Lenovo Counting on China Advantage to Challenge Apple Lead

Bloomberg

Lenovo Group Ltd. (992) [1], set to overtake Hewlett-Packard Co. (HPQ) [2] as the biggest PC maker this year, now has its sights on the smartphone and tablet markets, as it takes on Apple Inc. and Samsung Electronics Co. in China [3].

“We want to test the market, see the first steps toward success in China, then roll out to the rest of world,” Chief Executive Officer Yang Yuanqing [4] said. “We want to win in the smartphone area and even the TV area.”

Lenovo Group Ltd , whose headquarters are in Beijing and Morrisville, North Carolina, will introduce a wider array of phone models this fiscal year.

The maker of Thinkpad laptops, a business it acquired from IBM, has added tablets and phones to lessen its dependence on PCs, taking it into direct competition with the world’s most valuable company. Yang said Lenovo’s brand name [1], product development and distribution in China will give it an edge over Apple and other rivals that create devices elsewhere before selling them in the world’s biggest PC and smartphone market.

Yang is not alone in that view. A China-first strategy gives Lenovo “the right balance between near-term profitability and long-term growth,” said Masha Gordon, head of emerging- market equity portfolio management at Pacific Investment Management Co. “Lenovo is likely to leverage its global PC footprint to expand its global presence in these new areas.”

Lenovo already outsells Apple (AAPL) [5]’s iPhone in China, where the Beijing-based company introduced its first touch-screen handset in 2010. The company’s smartphone shipments in China outpaced its PC unit sales for the first time in the second quarter, overtaking the iPhone as well, according to researcher IDC.

Global Stakes

Outside of China, Lenovo will struggle to sell products that are more distinguished by software they can use rather than the device itself, said Jean-Louis Lafayeedney, an analyst at JI Asia [6] in Hong Kong.

“I don’t see Lenovo being able to do it, not in the foreseeable future,” said Lafayeedney, who rates the shares sell. He said the company lacks the software development power to lure users away from Apple’s operating system and Samsung, which sells devices based on Google’s Android.

Apple introduces its best-selling iPhone and iPad in the U.S. months before they arrive in China. The Cupertino, California-based company has yet to announce a debut date for its latest smartphone model in mainland China, after starting sales of the iPhone 5 Sept. 21 in countries including the U.S., Japan [7] and Hong Kong [8]. The iPhone 5 will be available in China by the end of the year, the company has said.

China Smartphones

Samsung controlled about 19 percent of China's smartphone market in the second quarter, the biggest share. Like Lenovo, the South Korean company offers products through all three of China's largest mobile phone carriers.

IPhones aren't sold to market leader China Mobile Ltd.'s 693 million subscribers, more than the combined populations of the U.S., Japan and Brazil [9].

China will overtake the U.S. as the world's largest smartphone market this year, with shipments climbing 52 percent [10] to 137 million, according to market researcher IDC.

Lenovo is spending 5 billion yuan [11] ($793 million) to set up a plant to research and produce mobile devices, it said in May. The factory will open in October 2013 and will have sales of 10 billion yuan by 2014, quintipling to 50 billion yuan in five years, the company estimates.

"Our development cycle will be much faster than our competitors," said Yang. "Not only are we an innovative company, we understand emerging markets [12]. We have a different strategy."

Price Spectrum

Lenovo intends to develop products across the price spectrum, from the latest high-functioning smart TVs to smartphones priced to compete in emerging markets, said Yang.

"I don't think every Chinese can afford $400 to $500 for a smartphone or tablet, but we will develop the appropriate product for those customers. That will be Lenovo's advantage."

A 16 gigabyte version of the newest iPad with 3G service costs 4,688 yuan at Apple's online store in China. Lenovo's ideatab S2007A 16 gigabyte version with 3G service is 2,499 yuan at TMall.com.

Yang has also said he intends to use acquisitions to build the global "four screens" business.

The maker of the Ideaphone smartphone this month agreed to buy Brazil-based PC, tablet and handset maker Digibras Participacoes SA in a $147 million deal. Lenovo said on Sept. 18 it agreed to buy Stoneware Inc. of the U.S. