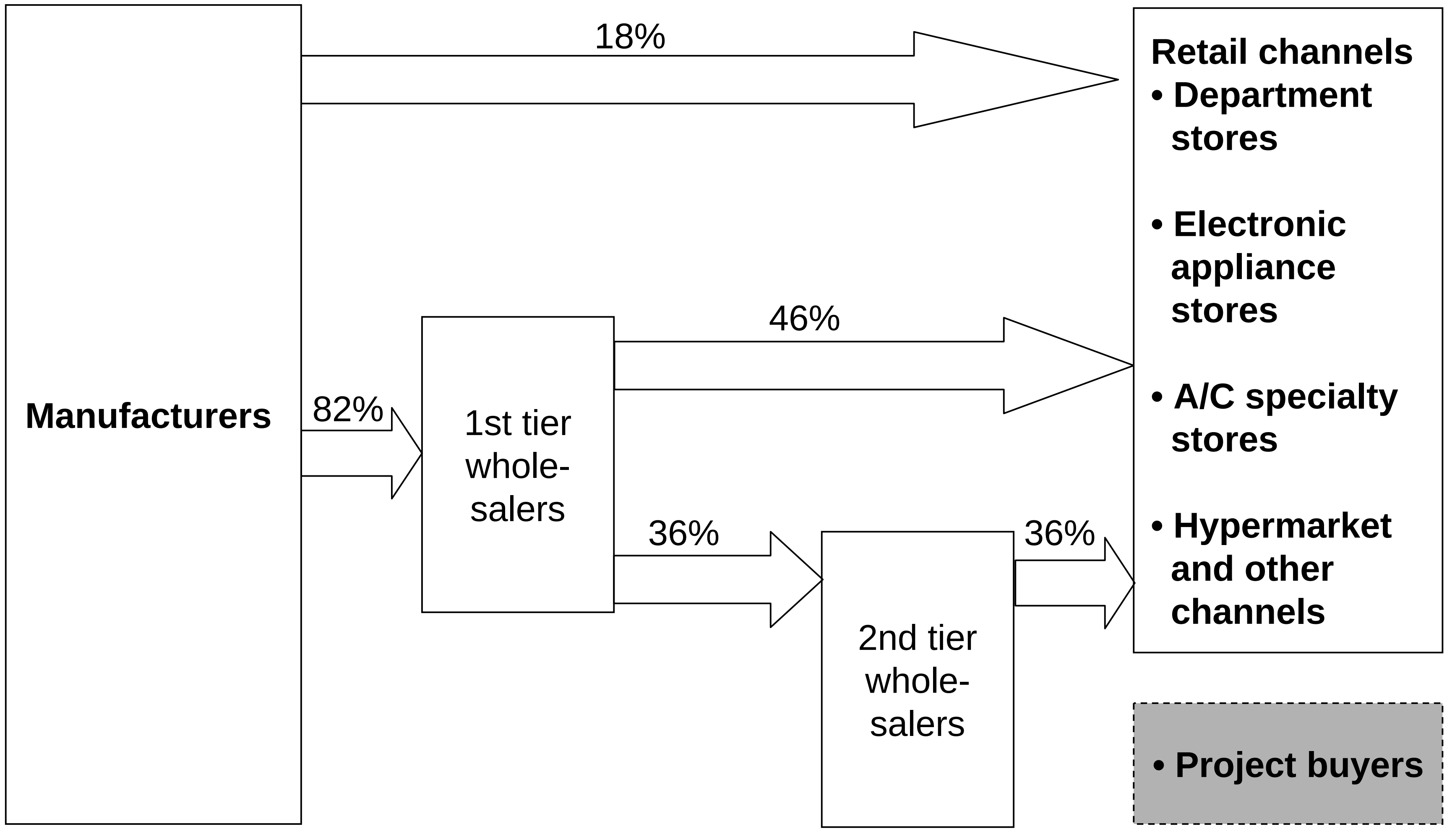
- Project-based group selling counts for about 9% of A/C sales nationally
- Group buyers tend to interact with A/C makers directly for A/C purchases
- Most major A/C makers have dedicated department handling project-based businesses
- Top 5 dominate project-based group sales

Open question: What is the profitability potential of group sales?

Source: LGETA previous qualitative………..

THE OVERALL DISTRIBUTOR MODEL IS STILL THE MOST COMMON CHANNEL OF DISTRIBUTION FOR MANUFACTURES

ESTIMATE



Source: Field interviews, team analysis

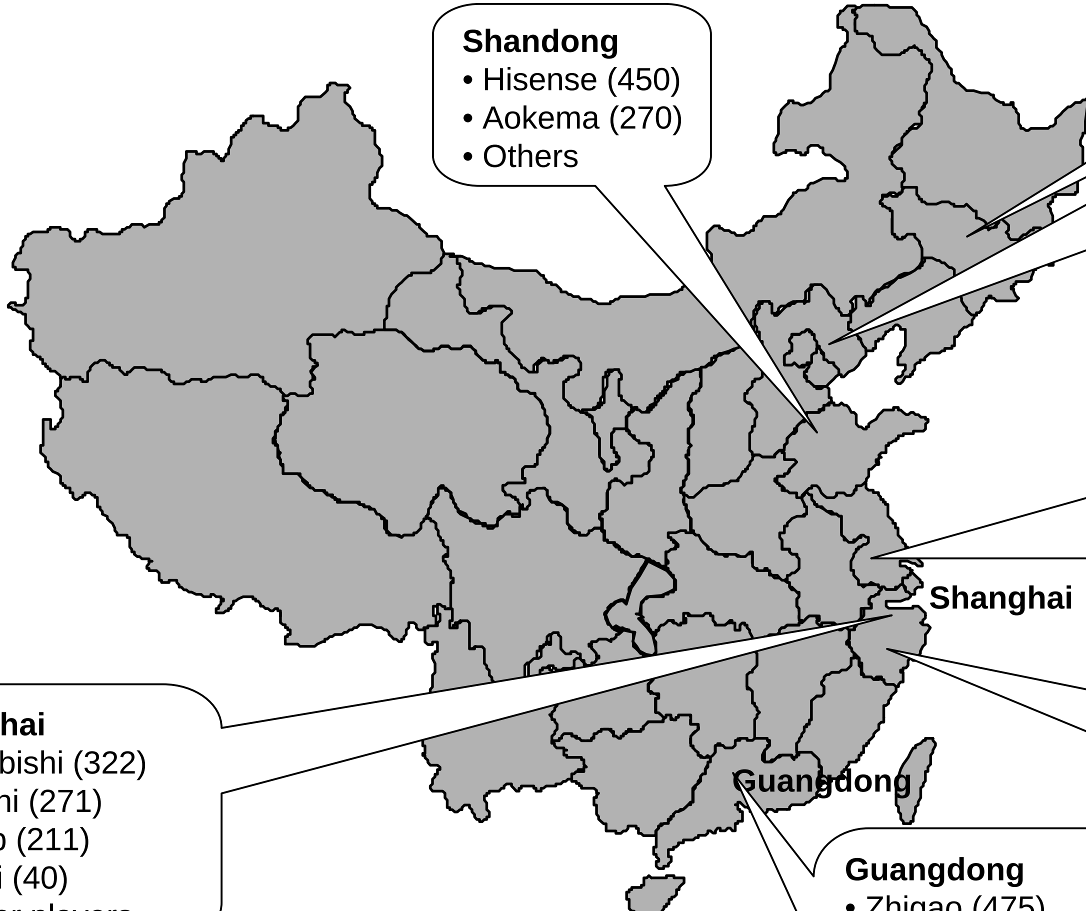
THERE ARE SOME SIGNIFICANT RISKS ON PROFITIBALITY AND PRICE DEVELOPMENT IN THE MARKET WHICH MIGHT LEAD TO INDUSTRY CONSOLIDATION

- Capacity exceeds actual demand by more than 100% which exarbates the danger of price war
- Major players have low profitability and further price reductions will create major losses in the industry
- Small regional players will prices low particularly in the low end segment unless local government take actions to force closures

Industry consolidation is likely to happen

DESPITE MAJOR PLAYERS TAKING 80% OF TOTAL MARKET SHARE, THE MARKET IS STILL REGIONALLY FRAGMENTED

Location and sales of sample players of more than 50 A/C manufacturers in China



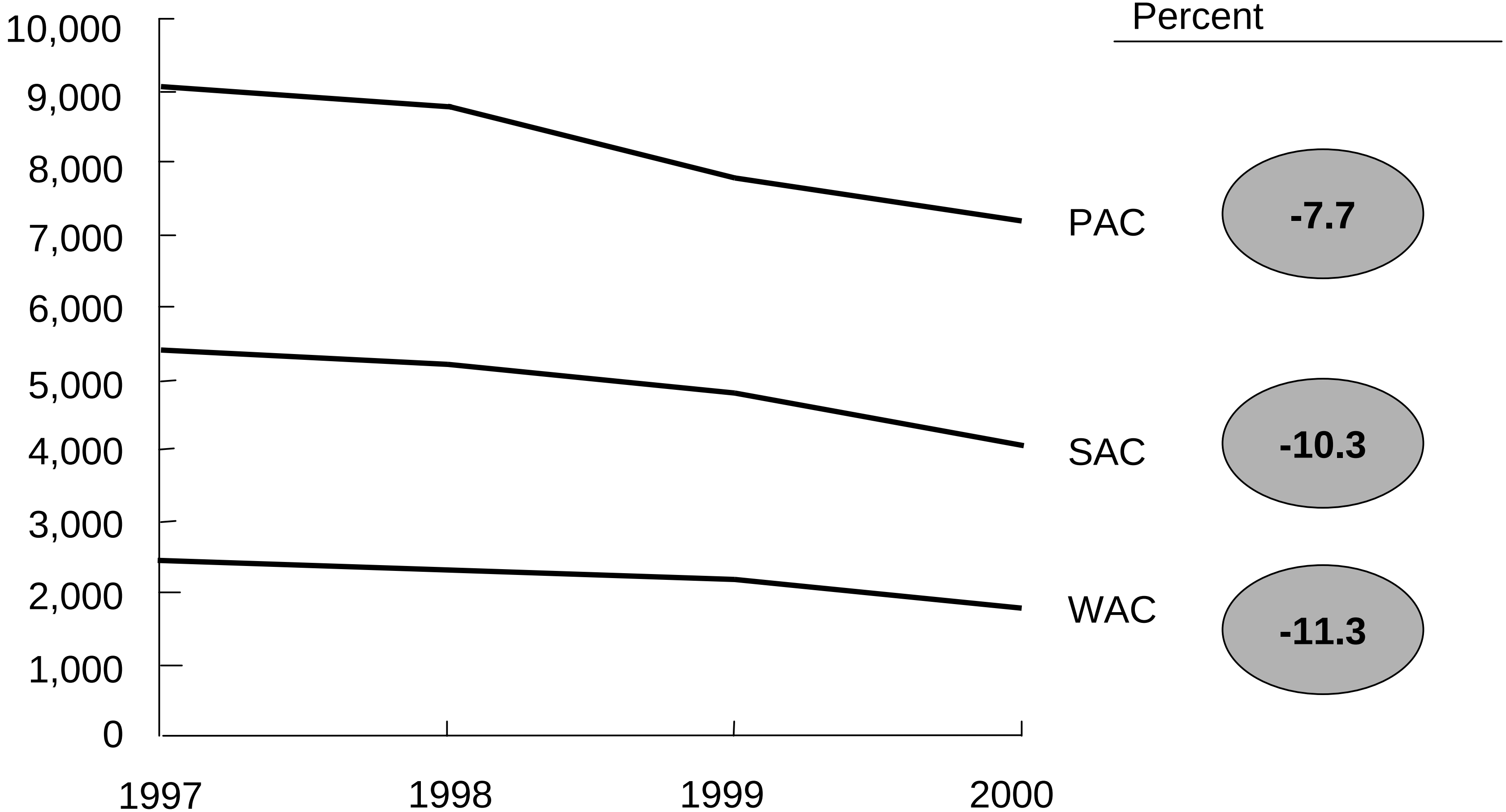
* ( ) is the sales volume in 2000, unit: 000 set

Source: LGETA

PRICES FOR ALL PRODUCT SEGMENTS HAVE BEEN DECLINING SIGNIFICANTLY OVER THE PAST YEARS

RMB

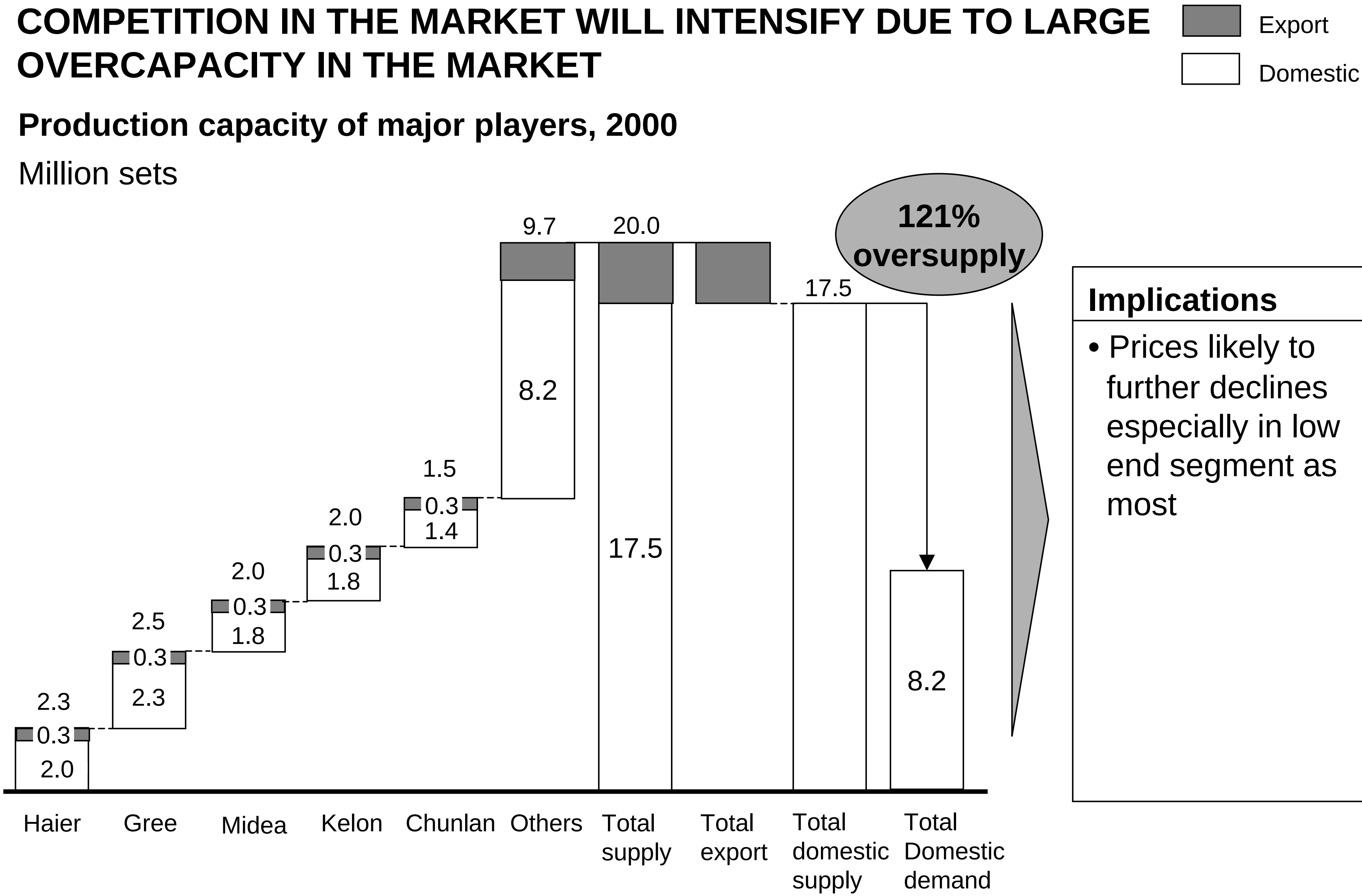
Average price drop per product type
Percent



COMPETITION IN THE MARKET WILL INTENSIFY DUE TO LARGE OVERCAPACITY IN THE MARKET

Production capacity of major players, 2000

Million sets



Implications

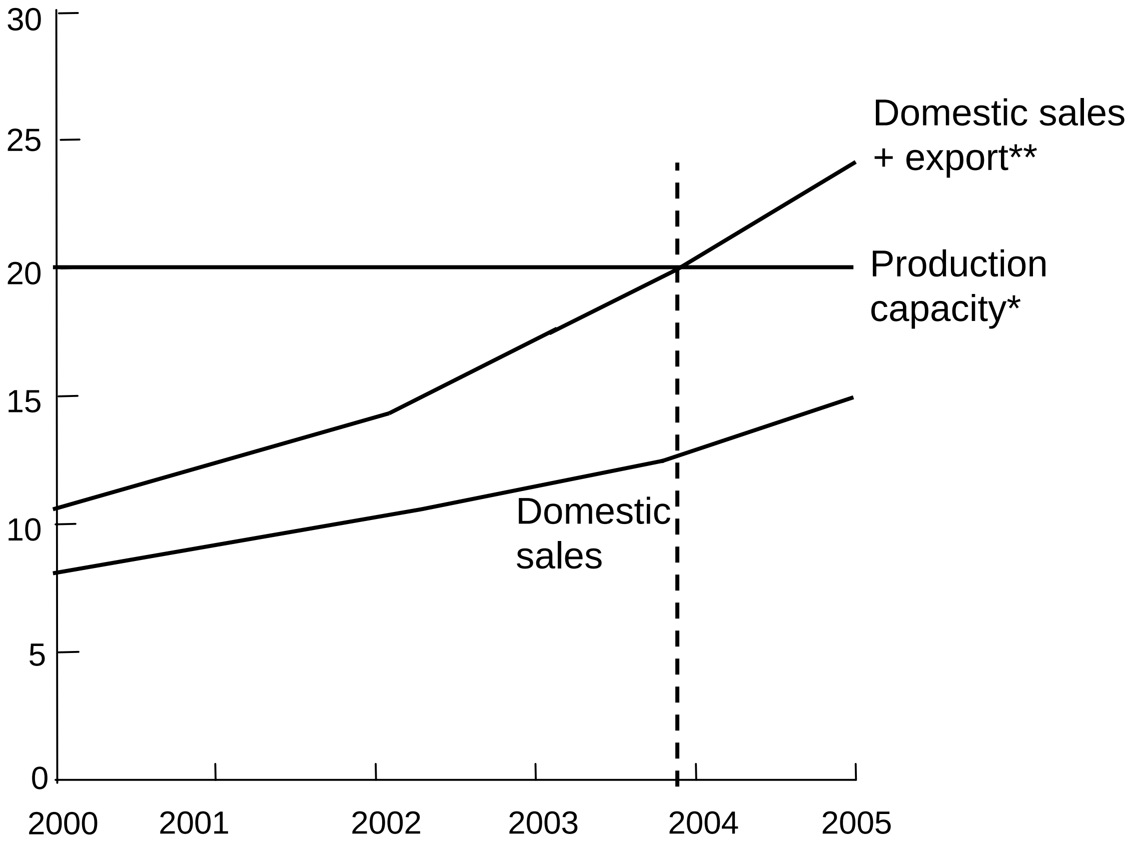
- Prices likely to further declines especially in low end segment as most

Source: Field interview; SMR report; ABI; China Home Electric Appliances Association; Literature search; Mckinsey analysis

CURRENT PRODUCTION CAPABILITY WOULD NOT BE FULLY UTILIZED UNTIL 2004

Million units

Production capacity



Implication for LG

- Price will remain depressed, due to large over-capacity of small players
- Industry profitability will remain low, unless local governments take actions to force closures of unprofitable A/C manufacturers

* Assumed that capacity stays fixed;
**Assumed that export growth rate stays fixed

Source: Team analysis

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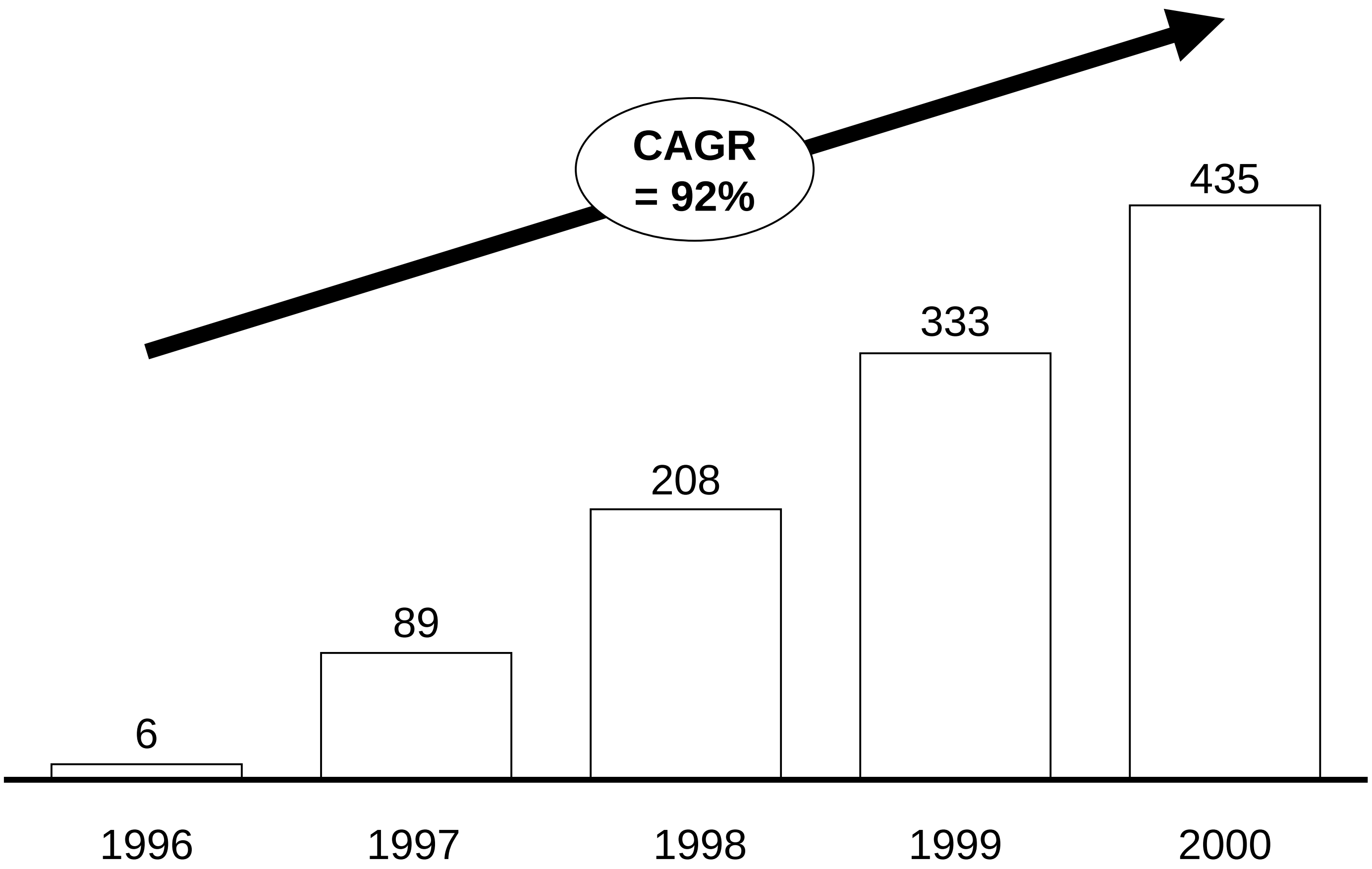
DESPITE SUBSTANTIAL GROWTH LG HAS STILL MANY OPPORTUNITIES INCLUDE FOR IMPROVEMENT

	Achievements	Gaps
Market	• High growth achieved over last 5 years • Significant market share in core markets, first tier/second tier cities	• LG is virtually not present in tier markets, which account for 40% of total market in Y2000
Product	• Strong product features • High quality level perceived from users • Strong position in PAC air conditioner segment	
Customers	• Successfully captured “quality assured technophile” segment especially in first tier/second tier cities	• Current customer portfolio limited to technophiles which leaves 65% of customer base untouched
Brand / marketing		• General low brand recognition • Trust worthiness not perceived by customers as part of G’s brand image • Misallocation of marketing spending mix
Coverage	• Relatively high coverage in large electronic appliance stores in first and second tier cities	• Relatively low coverage in small stores • Relatively low unit sales per store compared to competitors
Sales execution	• Relatively high market share in Beijing, Tianjin due to strong support from Tianjin factor	• Sales execution poor especially key markets in the South
After sales service		• After sales service perceived as poor by traders and consumers • Operational problems on service like low service quality control, lack of parts, slow processes
Organization		• Complicated decision-making processes due to separated organizations for sales and services

LG'S AIR CONDITIONER BUSINESS HAS ACHIEVED HIGH GROWTH OVER PAST 5 YEARS

Domestic sales

Thousand sets

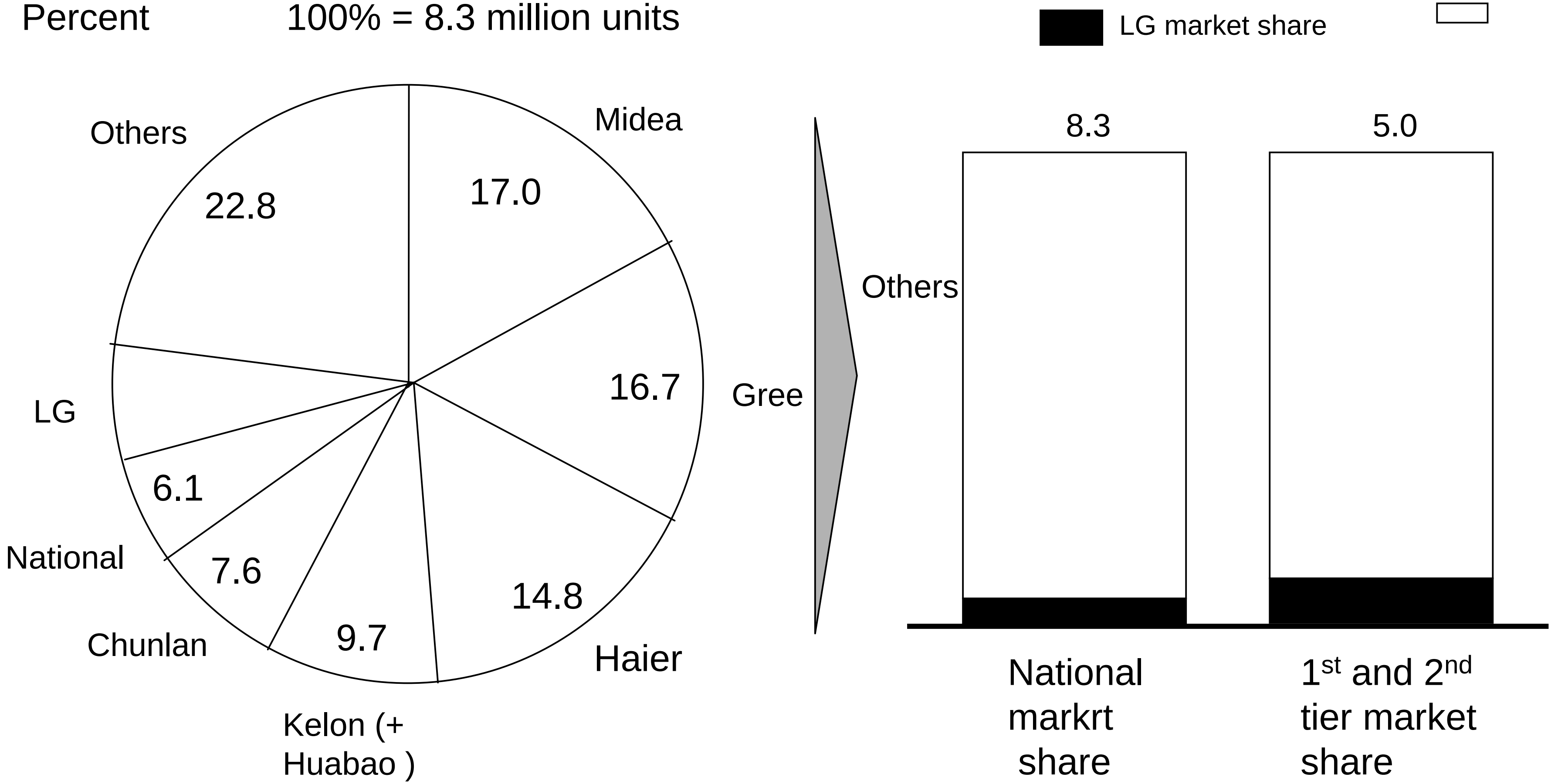


Source: LGETA A/C business

LG HAS CAPTURED ALREADY 5% OF THE OVERALL MARKET AND REACHES 9% IN 1ST TIER AND 2nd TIER CITIES

China A/C market share by brand

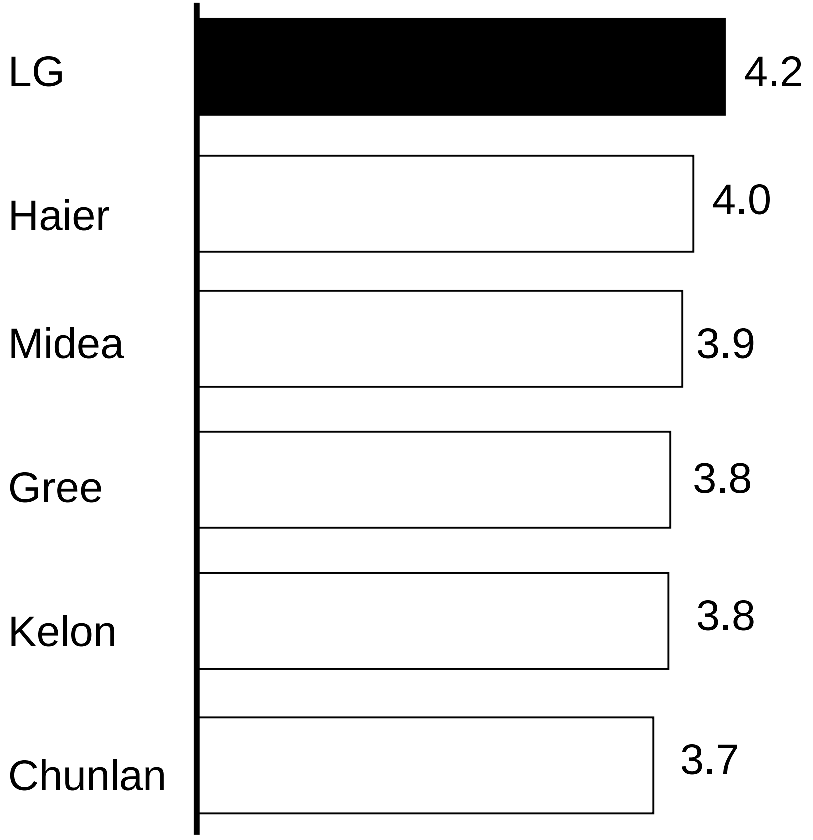
Percent 100% = 8.3 million units



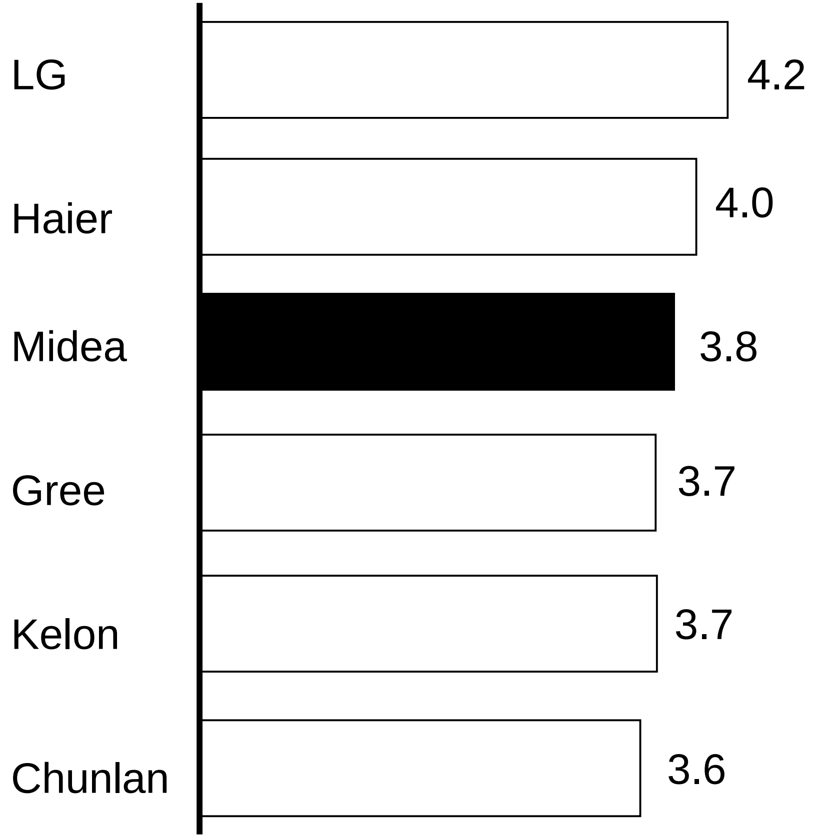
Source: Air conditioner Business Information, 2000 (ABI); China Home Electric Appliances Association

LG OWNER'S ACTUAL EXPERIENCE TOWARDS LG'S PRODUCT FEATURES IS QUITE PROMISING

Actual owners' experience on A/C makers' product features (multi-function), 5-point scale



General public's perceptions on A/C Makers' product features (multi-Function), 5-point scale

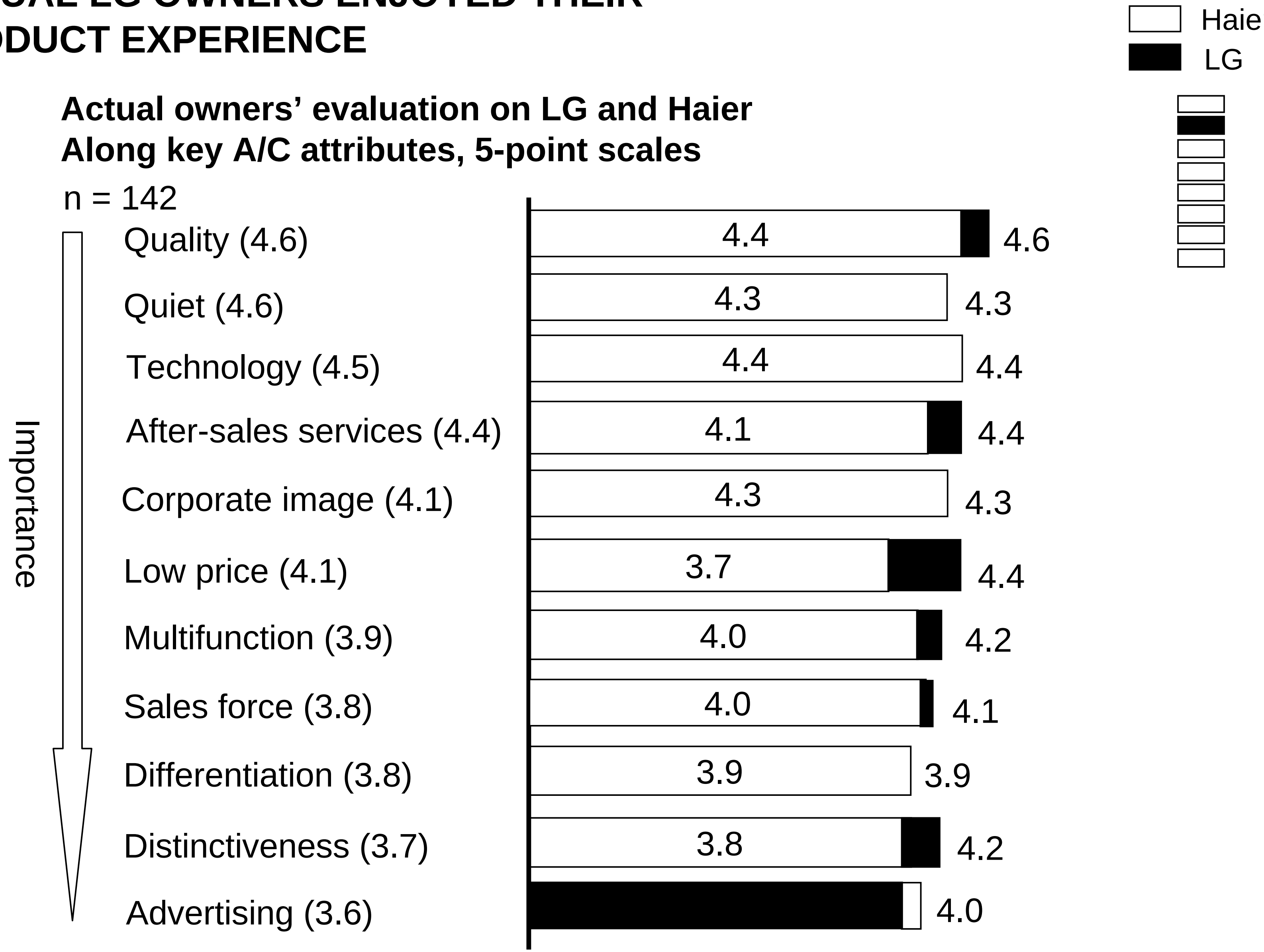


Source: LGETA A/C Market survey – A/C owners, 2000

ACTUAL LG OWNERS ENJOYED THEIR PRODUCT EXPERIENCE

Actual owners' evaluation on LG and Haier
Along key A/C attributes, 5-point scales

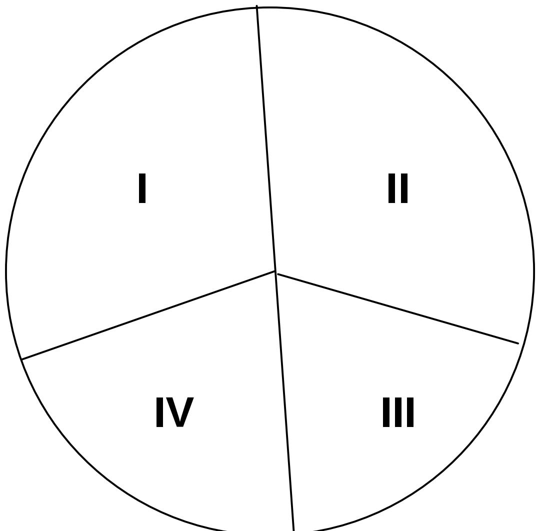
n = 142



Source: LGETA A/C Market survey – A/C owners, 2000

AMONG INDIVIDUAL CONSUMERS, THERE ARE FOUR DISTINCTIVE CONSUMER SEGMENTS

100% = 465 A/C owners



I. Quality assured technophile (34%)
- Care the most of product quality and the technology used
- Relatively high average A/C purchase spending

II. Worry-freer (32%)
- Emphasis both quality and service to ensure worry-free A/C consumption
- Care about brand
- Relatively high A/C purchase spending

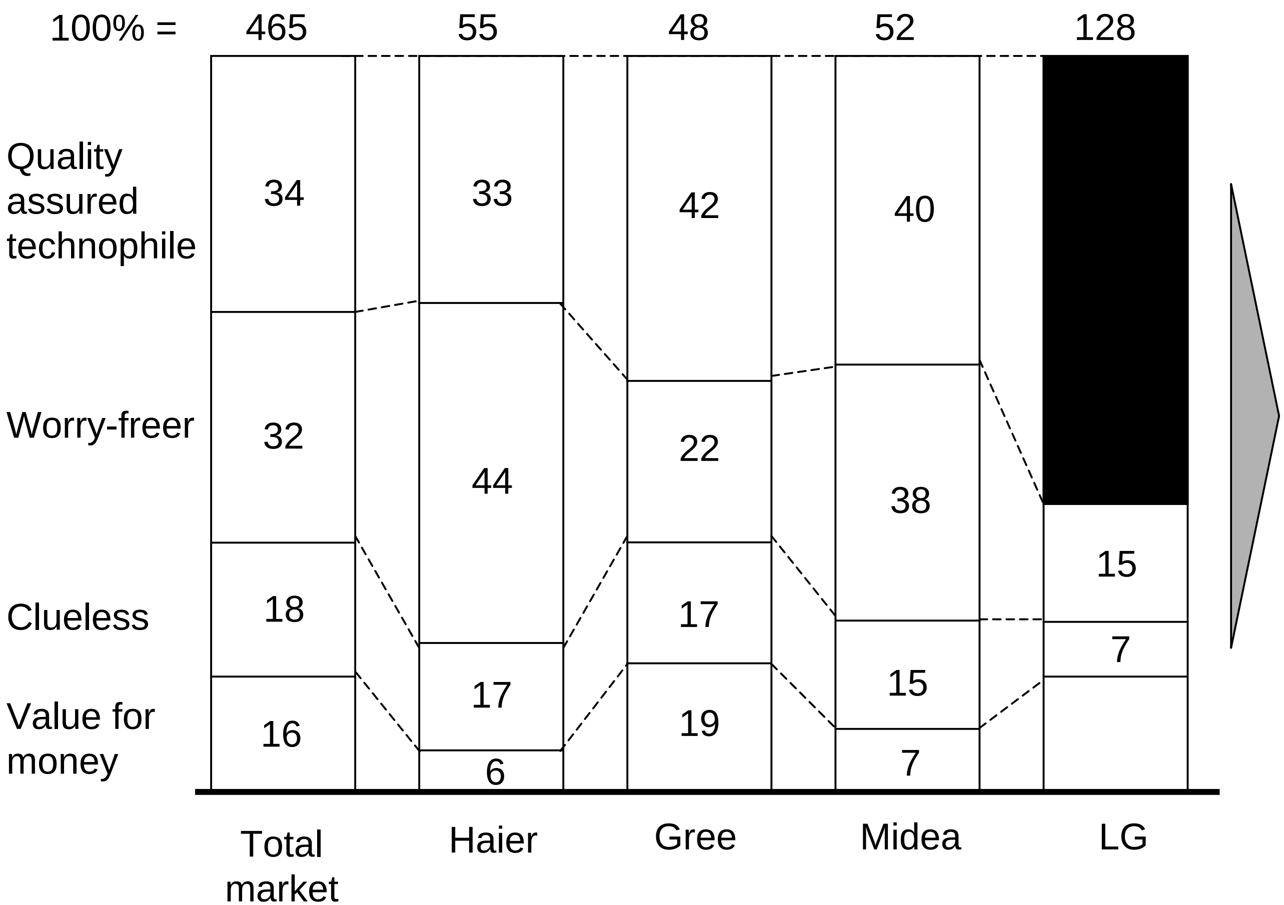
III. Clueless (18%)
- Preference equally distributed, immature A/C consumers
- Unable to identify their most important needs
- Relatively low average A/C purchase spending

IV. Value for money (16%)
- Require product quality and at the same time emphasize on lower price
- Relatively low A/C purchase spending

Source: LGETA A/C Market survey – A/C owners, 2000

LG HAS SUCCESSFULLY CAPTURED "QUALITY ASSURED TECHNOFILE" SEGMENT BUT SHOULD PAY MORE ATTENTION TO PENETRATE THE "WORRY-FREER" SEGMENT

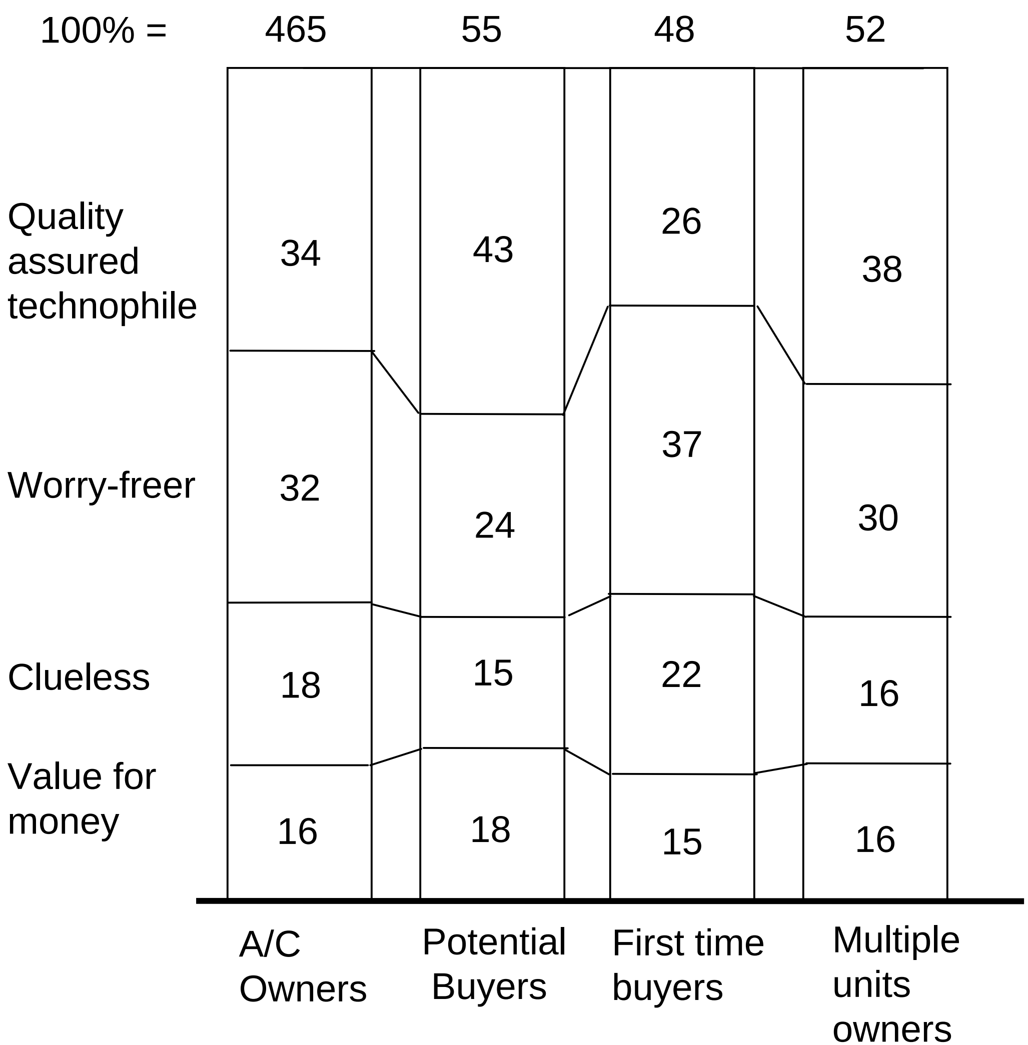
N = 465 A/C owners; Percent



- LG A/C has done a good job in attracting quality assured technophiles consumers
- However, LG needs to strengthen its brand perception among worry-freer segment in quality and service in order to reach this segment

Source: LGETA A/C Market survey – A/C owners, 2000

QUALITY ASSURED TECHNOPHILE AND VALUE FOR MONEY SEGMENTS ARE LIKELY TO GROW



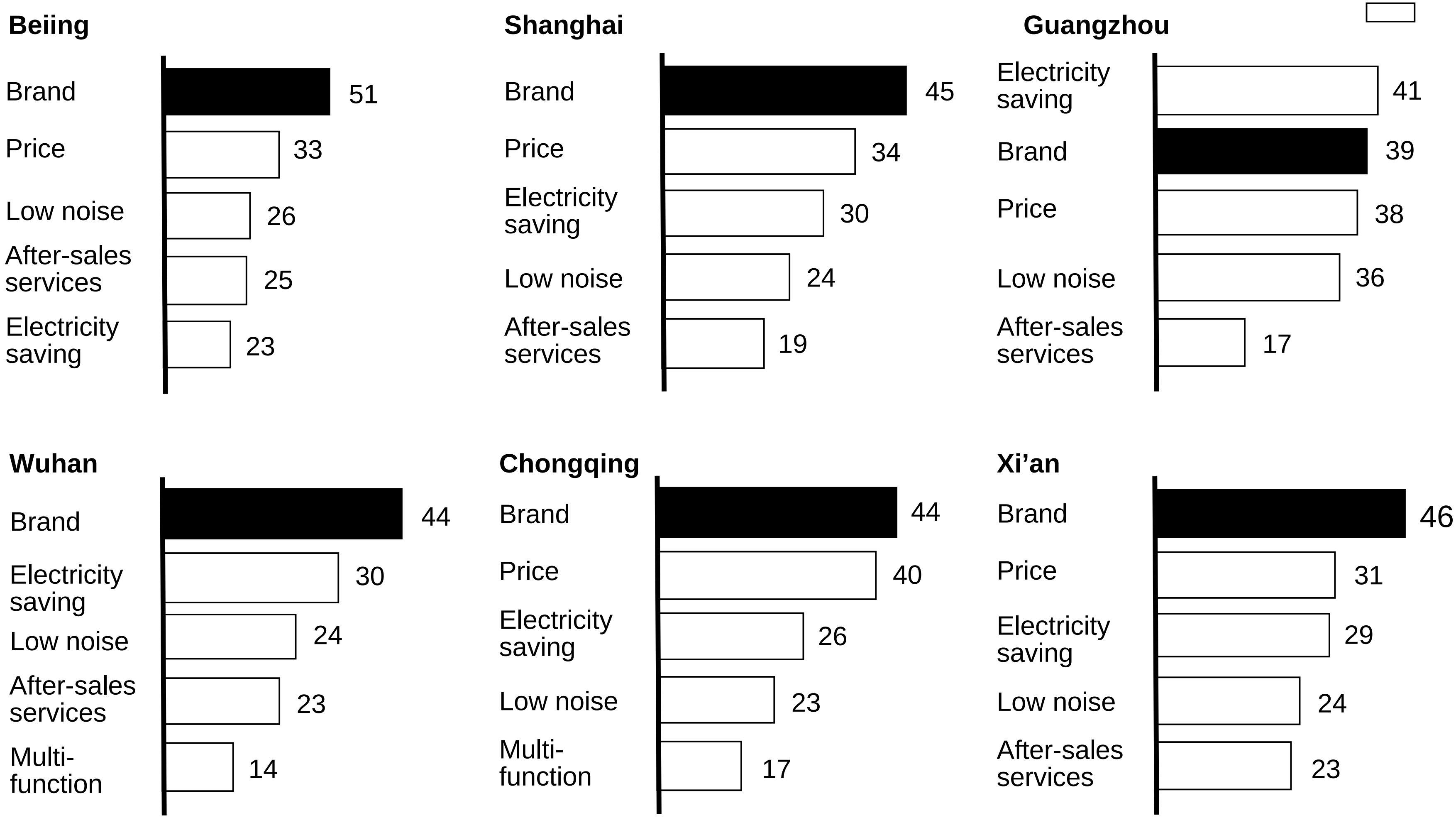
- Quality is becoming more and more important for future A/C purchase
- With quality for services is requirement for services is getting less demanding, however, worry-freer remains to be an important segment
- Future A/C purchasers may be more knowledgeable, and value for money segment is likely to grow for non A/C owners

Source: LGETA A/C Market survey – A/C owners and non-owners, 2000

BRAND IS ONE OF THE MOST IMPORTANT FACTORS THAT INFLUENCES CONSUMERS' A/C PURCHASE DECISION-MAKING

Factors mentioned as KBFs

Pervent

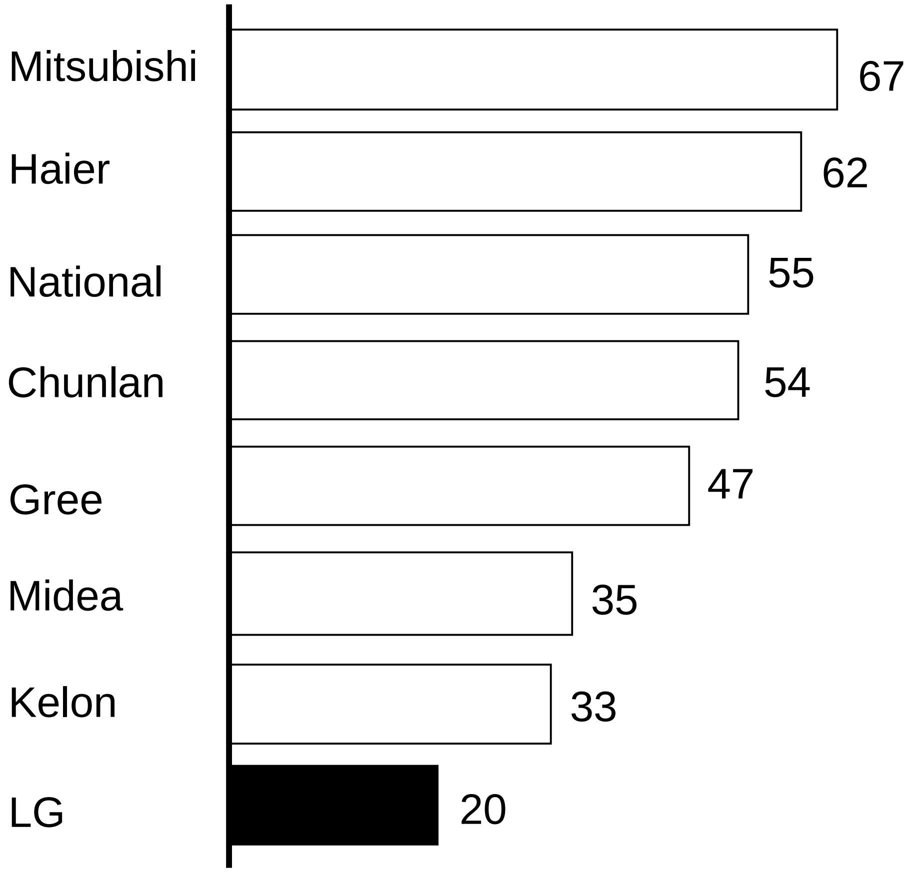


Source: LGETA A/C Market survey – A/C owners, 2000

HOWEVER, LG A/C DOES NOT WIN CONSUMERS BY ITS BRAND

BEIJING DATA*

Percentage of brand mentioned as KBFs by purchasers of certain brands
Percent



LG A/C's brand is not only weaker than other foreign brands, but also weaker than most leading Chinese brands

* In IMI sampled cities, only Beijing has relatively large number of LG owners for statistcally signfican analysis

Source: IMI Consumer Behaviors and Life Patterns Yearbook, 2000

A/C BRAND IS MAINLY ABOUT QUALITY AND TRUSTWORTHY IN CHINA AS INDICATED BY BOTH QUALITATIVE AND QUANTITATIVE RESEARCH

"To me, good brand means quality and reputations"

"If quality is no good, don't mention the brand to me"

"I think that good brand should have good quality and good after-sales services"

"You have to have sufficient consumer awareness and reputation in order to claim yourself as a good brand"

"The product reliability from my actual usage experience forming my perception of a brand"

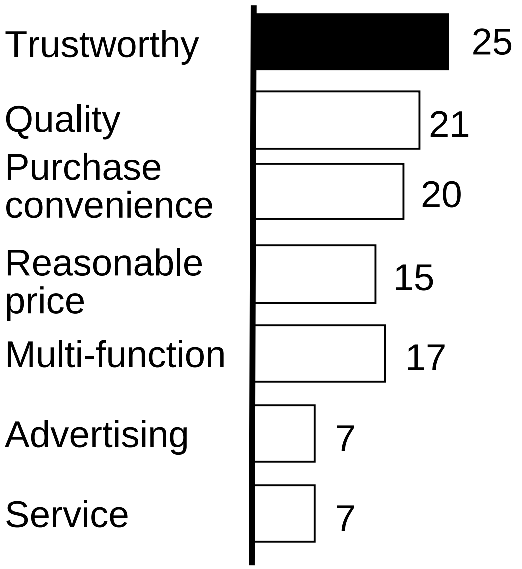
"Brand is very important to me, because it equals to reputation"

"I prefer Japanese brand, as I believe that Japanese products have better quality"

- Quotes from A/C owners focus group interviews

Percentage of A/C KBFs mentioned when brand is not included; Percent

N = 465, LGETA A/C market survey



Source: LGETA A/C market survey – A/C owners, 2000; LGETA A/C focus group interviews, 2001

LG A/C'S USER EXPERIENCE IS MUCH BETTER THAN GENERAL CONSUMERS' PERCEPTION TOWORDS LG A/C

"I think foreign brands are relatively better. My kid bought a LG computer, and it's good. She say that LG A/C is good, too."

"Comparing with Haier, I bought LG. There were lots of LG ads and LG quality is good."

"I first noticed LG's design when bought it. It looks good, not much different from Panasonic."

"I have first-hand experience, I'll buy LG again in the future. I know its features and its quality, I'll only buy this brand."

"LG has pretty good quality. My LG A/C never broke down, I don't know if LG has any weaknesses."

- Quotes from A/C owners from focus group interviews

"In my opinion, LG is not as good as domestic ones, it's not as good as Haier."

"I perceive LG inferior to domestic ones. Korea's economy is not good these years. Daewoo want bankrupt. I think Haier is better."

"I always feel that Korean electronics are similar to Chinese ones, less competitive to Japanese ones."

"LG is different from Haier, it does not have high-tech concept, as Haier does."

"I don't think that LG is good at electronics, I feel that Korea is good at hand crafting."

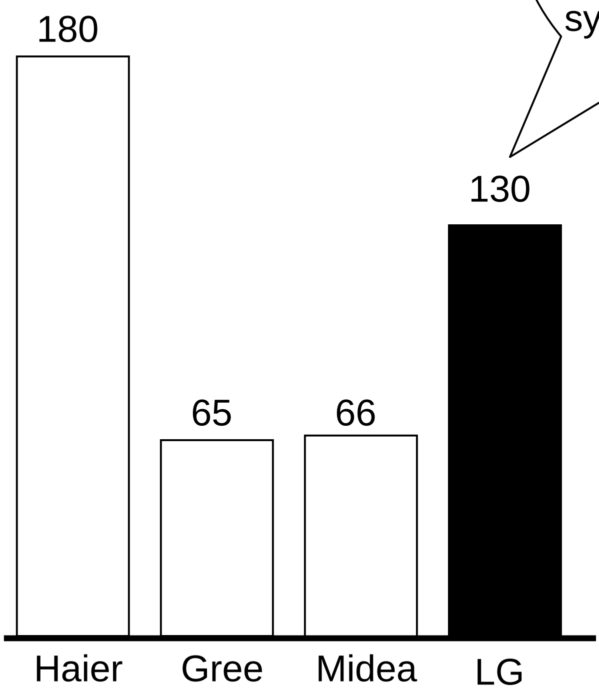
"I am surprised that you told me LG is a Fortune 500 company, and has the largest A/C sales in the world. You got to show me the evidences."

-Quotes from non LG owners from focus group interviews

Source: LGETA A/C owners focus group interviews, 2001

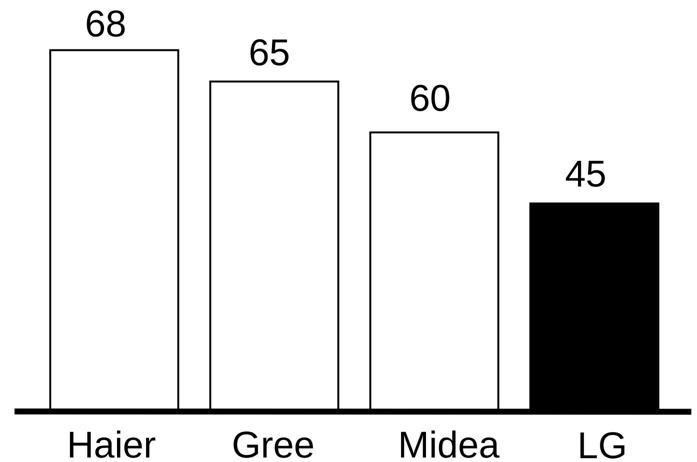
LG HAS MADE SIGNIFICANT INVESTMENT ON ADVERTISING

Total advertising spending at corporate level, 2000
RMB millions

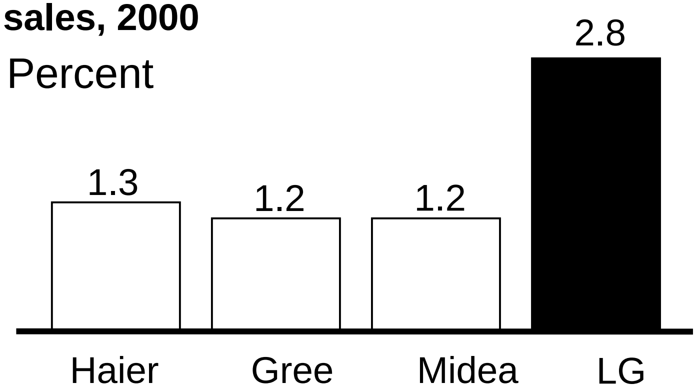


LGE's ads spending has been divided into different product lines, with little corporate level synergy

Total A/C advertising spending 2000
RMB millions



A/C ads spending as percentage of A/C sales, 2000
Percent



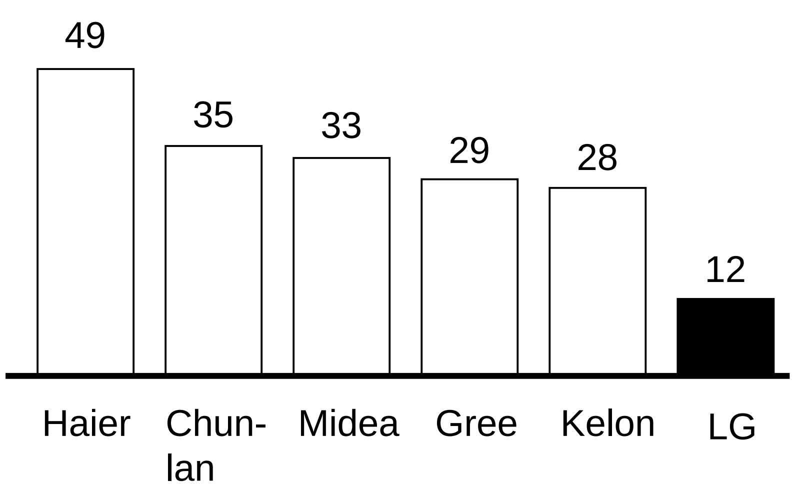
Source: Ac Nielsen Media Audit; A/C Commercial Information Annual Report

HOWEVER, LG HAS SIGNIFICANT GAPS IN CONSUMER AWARENESS ACROSS THE COUNTRY

Regional market leaders
LG

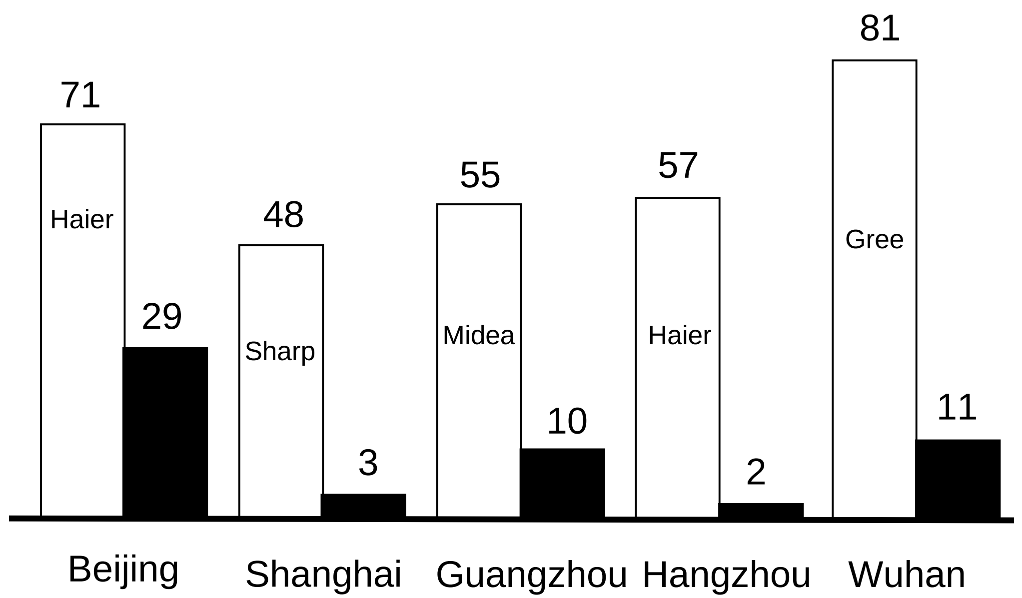
Percentage of unaided awareness for LG and the other top 5 A/C makers

N = 705
Percent



Percentage of unaided awareness for LG and regional market leaders

N = 705
Percent

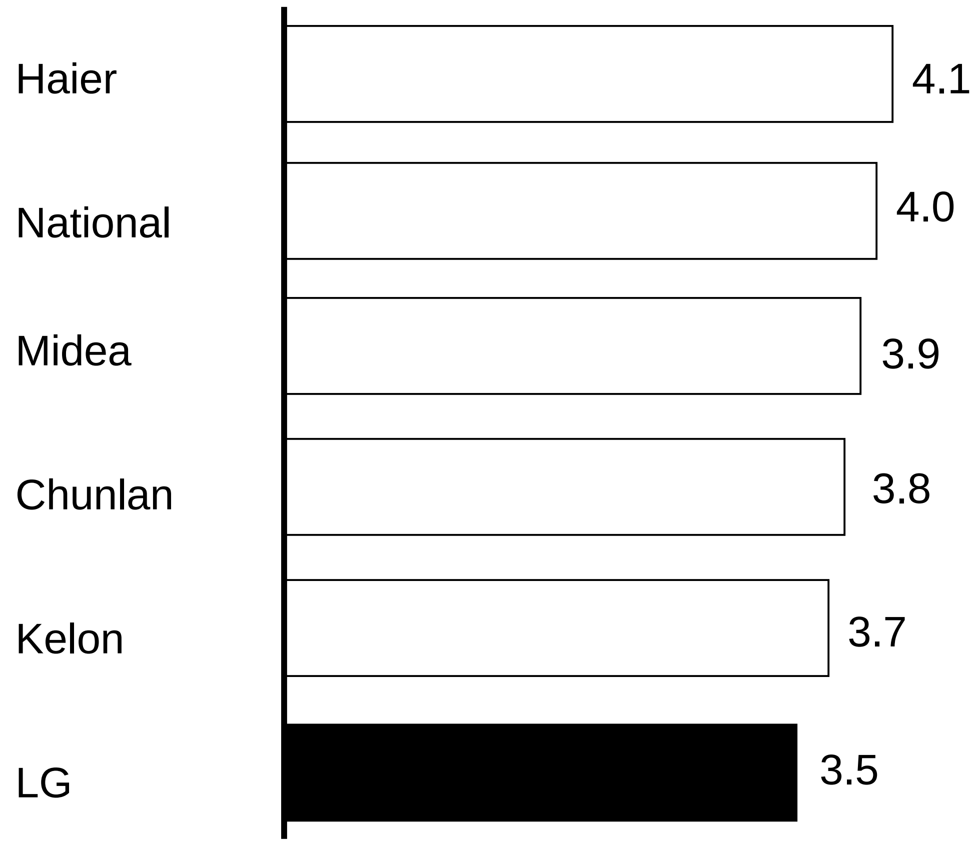


Source: LGETA A/C market survey – A/C owners and non-owners, 2000

AND LG'S ADVERTISING IS RANKED THE LOWEDT EVEN BY CONSUMERS WHO ARE AWARE OF LG A/C

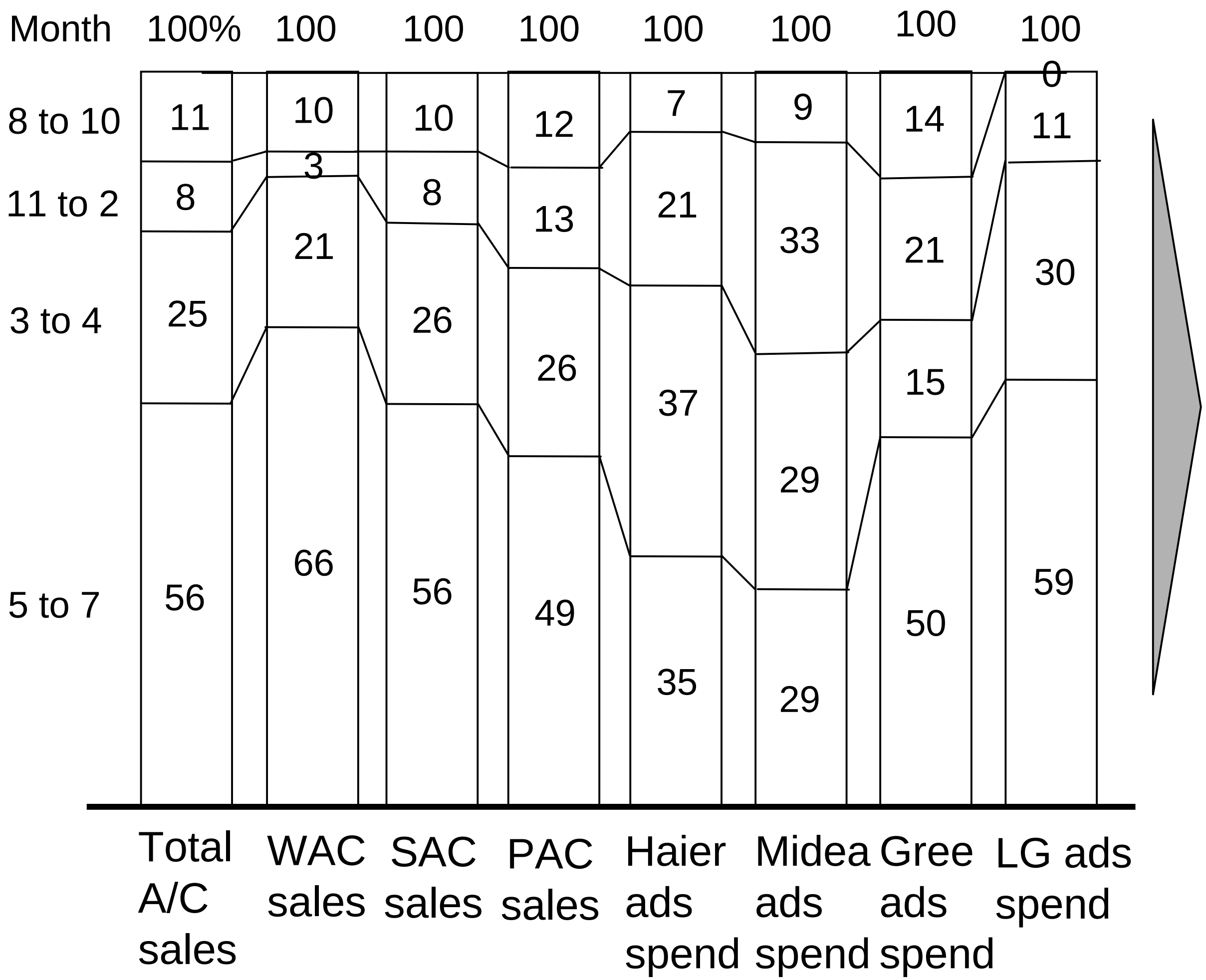
Consumers' perception on A/C makers' advertising performance, 5-point scale

n = 705



Source: LGETA A/C Market survey – A/C owners and non-owners, 2000

LG'S MONTHLY ADVERTISING ALLOCATION IS NOT FULLY SUPPORTIVE TO LG A/C'S BRANDING AND SALES, ESPECIALLY FOR PREMIUM ONES



- The more premium the product, the less seasonality
- Haier and Midea are building their brands continuously and consistently
- LG seems not having effective advertising support to its branding as well as sales

Source: Acnielsen Media Audit; A/C Commercial Information Annual Report

LG NEED TO ADD MORE PROMOTERS AND ORGANIZE MORE PROMOTIONS, ESPECIALLY DURING OFF-SEASON

Comments from sales people

Haier
- “Haier trains its promoters better by providing more materials”

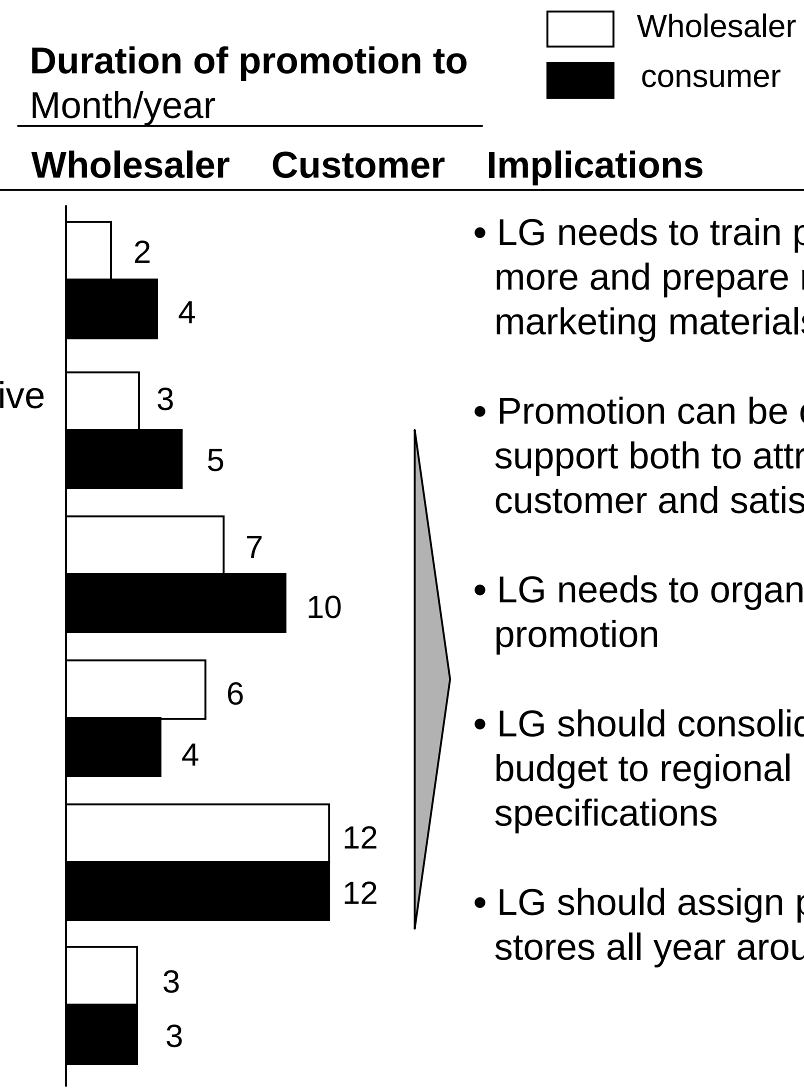
Gree
- “In each stores, it has its exclusive display areas with promoters”

Midea
- “As promoters conduct market research, so it can react faster to market change”

Kelon
- “Kelon also assigns promoters timely all year round”

Chunlan
- “They (promoters) stay here all year round”

LG
- “In off-season, the promoters leave, then they lose market share significantly ”



Implications
- LG needs to train promoters more and prepare more marketing materials
- Promotion can be of dealer support both to attract customer and satisfy dealers
- LG needs to organize more promotion
- LG should consolidate some budget to regional branches specifications
- LG should assign promoters in stores all year around

McKinsey&Company

KEY PROBLEMS IDENTIFIED IN AFTER SALES SERVICE INCLUDING LOW COVERAGE OF MARKET, SLOW SETTLEMENT PROCESS, AVAILABILITY OF SERVICE PARTS AND POSSIBILE LOOSE CONTROL ON SERVICE QUALITY

Key problems identified	Description
• Low coverage of market	• Only 6 service centers in the whole county • Service staff works only in central cities and supports other cities only at the request of retailers
• Slow reimbursement process	• Take 2 months to settle service/installation fee to retailers • Complex process involving service center and factory
• Availability of service parts	• Due to low service center coverage it takes long time to ship parts to retailers • Factory cannot manufacture and ship required parts on a timely basis, especially in peak season • Extremely complex order process to factory
• Loose control on service quality	• Although there are complete terms in its contract with service stations, LG does not monitor the performance of its service stations and take actions to improve their service quality
• No distinctive service guarantee	• LG should provide distinctive service guarantee, e.g., free replacement of compressors for 5 differentiate itself from competitors

REIMBURSEMENT PROCESS FOR INSTALLTION TAKES MUCH LONGER THAN COMPETITORS DUE TO COMPLEX SETTLEMENT PROCESSES

EXAMPLE

	Installation	Collect installation card	Check validity	Send card to factory	Reimbursement
Who ?	Installation team of retailer	Service center, LG	Service center, LG	Service center, LG	LGETA
Time :	24 hours after sales	1 – 5 days*	1 month	1 – 3 days*	1 month

Total reimbursement process takes around 2 months for settlement due to complex approval process compared to Haier where reimbursement is issued by service center itself

* Estimate
Source: Service center interview

IMPROVEMENT INITIATIVES WHICH SHOULD BE CONSIDERED BY LG

LG improvement initiatives

Short-term actions

- Brand re-positioning and communication improvement to improve brand awareness and perception
- Reallocation of advertising budget in terms of media mix, seasonal allocation, copy design and execution
- Increase coverage in existing core markets (first/second tier cities) by improving sales execution with more promotional events, higher number of well trained promoters, tighter control of cross regional sales
- Streamline organization and decision making process between factory and sales organization
- Organizationally link operations by increasing coverage, improving quality control and training for subcontractors
- Improve service operations by increasing coverage, improving quality control and training for subcontractors
- Tighten marketing budget control by product line to ensure effective resource allocation

Mid/long-term activities

- Evaluate tailored business model for distribution in different markets (fits tier/second tier and third tier cities)
- Establish key account management system to respond to structural changes in trade
- Evaluate opportunities in project sales
- Evaluate different options for profitability increase

NEXT STEPS AND END PROUCTS

	Actions	End products	Decisions
Marketing/branding	• Develop marketing/branding improvement program	• Marketing plan -Pricing policy -Marketing mix	☐
Channel management	• Design business models for distribution in representative markets	• Business model options -Trade off analysis for final decision	☐
Sales	• Develop operational improvement initiatives • Evaluate key account management and project sales opportunities and approaches	• Implementation plan for improvement action • Layout of approaches for project sales and KAM	☐
Demand analysis	• Evaluate different industry consolidation scenarios and possible responses from LG	• Options for final decision	☐

IN MID TERM LG SHOULD THINK ABOUT DEVELOPING RIGHT BUSINESS MODEL FOR DIFFERENT CITY CLUSTERS

Specific decisions to make

Decisions on structure

- Direct sales vs. indirect sales
- Number of layers of wholesalers and number of wholesalers
- Territorial exclusivity vs. non-exclusivity

Decisions on wholesaler

- Brand exclusivity vs. non-exclusivity
- Performance standards
- Skills
- Financial strength/credit

Decisions on relative role

- Marketing activities
- Sales activities
- Logistics activities
- Credit extension and collection activities

POTENTIAL DISTRIBUTION MODELS LG COULD CONSIDER

Examples

	"Do-it-yourself"	**Direct sales-distributor hybrid model**	**Shadow management**	**Pull-based model**
Proponents	• Company A	• Coke/Bud	• P&G	• Yaniing
Industry	• Food	• Soft drinks	• Personal care fabrics	• Beer
Differentiating Factors	• Invests in own logistics setup with minimal reliance on distributors resulting in higher level of service to trade • Offers very little trade incentives • Takes advantages of lower selling and distribution costs to fund A&P • Has large, internally trained merchandising and promotion team	• Use direct sales for key outlets • Use distributors to gain wide coverage of Mom-and –Pop stores	• No direct sales force • P&G provides direct delivery to 20% of outlets • P&G uses distributor sales representatives who handle only P&G products; salary paid by distributor, bonus paid by P&G • Uses 1-4 existing large distributors in each city • invests in sales force who spend all their time at distributor sites • Adheres to strict credit payment terms	• Invests in advertising to create pull • Uses 65-70 primary distributors and thousand of secondary and tertiary sub-distributors for blanket coverage • Provides little distributor support • Demands payment on delivery • May be suitable only for market leader that commands volumes that will satisfy distributors

DIFFERENT MODELS HAVE TO BE EVALUATED AND TRADE OFF TO BE CONSIDERED

● High
○ Low

	Speed of attaining distribution targets	Degree of control	Willingness to invest in resources: Fixed cost	Willingness to invest in resources: Variable cost	Distributor credit risk
Do-it-yourself	◔	●	●	○	○
Direct sales-Distributor hybrid	◕	◑	◑	◑	◕
Shadow management	◑	◕	◔	◕	◑
Pull-based	●	⊕	◔	●	○

* Evaluation would be different if different types of distributors (I.e., SOE versus entrepreneurial) were used for each model. Thus, for simplicity, assume type of distributor used it constant across four distribution models

Source: Mckinsey analysis

FOR DIFFERENT CITY CLUSTERS DIFFERENT DISTRIBUTOR MODEL MIGHT BE APPROPRIATE

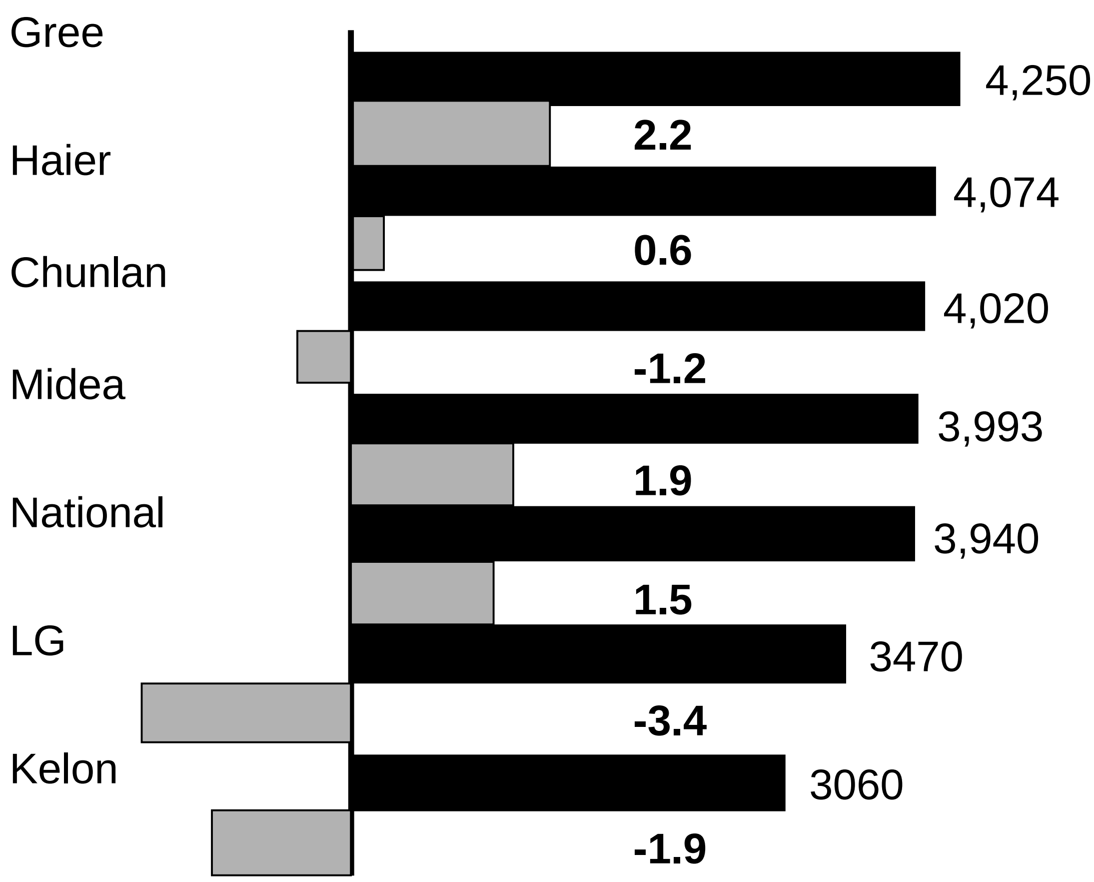
Examples

Categorization of cities	First tier city	Second tier city	Third tier city
Overall market development	• Relatively developed	• Significant number of active outlets (100~500) • Medium consumption	• <1,000 cases annually • Small number of active outlets (<100) • Very small consumption
Modern off-trade development	• Large number of active outlets (~1,000) • Large consumption	• Developing	• Very rare
Wholesale industry Structure development	• Several quality wholesalers • Complicated channel structure; many layers	• Very few quality wholesalers • Relatively simple channel structure, two layers at most	• No quality wholesalers • Simple channel structure; two layers at most
Business model	• Direct sales to retailers • First tier accounts • Own channel	• Few direct accounts • Indirect channels	• Served through City A and B distributors
examples	• Beijing • Shanghai	• Qingdao • Dalian	• Zhanjiang • Shijiazhuang • Taiyuan

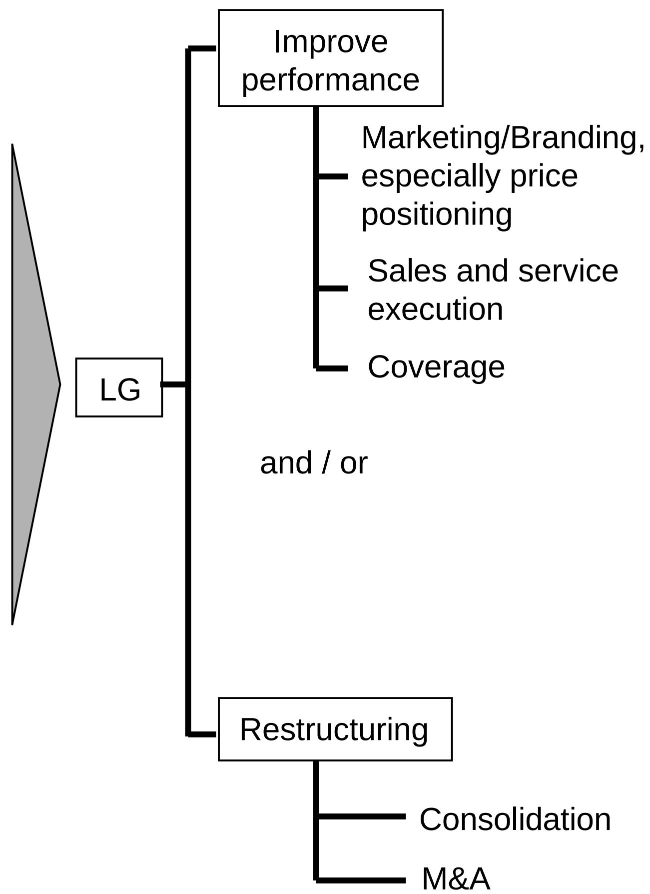
Source: Interviews; team analysis

COMPARING LG'S COST POSITION AND EBIT TO COMPETITOR'S LG CLEARLY SHOWS A RPICING ISSUE WHICH IS RELATED TO ITS POSITION IN THE MARKET

Average cost per set in RBM vs Ebit (%)

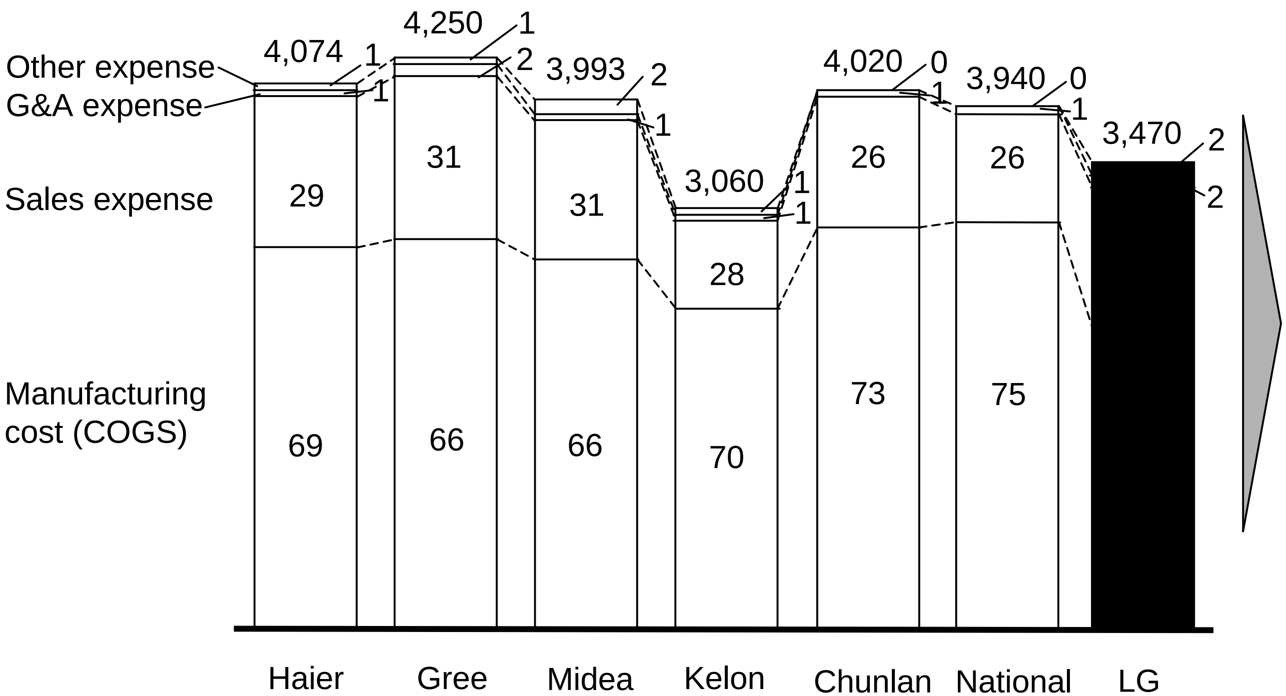


Implications for LG



COMPARISON OF LG VS. COMPETITORS' AVERAGE COST PER SET

Average cost per set
RBM/set



LG's cost position compared
To competitors seems to be quite
Favorable except its sales
Expenses but its profit per set is
The lowest compared with all
Other competitors which indicates
A pricing issue

	Haier	Gree	Midea	Kelon	Chunlan	National	LG
EBIT (million RBM)	30	134	110	-46	-31	30	-50
EBIT (per set RBM)	24	97	78	-57	-49	59	-115

AGENDA

- Progress update
- Market development
  -Market demand
  -Trade structure
  -Competition
- LG's current performance and improvement opportunities
- **Next steps**
- Appendix
  -Key assumptions of demand forecast model
  -Profiles of consumer segmentation
  -Profiles of top A/C competitors (including profitability analysis)

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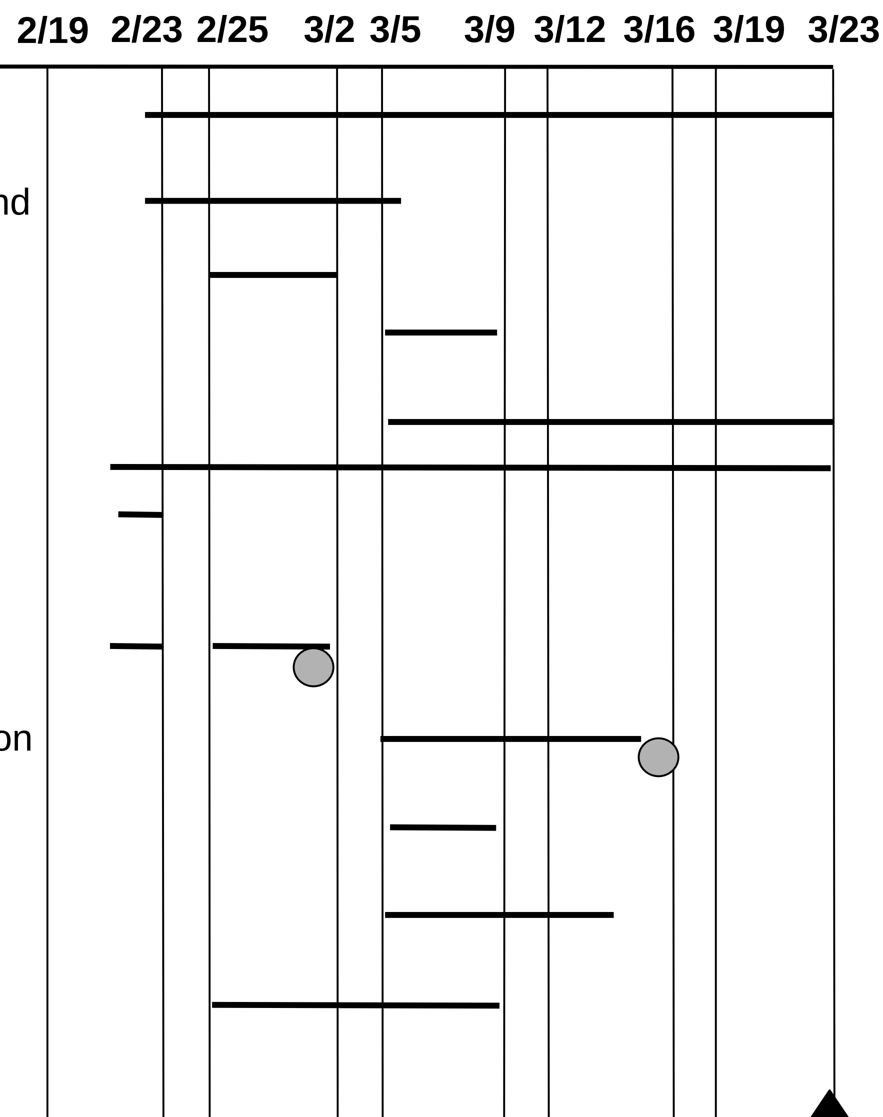
KEY ACTIVITIES AND TIEMLINE: PHASE 2

Workshop

Progress review

Major Activities

- Performance improvements
  - Develop improvement plan for pilot market including training and incentive plan for promoters etc
  - Review current pilot
  - Develop test actions to improve sales execution
  - Conduct pilot with LGETA team
- Overall China strategy
  - Develop high level growth scenarios and detail current forecast
  - Build and evaluate brand repositioning scenarios
  - Develop marketing plan based on brand repositioning
  - Build guidelines for regional channel mix
  - Develop key account management process
  - Design organization structure improvements and process changes



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FORECAST MODEL APPROACH

Define approach

- Define desired end products and level of detail
- Define key drivers for air-conditioner demand
- Decide on basis of starting point and historical data set
- Decide on benchmark markets suitable for China reference

Build model structure

- Translate drivers into model structure
- Decide on key assumptions driving demand
- Select appropiate methodology
- Build correlation between penetration and income per capita
- Build model curve and deviations

Forecast Iterations

- Run forecast iterations
  - -Total demand
  - -By product type
  - -By market type (1st tier vs. 2nd tier)

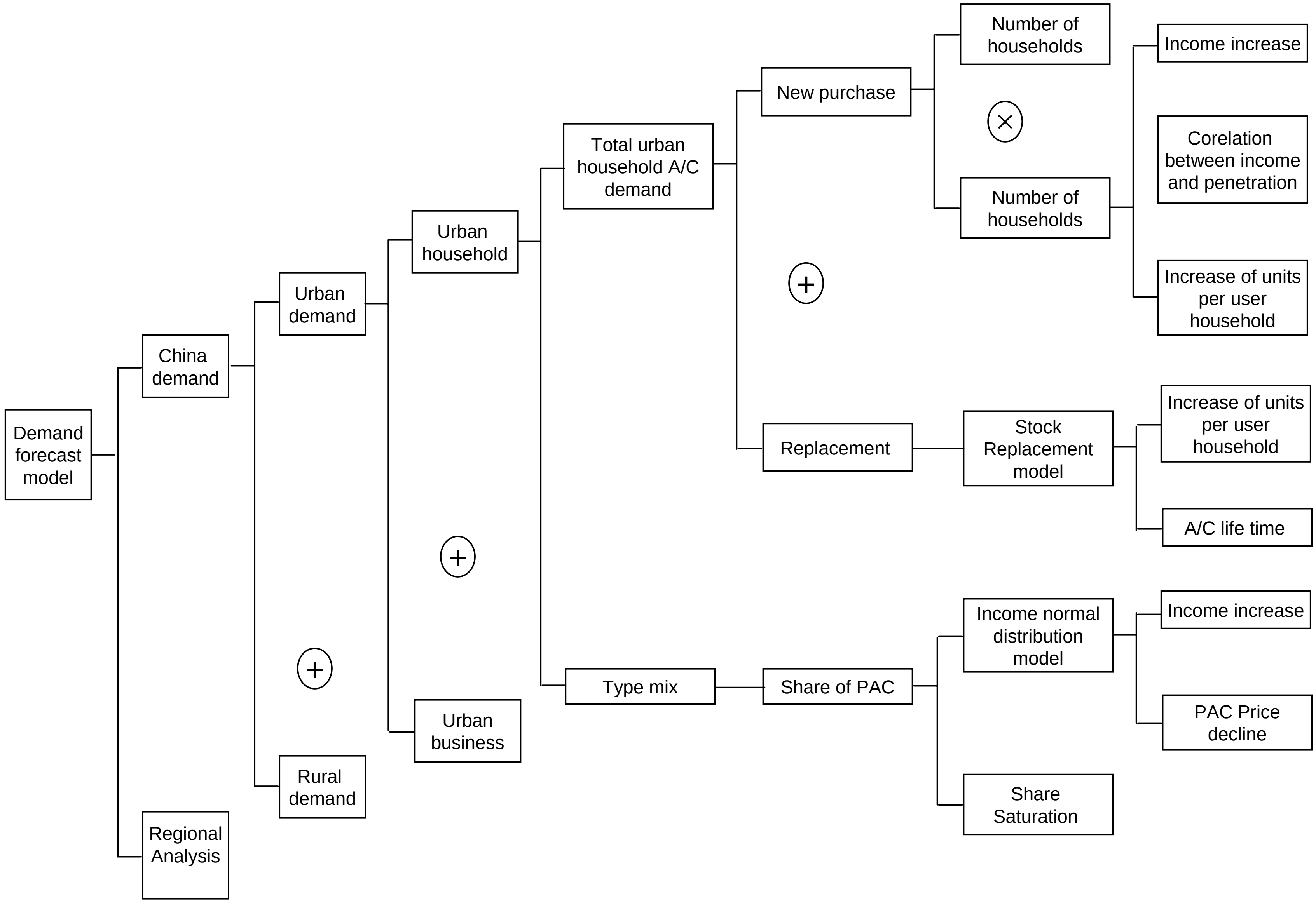
KEY ASSUMPTIONS (1/2)

ITEM	ASSUMPTIONS	RATIONALE
Definition of regions	• First tier: Cities whose income per capita in 1999 was more than 9000 RMB per year, e.g., Shenzhen, Guangzhou, Shanghai, Beijing • Second tier: Cities whose income per capita in 1999 was between 5854 RMB (the national average income) and 9000 RMB per year, e.g., Wuhan, Jinan • Third tier: Cities and rural areas whose income per capita was less than 5854 RBM per year	Development Grade per city Compared to its income
Household growth rate	• Annual growth rate in urban areas from 2001-2005: 3.3% • Annual growth rate in rural areas from 2001-2005: 1.6%	Historical data
Household annual Income growth rate	• Compounded annual growth rate in urban areas from 2001-2005: 5.0% • Compounded annual growth rate in rural areas from 2001-2005: 4.5%	Historical data

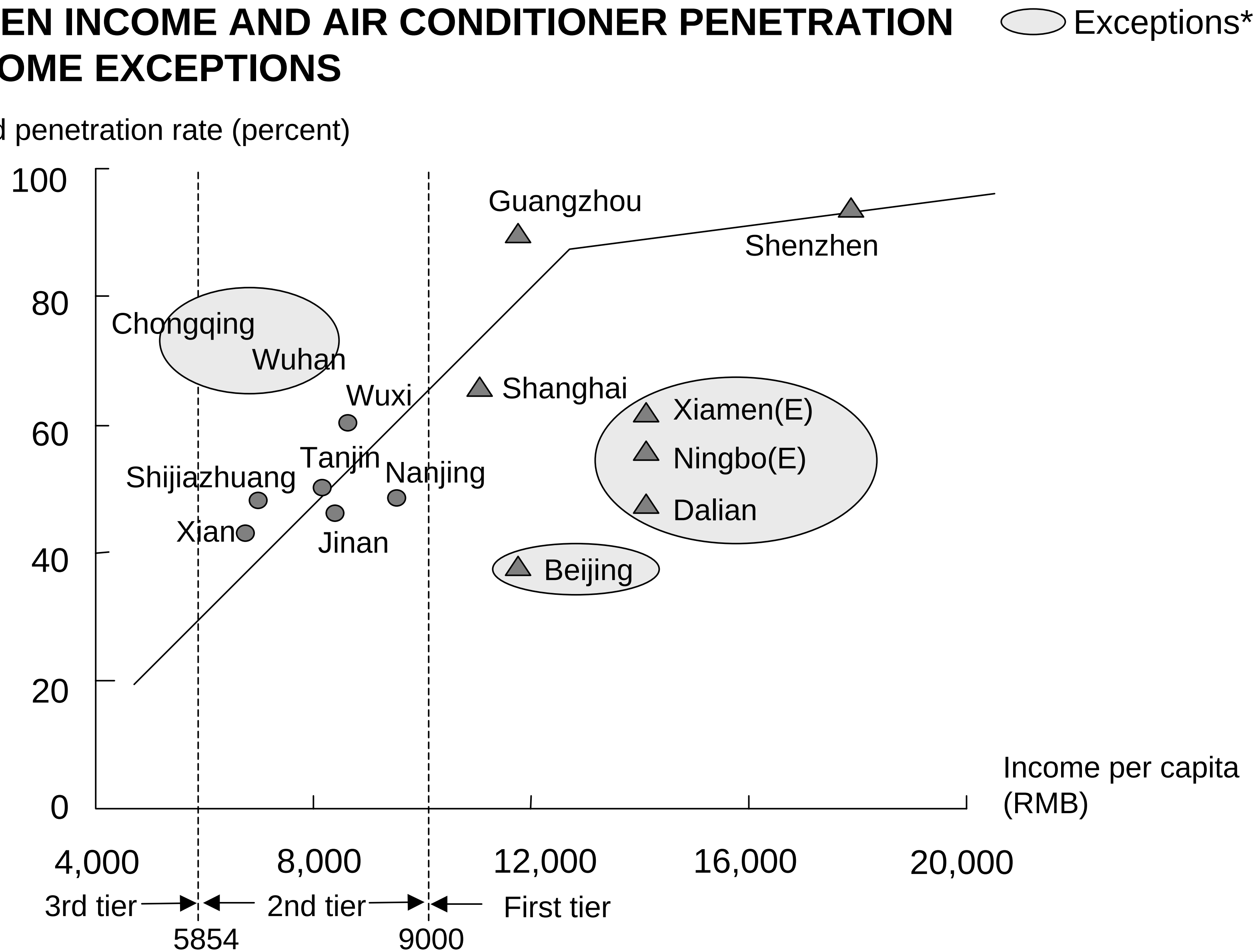
KEY ASSUMPTIONS (2/2)

ITEM	ASSUMPTIONS	RATIONALE
Penetration rate of A/C	• 17% in urban area and 1% in rural area in 2000	Statistical yearbook
Average units per Household user	• Urban households: 1.2 units per household in 2000 and 1.3 units per household in 2005 • Rural households: 1.1 units per household in 2000 and 1.2 units per household in 2005	Benchmark from Taiwan: 1.7 units in 1996; Benchmark from Japan: 2.8 units In 2000 for urban households
Business users	• Business users captures 29% market share in urban areas and 40% in rural areas in 2000	Historical data
Demand of PAC	• Demand is driven by income increase and price decrease • The price of PAC decreases 10% per year until it hits the cost at 4000 RBM per unit • Household saturation at 30% of new product sales	Historical trend
Demand of WAC	• Share of WAC decrease from 17% to 12% market share in urban areas	Historical data
Demand of SAC	• The remaining share after WAC and PAC	

WE DEVELOP MODEL STRUCTURE AS FOLLOWING



REGIONAL ANALYSIS INDICATES STRONG CORRELATION BETWEEN INCOME AND AIR CONDITIONER PENETRATION WITH SOME EXCEPTIONS



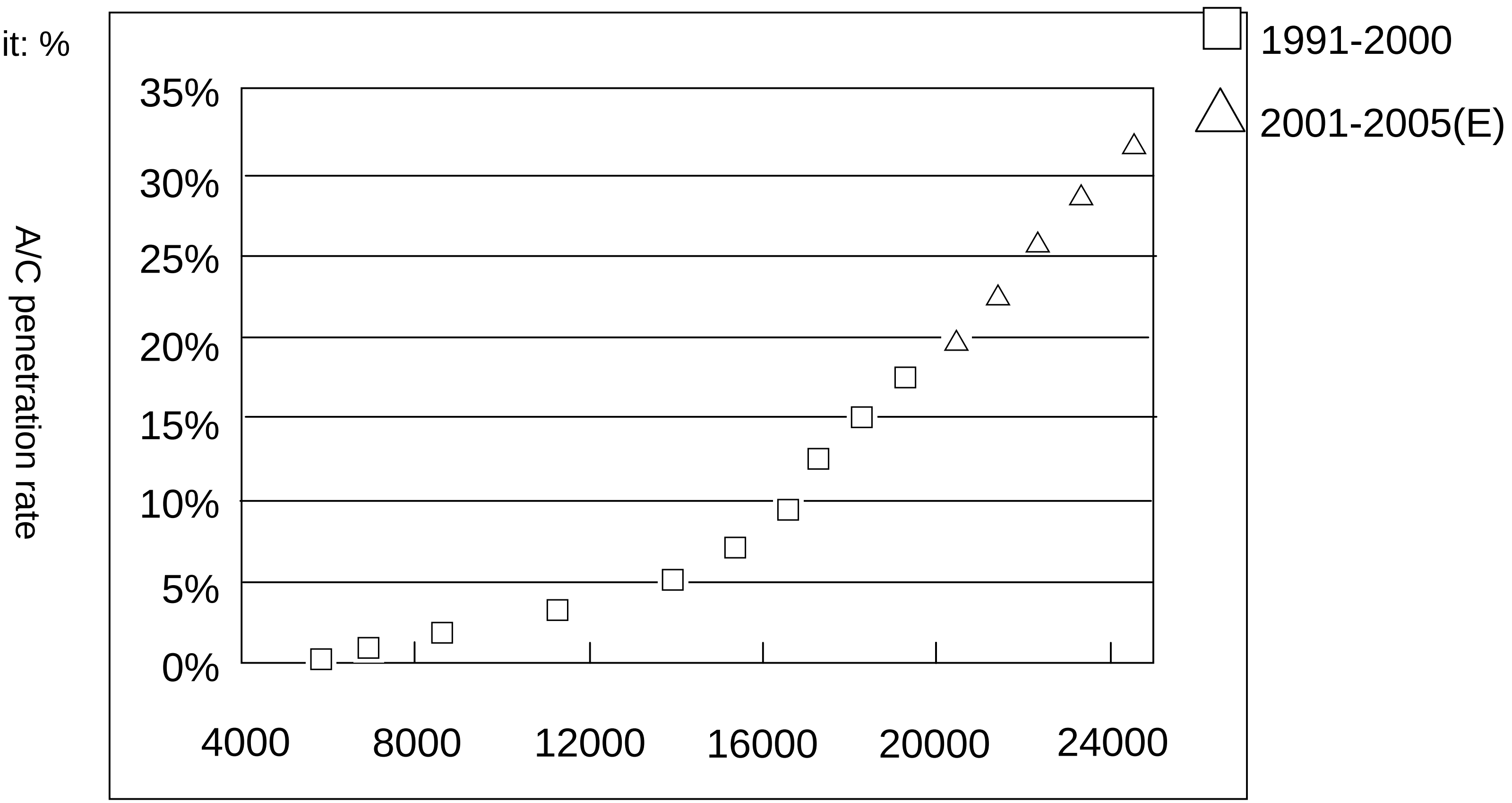
*Exception due to special regional weather conditions

Source: Mckinsey analysis

HISTORICAL DATA INDICATES CORELATION BETWEEN A/C PENETRATION RATE AND HOUSEHOLD INCOME

Corelation between A/C penetration and annual disposable income per household in China (1991-2005)

Unit: %

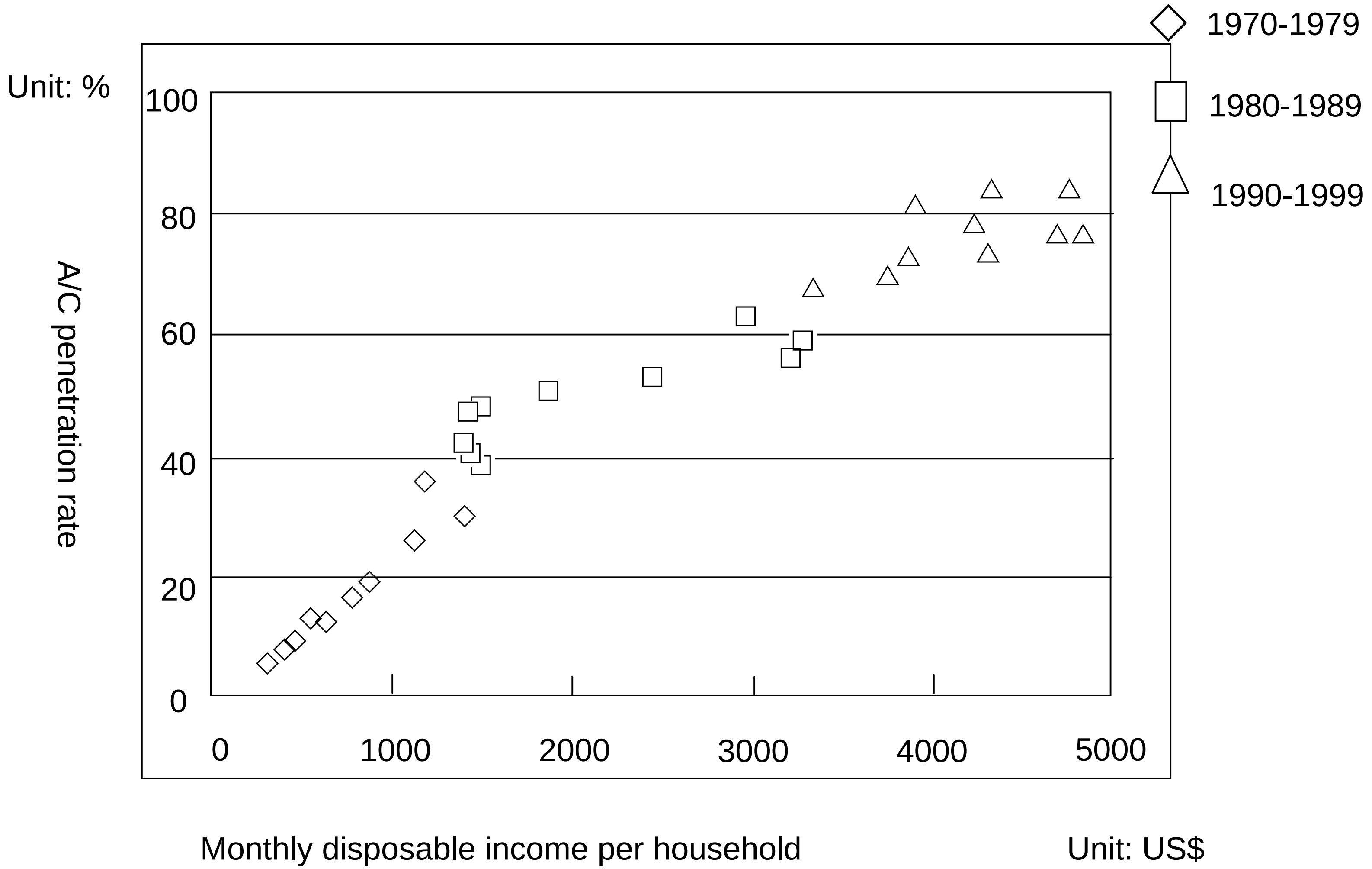


Unit: RMB

Annual disposable income per urban household

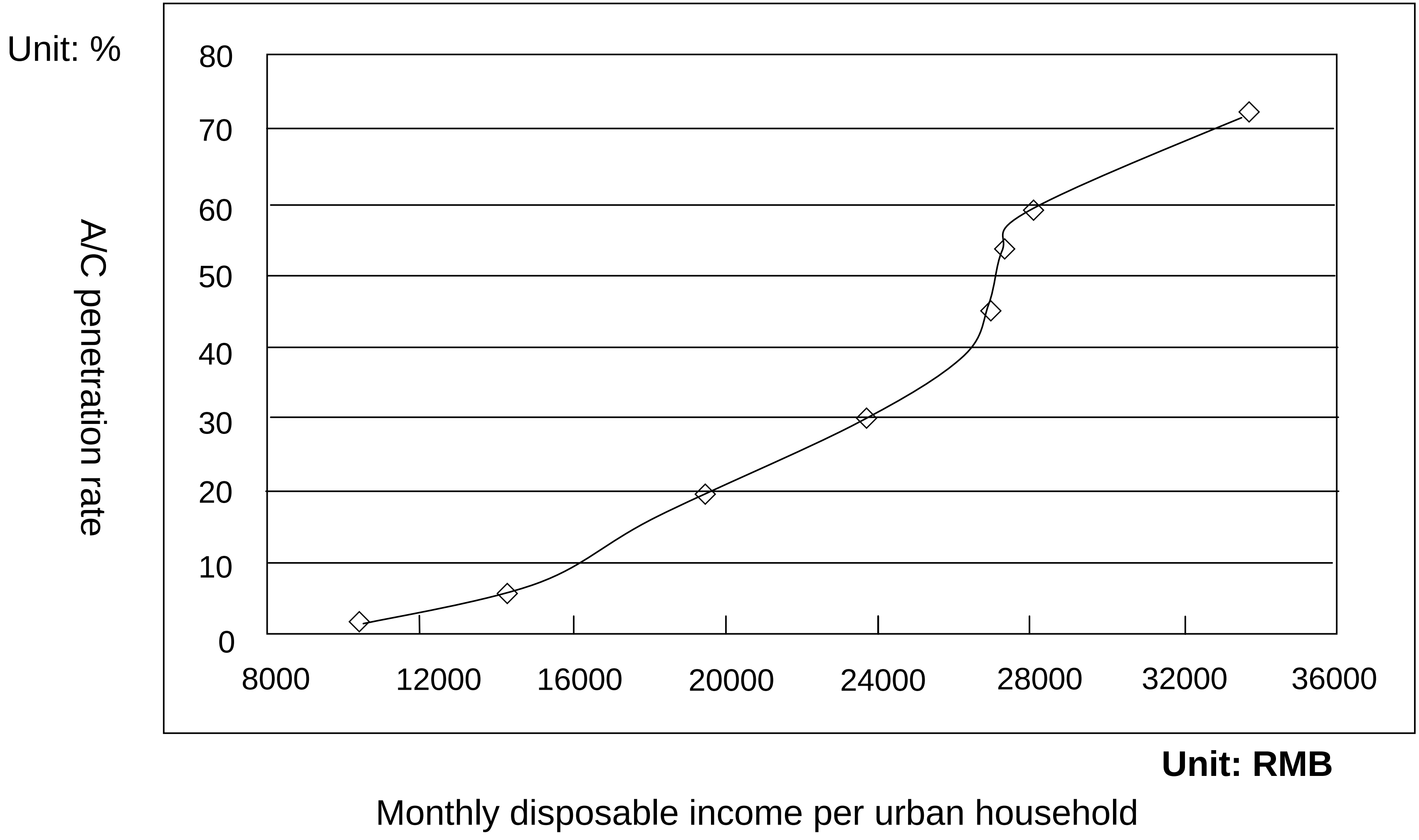
SIMILAR CORELATION COULD ALSO FOUND IN JAPANESE A/C MARKET BENCHMARK

Corelation between A/C penetration and monthly disposable income per household in Japan (1970-1999)



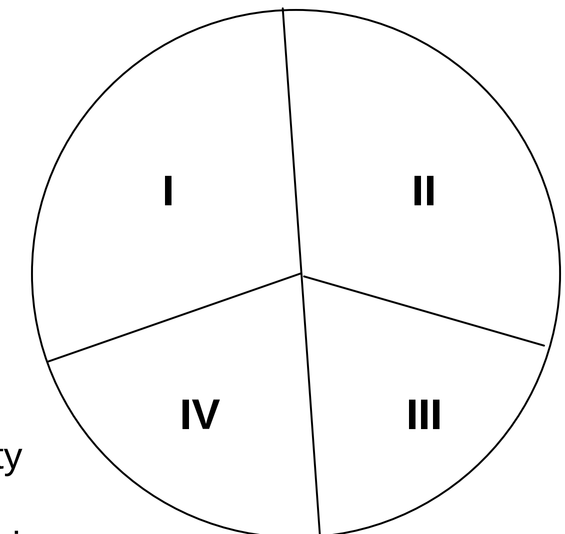
SAME METHODOLOGY IS ALSO APPLIED IN REGIONAL ANALYSIS

Corelation between A/C penetration and annual disposable income per household in Shanghai (1991-1999)



AMONG INDIVIDUAL CONSUMERS, THERE ARE FOUR DISTINCTIVE CONSUMER SEGMENTS

100% = 465 A/C owners



I. Quality assured technophile (34%)
- Care the most of product quality and the technology used
- Relatively high average A/C purchase spending

II. Worry-freer (32%)
- Emphasis both quality and service to ensure worry-free A/C consumption
- Care about brand
- Relatively high A/C purchase spending

IV. Value for money (16%)
- Require product quality and at the same time emphasize on lower price
- Relatively low A/C purchase spending

III. Clueless (18%)
- Preference equally distributed, immature A/C consumers
- Unable to identify their most important needs
- Relatively low average A/C purchase spending

Source: LGETA A/C Market survey – A/C owners, 2000

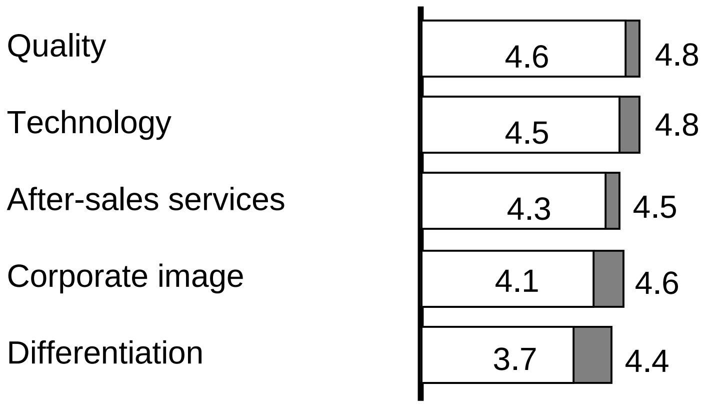
DIFFERENT CUSTOMER SEGMENTS HAVE DIFFERENT ATTRIBUTES AND BEHAVIORS – QUALITY ASSURED TECHNOPHILE SEGMENT

Market average

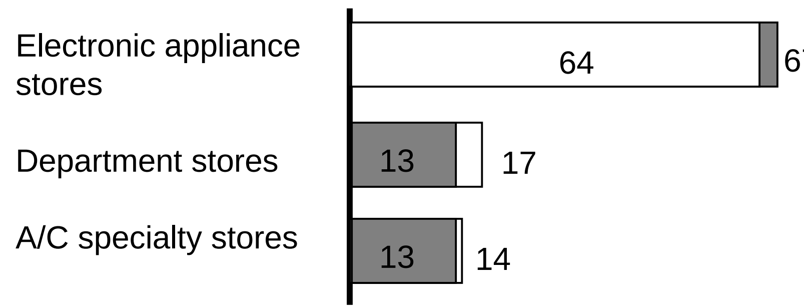
Quality pursuer and technophile

Difference vs. average

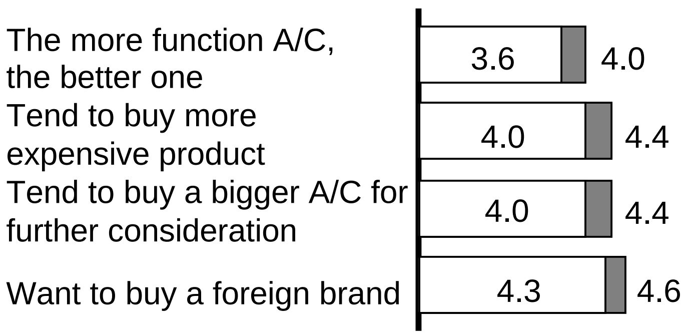
Importance of FBKs (5-point scale)



Preferred A/C purchase place
Percent



Attitudes – agreement on the statements (7 – point)



Demographics
Percent

The quality assured technophile segment counts for 34% of the total market with average intended A/C unit purchase spending about RBM 4,100. A little over 100 RBM more than the market average.

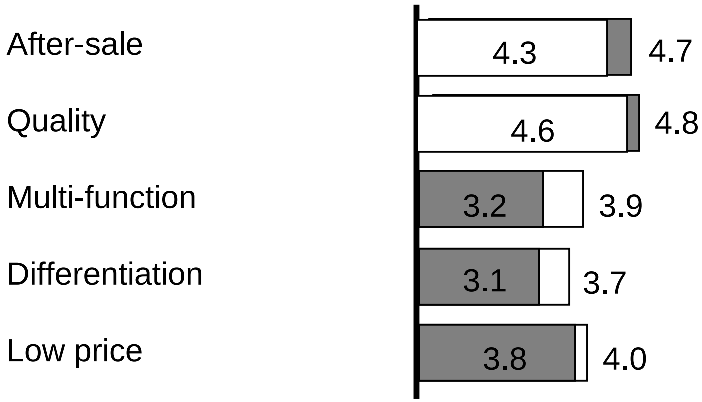
Source: LGETA A/C market survey-A/C owner, 2000

DIFFERENT CUSTOMER SEGMENTS HAVE DIFFERENT ATTRIBUTES AND BEHAVIORS – WORRY – FREE SEGMENT

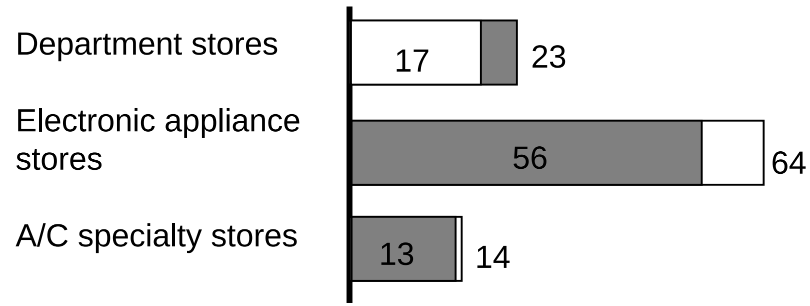
Market average
Worry-freer

Difference vs. average

Importance of FBKs (5-point scale)



Preferred A/C purchase place
Percent



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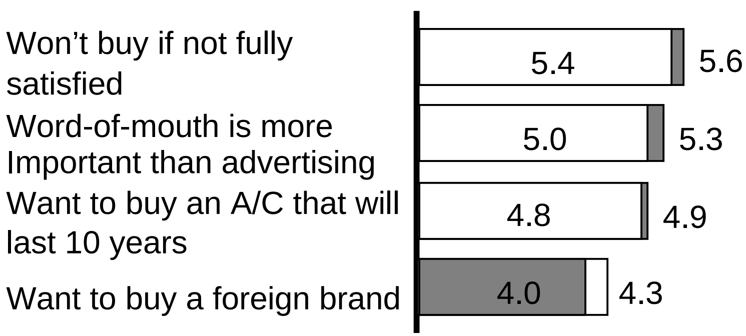
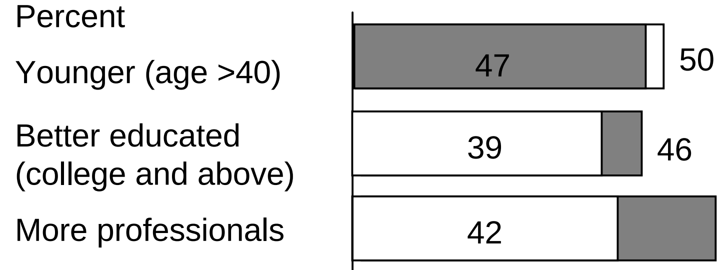


Demographics
Percent



The worry-free segment counts for 32% of the total market, with average intended A/C unit purchase spending about RBM 4,200. RBM 150 more than the market average.

Source: LGETA A/C market survey-A/C owner, 2000

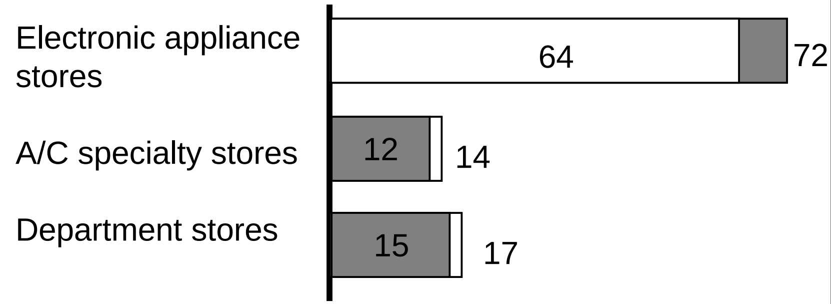
DIFFERENT CUSTOMER SEGMENTS HAVE DIFFERENT ATTRIBUTES AND BEHAVIORS – CLUELESS SEGMENT

Market average
At loose enter

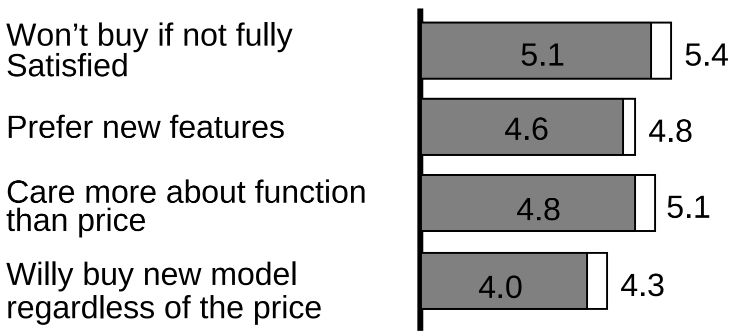
Difference vs. average

Importance of FBKs (5-point scale)

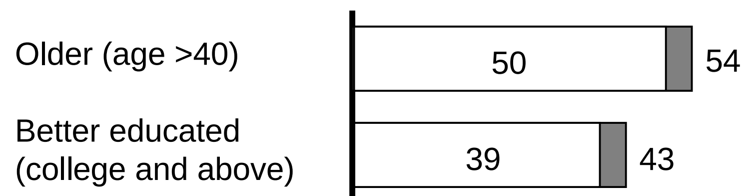
Preferred A/C purchase place
Percent



Attitudes – agreement on the statements (7 – point scale)



Demographics
Percent



The clueless segment counts for 18% of the total market, with average intended A/C unit purchase spending about RBM 3,900. About 200 RBM less than the market average.

Source: LGETA A/C market survey-A/C owner, 2000

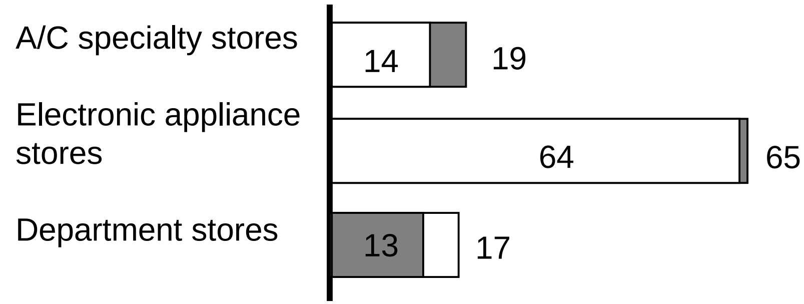
DIFFERENT CUSTOMER SEGMENTS HAVE DIFFERENT ATTRIBUTES AND BEHAVIORS – VALUE FOR MONEY SEGMENT

Market average
Bargain hunter

Difference vs. average

Importance of FBKs (5-point scale)

Preferred A/C purchase place
Percent



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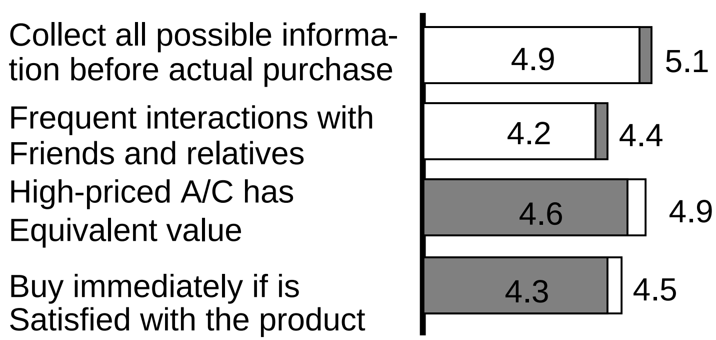
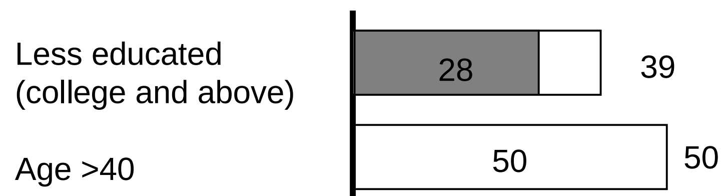


Demographics
Percent



The value for money segment counts for 16% of the total market, with average intended A/C unit purchase spending about RBM 3,800. About 300 RBM lower than the market average.

Source: LGETA A/C market survey-A/C owner, 2000

KEY SUCCESS FACTORS OF LEADING AIR CONDITIONER COMPANIES IN CHINA ARE ANALYZED ALONG THE FOLLOWING DIMENSIONS

	Product development	**Sourcing**	**Manufac-turing**	**Logistics**	**Sales/ marketing**	**After-sales service**
Key success factors	• Technology level • Product innovation • Time to market	• Raw material cost • Supplier management	• Quality • Flexibility • Manufac-turing cost	• Product delivering system • Inventory cost	• Branding • Value proposition • Price policy • Sales/ distribution channel • Expenditure	• Quality • Lead time to the customer/ end user • Service cost

HAIER AIMS TO BE A WORLD-CLASS COMPANY WITH DISTINCTIVE BRAND IMAGE

Core strategy

Building a leading International brand Through product and Service leadership

Key elements	Implications for LG
• Consistent brand image for all products	• LG needs to leverage the synergy of other products' image for A/C
• Provide best service through broad service force coverage, strict service quality control, and customer-oriented service policy	• LG needs to provide distinctive service warranty to distinguish from other competitors
• Distinctive channel strategy by developing direct sales	• LG needs to tailor distinctive strategies in different regions
• Develop and introduce new products with specific features to serve targeted consumer segments • 8 information station world-wide to collect technology information and more than 6 research institutions in China, Japan, US, Europe, etc.	• Technology gap between LG and its Chinese competitors is narrowing, and LG needs to improve marking and sales to achieve share growth in China

HAIER PROFILE

Name : Haier Air Conditioner Co., Ltd.

Address : Haier Industry Zone, Hi-tech Zone, Qingdao, Shandong

Starting year: February 8, 1996

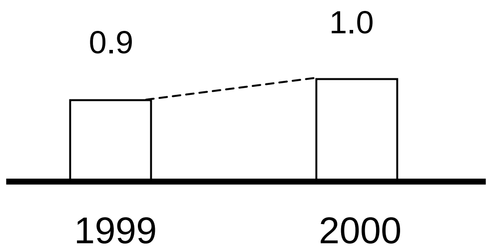
Registered capital: RBM 165m million

# of employee: 1,800

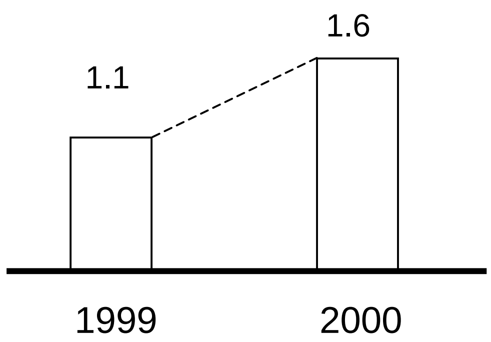
Equity structure: Haier Air Conditioner Group Co., Ltd. 75%
Yongshi(KH)Co., Ltd. 25%

Production line: Air conditioner, air conditioner and cooling equipment installation, service

Domestic sales of air conditioner
million sets



Production of air conditioner
million sets



Source: Haier Group

HAIER AIMS TO BE A TECHNOLOGY LEADER WHO PRODUCES HIGH QUALITY AIR CONDITIONER WITH ADVANCED FEATURES

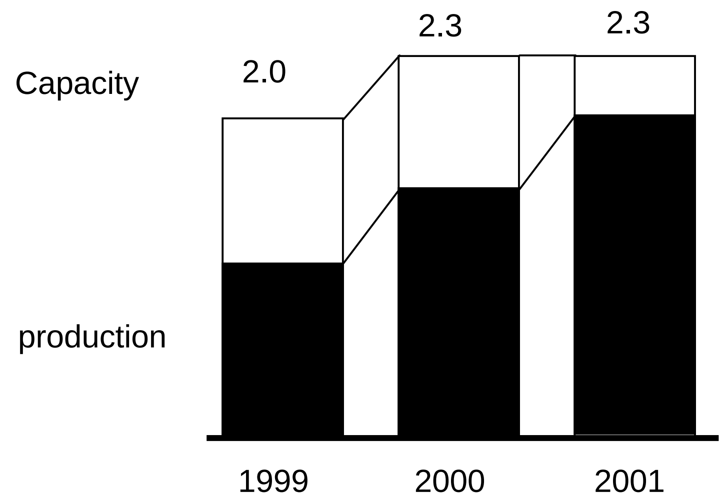
	Haier strategy	Practice
Technology development	• Started by importing technology • Developed own R&D capability • Formed technology alliance with key technology developers	• Imported technology from Hitachi, Mitsubishi, etc. • Established Haier A/C Research institute • Formed technology alliance with Philips, Hitachi, Motorola, etc.
R&D capability development	• R&D capability development is core part of Haier strategy • Implemented effective incentive system • Made significant investment on R&D	• Manage R&D rigorously with top management involvement • Invest 4% of annual sales to R&D
New product launching	•Launch new products rapidly •Incorporate advanced technology features	• In year 2000, over 20 new models were introduced • New models are mainly inverters, with healthy features • All new models incorporate advanced features, such as air cleaning

HAIER EXPANDS ITS PROCUCTION RAPIDLY WHILE FOCUSSING ON SPLIT TYPE

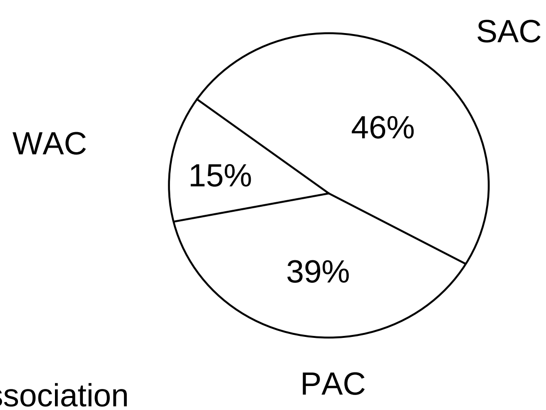
Key facts:

- 9 production lines
- 4 factories (Qingdao(3),Wuhan(1))
- Total annual production capacity of 2.3 million sets
- Production planning system with information system and database support
- SAP implementation has improved manufacturing ans sales coordination

Capacity and production plan million sets

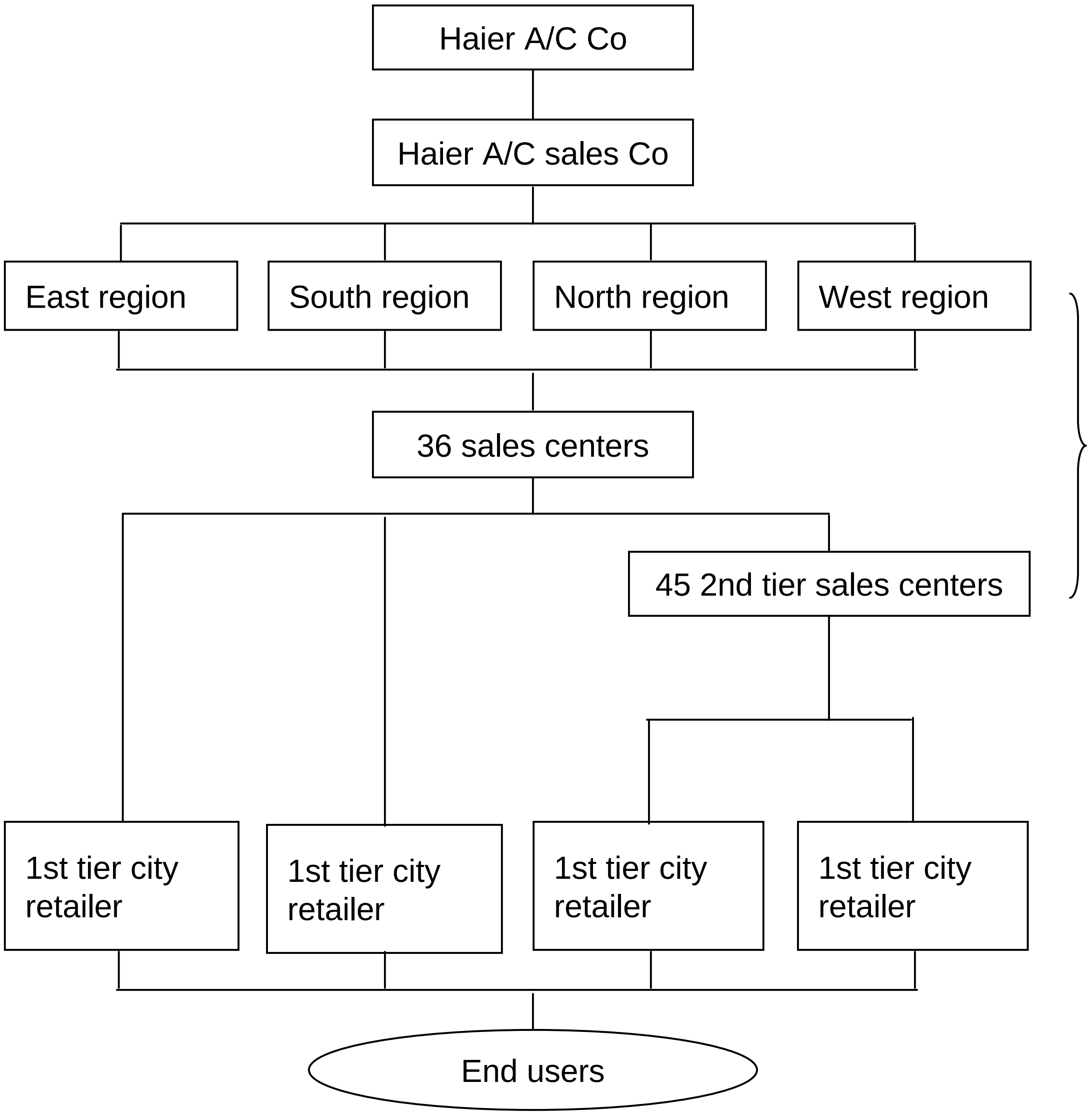


Product Type Split (Year 2000)*
Percent



***** First 11 month data
Source: Literature search; China Household Electrical Appliances Association

HAIER DISTRIBUTES DIRECTILY TO RETAIL OUTLETS, BYPASSING WHOLESALERS



Role	Sales policy
• Manufacturing	•No sales right
• Sales function	• Sales policy setting • Sales/channel management
• Regional sales management(market management, service, etc.) • Regional A/P planning and implementation	• Strict region price control • Cross-region sales are strictly forbidden
• Direct sales to market	• Large numbers of specialty stores (30% of total sales) • Directly manage retailers • Low margin to retailers

SERVICE IS A KEY COMPETITIVE ADVANTAGE OF HAIER

● High
○ Low

	Service policy and practice	Competitive advantages
Warranty	• A/C: 3 Years • Components: 6 Years	◐
Service Organiza-tion	• Broad service network with 12 service centers nationally • Service centers are in charge of authorized service station management and service fee payment	●
Installation	• Free delivery and installation • Installed within 24 hours • Follow-up service	●
Main-tenance	• Free relocation service once within 3 years • Complete reparation within 24 hours • Easier to return compared with others	●
Parts	• Timely parts supply with regional warehouses	●

- Leader in service
- Reliable service attracts buyers and increases sales
- Service as a key selling point to gain competitive advantage

GREE'S STRATEGY IS TO ATTRACT CONSUMERS THROUGH ITS DISTINCTIVE PRODUCT QUALITY AND FEATURES

Core strategy

- Become professional air conditioner manufacturer by focusing its business only on air conditioner and producing best quality products

Key elements	Implications for LG
• Low-key marketing strategy with less mass media exposure	• Might have cost advantages in advertising compared to LG
• A/C specialist strategy	• LG needs to develop distinctive quality image to compete in quality sensitive customer segments
• Merge wholesalers to its subsidiaries by owning the majority of shares	• More difficult for LG to find better wholesalers in those markets
•Update technology and introduce new models faster than other players	• LG needs to introduce new models faster and tries to be ahead of industry pace
• Broad service coverage to ensure timely and high quality service	• LG needs to invest more to increase service coverage
• Periodic free repair and maintenance service to current users	• LG needs to provide distinctive service to attract consumers

HAIER PROFILE

Name : Gree Electronics Appliances inc.of Zhuhai

Address : No.6 JinJi West Road, Qianshan,Zhuhai,Guangdong

Starting year: 1985

Registered capital: RBM 325 million

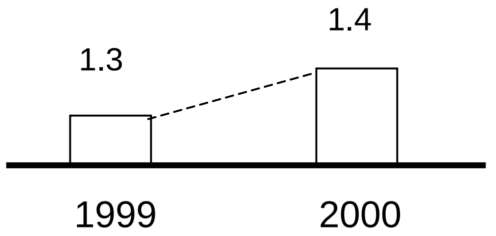
# of employee: 5,000 employees

Equity structure:

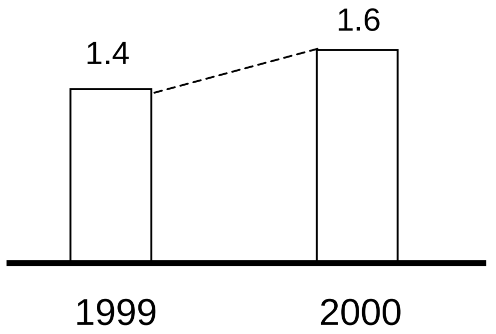
Gree Group Co.	55%
Other shareholders	45%

Production line: Air conditioner,watch, electronic fan

Domestic sales of air conditioner million sets



Production of air conditioner million sets



Source:Literature search;China Household Electrical Appliances Association

GREE POSITIONS ITSELF AS A SPECIALIZED AIR CONDITIONER MANUFACTURER

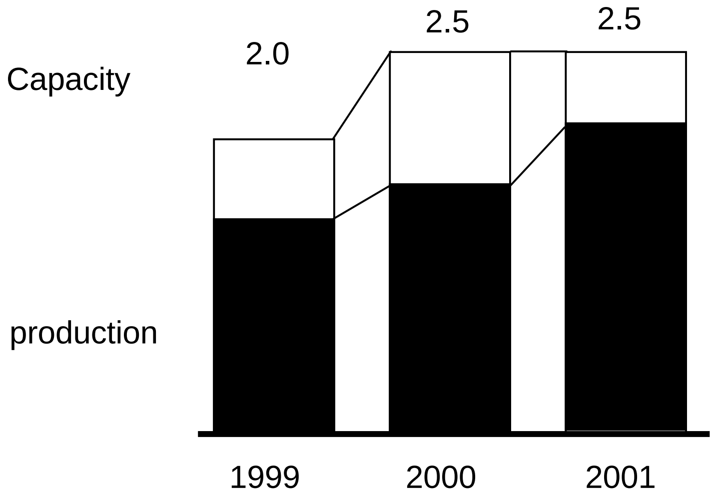
	Gree strategy	Practice
Technology development	• Started by importing technology • Developed own R&D capability	• Imported technology from Japan
R&D capability development	• Made significant investment on R&D • Develop own A/C technology	• In 2000,invest RMB 0.45 billion for R&D (RMB 0.06 billion) and capacity expansion (RBM 0.39 billion) • Established R&D center with 260 researchers
New product launching	• Launch new products rapidly	• On average,Gree introduces one new model per month

GREE HAS DEVELOPED LARGE PRODUCTION CAPACITY AND FOCUSES ITS PRODUCTION IN SPLIY TYPE

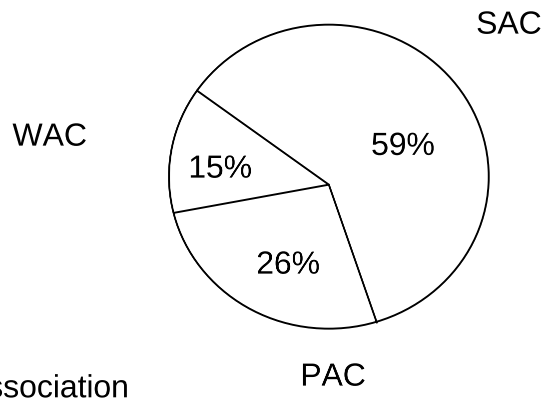
Key facts:

- Total annual production capacity of 2.5 million sets
- Established a manufacturing location in Brazil

Capacity and production plan million sets

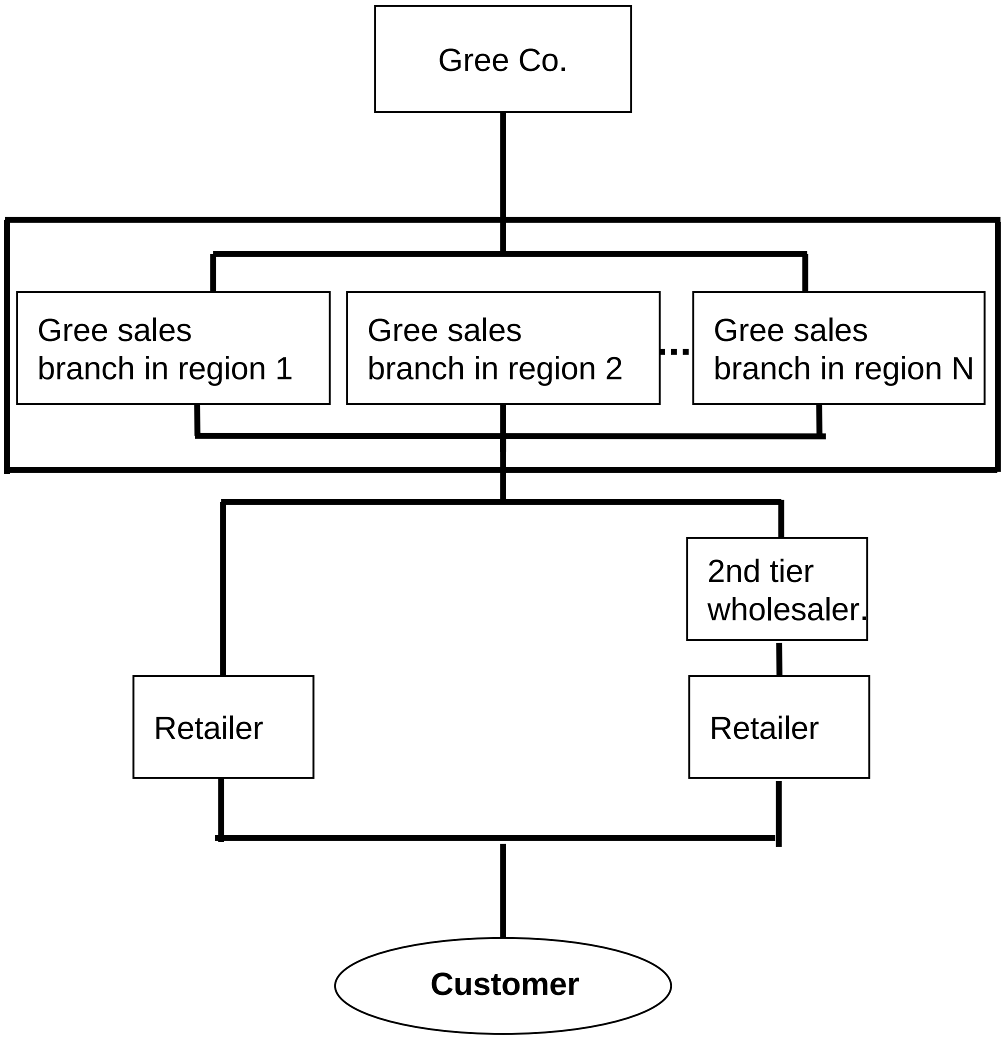


Product Type Split (Year 2000)*
Percent



***** First 11 month data
Source: Literature search; China Household Electrical Appliances Association

GREE SALES BRANCH SYSTEM HELPS ITS MANAGE CHANNEL EASILY



Role	Sales policy
• Develop overall strategy • manage sales branches	• 100% sales to branches
• Conduct regional wholesale • Develop regional sales strategy	• Invest in large-scale regional wholesalers to be shareholder • Average 6% margin • No cross-region sales permitted
• Distribute in 2nd tier and smaller cities	• Average 6% margin • Small portion of total sales
• Direct sales to customer	• Sales force assigned to work in retailer's store • 4-6% margin

GREE DOES NOT FOCUS ITS VALUE PRODUCTION ON SERVICE

High
Low

	Service policy and practice	Competitive advantages
Warranty	• A/C: 2 years • Components: 5 years	
Service Organiza-tion	• 570 certificated service centers in 126 cities • Factory reimburses installation and service fee	
Installation	• Dealers install and Gree provides technical support • Installed within 24 hours • Installation of WAC is not free	
Main-tenance	• Promise to complete repair service within 3 days after users ask for maintenance • Very strict quality control with strict penalty to unqualified service	
Parts	• Supply parts timely to service stations	

- Gree has no significant competitive advantages in service
- Gree does not take service as selling point
- Gree tries to improve its product quality, so as to reduce amount of the service

MIEDA FOCUSES ITS EFFORY ON THE MARKET COVERAGE OF SALES CHANNELS

Core strategy

Become one of the top 2 air conditioner manufactures in China through comprehensive market coverage and product lines

Key elements	Implications for LG
• National research and design center with 400 researchers	• Technology gap with LG will narrow
• Aggressive expansion of sales network in each region	• More fierce competition in LG's focus market
• Strict cross-regional sales management by using bar code system	• LG needs to control cross-regional sales
• Well established logistic network to ensure timely product delivery	• LG needs to streamline its logistics operation to ensure timely product delivery to wholesalers and consumers
• Deliver goods directly to 2dn tier wholesalers with no inventory at 1st tier wholesaler • Flexible regional sales strategy developed by regional branches	• LG needs to develop regional distribution model to serve different markets

MIDEA PROFILE

Name : Guangdong Midea Group Co., Ltd.

Address : Penglai Road.Beijiao Town,Shunde City,Guangdong

Starting year: August,1992

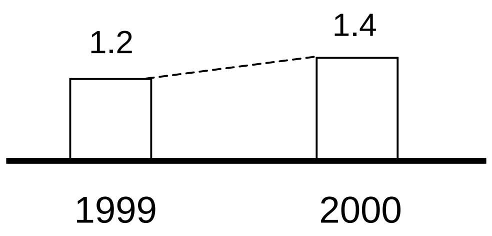
Registered capital: RMB 68 million

# of employee: 12,000 employees

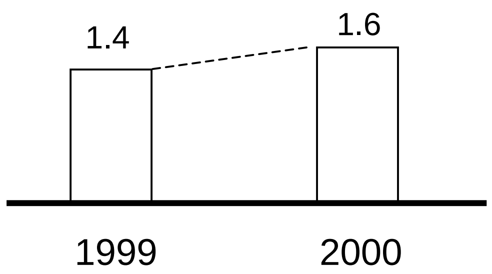
Equity structure: Midea Holdings Co. 19%
Other shareholders 81%

Production line: Air conditioner,electronic fan, microwave oven,kitchen appliances,compressor

Domestic sales of air conditioner
million sets



Production of air conditioner
million sets



Source:Literature search;Midea annual reports;China Household Electrical Appliances Association

MEDIA DEVELOPS STRONS RESEARCH CAPABILITY

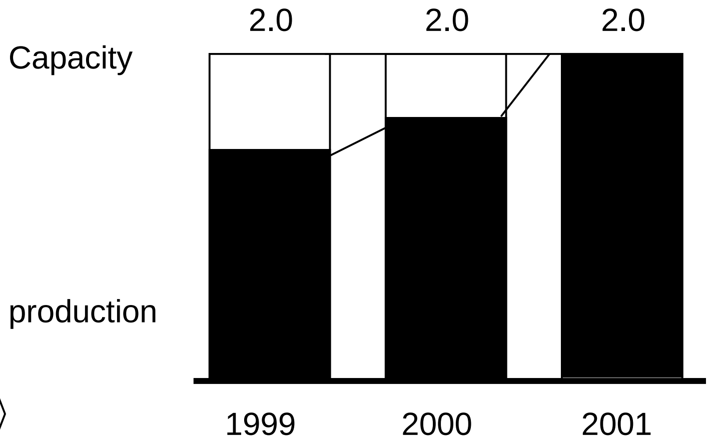
	Midea strategy	Practice
Technology development	• Started by importing technology • Developed own R&D capability • Formed technology alliance with key technology developers	• Imported technology from Toshiba • Established National research center with 350 researchers • Feature/techniques center with 80 researchers
R&D capability development	• Made continuous investment on R&D	• Invested 3-5% of annual sales to R&D
New product launching	• Introduces comprehensive product mix cover all segmented markets	• There will be 148 models in 2001

MIDEA DEVELOPS SPECIALIZED PRODUCTION LINES

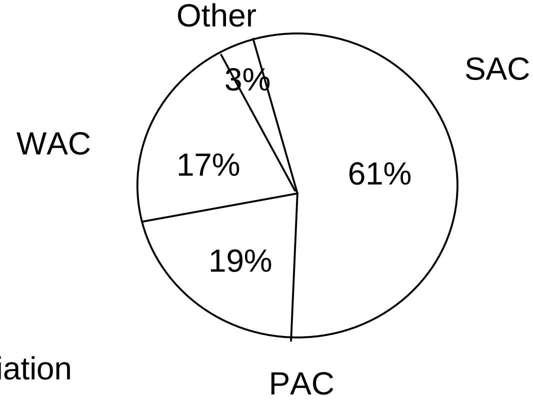
Key facts:

- 16 production lines,including 6 SAC lines,4 PAC line,2 WAC lines and 4 SAC/PAC lines
- Invested 150 million RMB to build up Wuhu A/C manufacturing base
- Total annual production capacity of 2.0 million sets

Capacity and production plan
million sets

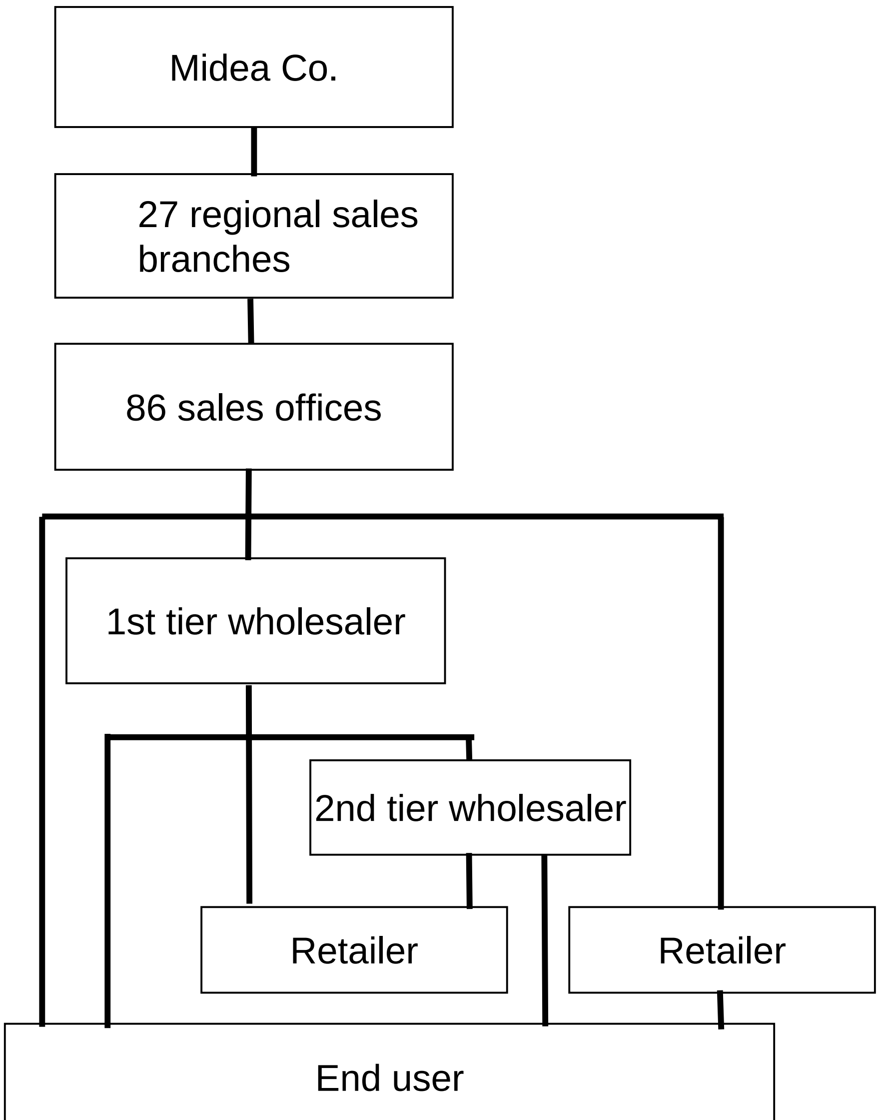


Product Type Split (Year 2000)*
Percent



***** First 11 month data
Source: Literature search; China Household Electrical Appliances Association

MIDEA ESTABLISHED AN EXTENSIVE SALES NETWORK IN CHINA



Rotes	Sales policy
• Develop overall sales strategy • manage sales branches	• No cross-regional sales are permitted • No Credit in trade term
• Manage regional sales • Establish network • Manage dealers	• Strict regional price control • High margins to wholesalers
• Manage local channel • Local sales operation	• Manage wholesalers directly • Deliver goods to 2 tier wholesalers
• Large 1 tier wholesalers with good sales channels and networks	• Manage next level Channel and market
• Smaller regional sellers	• Manage retailers
• Direct sales to market	• Manage sales by using bar code system • Midea provides direct retailer support

MIDEA TRIES TO KEEP ITS SERVICE QUALITY CATCH UP WITH OTHER PLAYERS

High

Low

	Service policy and practice	Competitive advantages
Warranty	• A/C:3 years • Components: 5 years	
Service Organiza-tion	• Service center in charge of regional service and authorized service station management • Factory in charge of service fee payment	
Installation	• Authorized installation stations install A/C • Midea keeps limited installation force, mainly in charge of technology support • Retailers/installation service providers'installation must be inspected by 1st wholesalers • Retailers make happy calls,Midea call retailers to confirm the installation quality	
Main-tenance	• Easy to return with few restrictions • Strict management of outside service providers by using strict penalty policy	
Parts	• Timely parts supply	

- High customer satisfaction of service quality with convenient return policy and high quality maintenance practice
- Very strict service quality management policy and practice make sure service stations to provide qualified service
- High sales volume gives Midea the ability to bargain with third party service stations

KELON CARRIES OUT DUAL-BRAND STRATEGY TO INCREASE ITS SALES REGIONALLY AND NATIONALLY

Core strategy

Become technology leading national brand under name of Kelon and serve low end customer segment by Huabao especially in South China

Key elements	Implications for LG
• Distinctive channel strategy by focusing on regional first tier wholesalers	• LG has to catch up to get closer control on the retail market
• Build research institute in Japan	• Direct competition in technophile consumer segment is going to intensify
• Most advanced manufacturing capabilities	• Might have cost advantage in manufacturing
• Decentralized and flat sales organization	• LG may have to face cost advantage of Kelon and its shorter response to the market
• High skill personnel policy for sales organization	• LG needs to consider incentive system and human resource policy improvement for sales personnel

KELON PROFILE

Name : Guangdong Kelon Electrical Holdings Co.Ltd.

Address : No.8 Rongqi Town,Shunde City,Guangdong

Starting year: December,1992

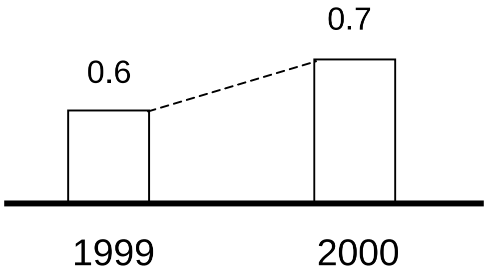
Registered capital: USD 36 Million

# of employee: 10,960 employees

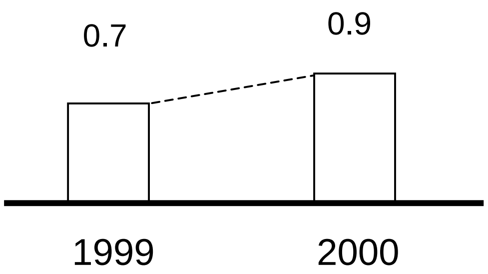
Equity structure: Kelon Group Co. 34%
Other shareholders 66%

Production line: Air conditioner,refrigerator

Domestic sales of air conditioner million sets



Production of air conditioner
million sets



Source:Literature search;Kelon annual reports;China Household Electrical Appliances Association

KELON IMPROVED ITS R&D CAPABILITY BY ESTABLISHING RESEARCH INSTITUTE IN JAPAN

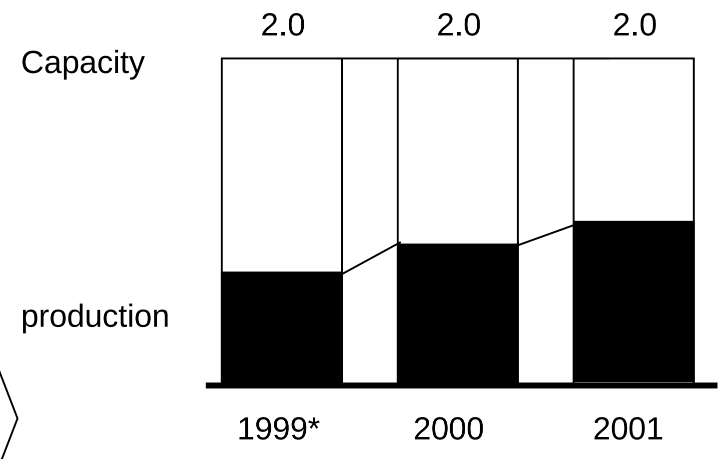
	Kelon strategy	Practice
Technology development	• Started by importing technology • Developed own R&D capability • Leverage foreign engineers' knowledge	• Imported technology from Japan • Established research institute in Japan by hiring Japanese engineers and researchers to do product development and information gathering
R&D capability development	• Made continuous investment on R&D	• Invested about 2% of annual sales id R&D
New product launching	•Introduce new models frequently	• Practice has to be further investigated

KELON EXPANDS ITS PRODUCTION CAPACITY BY MERGING HUABAO AIR CONDITIONER FACTORY

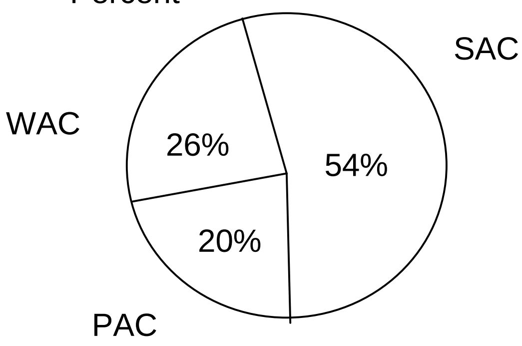
Key facts:

- Tripled its production capacity by acquiring Huabao's production lines
- Current annual production capacity is 2.0 million sets
- The assembly lines from Huabao are advanced,With robotic machines

Capacity and production plan
million sets

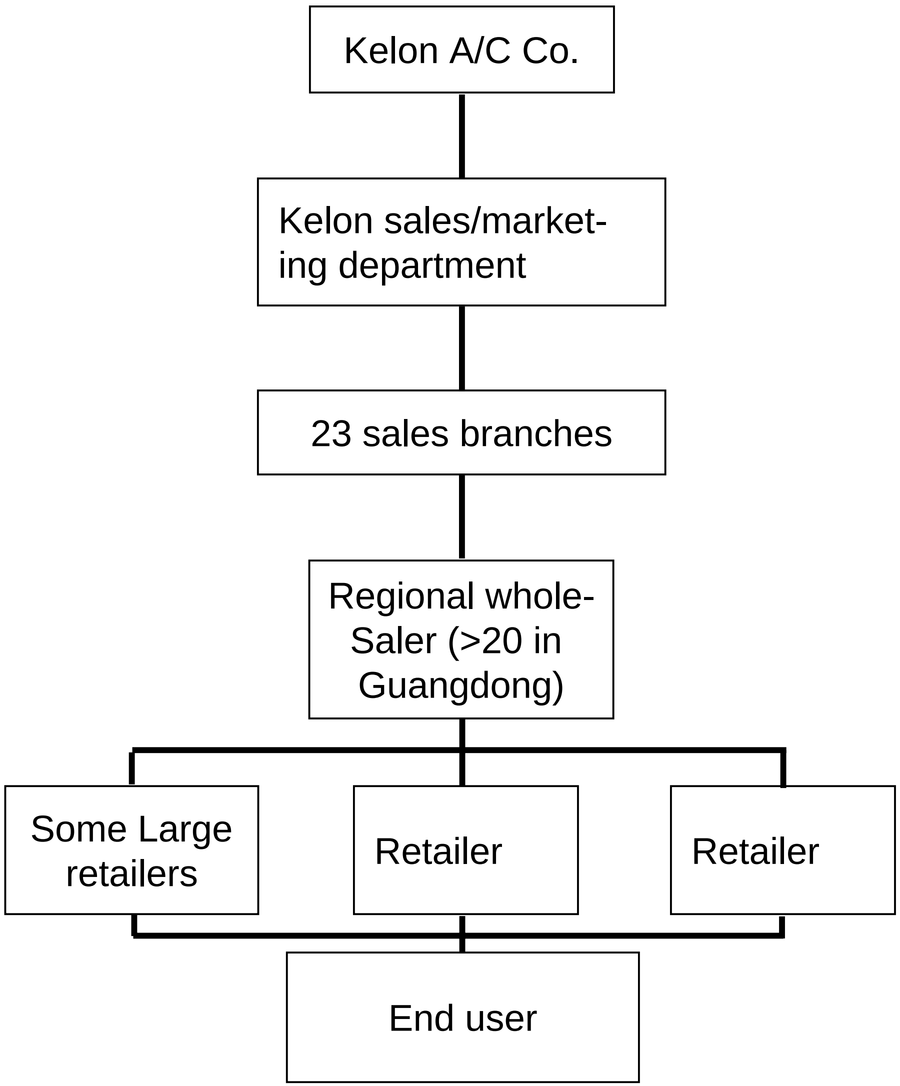


Product Type Split (Year 2000)**
Percent



* Kelon acquired Huabao In May ,1999.Before that,Kelon had production capacity of 0.8 million sets per year
**First 11 month data
Source: Literature search; China Household Electrical Appliances Association

KELON REORGANIZES ITS SALES STRUCTURE TO IMPROVE SALES EFFICIENCY



Responsibility	Sales policy
• Manufacturing A/C	
• Define sales strategy • Manage sales channel	• No Credit to dealers
• Define regional sales strategy • Develop and support distributors • Manage wholesalers	• Systematic wholesaler selection standard,such as loyalty,capital capability,relation,etc.
• Sell A/C in its region • Develop and support retailer channels	• Average 3-6% margin to wholesalers
• Sell A/C to consumer	• Average 7-8% margin to retailer • Kelon sales branches cooperate with some key retailers directly • Strict market price management

KELON HAS CLEAR SERVICE VISION AND GOOD CORPORATE IMAGE

High
Low

	Service policy and practice	Competitive advantages
Warranty	• A/C: 3 Years • Components: 6 Years • Motor and other components:4 Years	
Service Organiza- tion	• Factory in charge of service directly • Service center is part of sales branches • More than 20 service centers together with sales branches	
Installation	• Retailers install and Kelon provides technical support • 100% happy call by service centers • Installation fee is reimbursed within 40 days	
Main- tenance	• Retailers service staff does maintenance and Kelon provides technical support • Easy to return with few restrictions	
Parts	• Parts delivered within 15 days after dealers send out request • For A and B level dealers,they can apply parts with value of 130% of their down payments	

- In terms of service,Kelon tries to catch up with other competitors except Haier
- Very strict service quality management policy and practice make sure service stations to provide qualified service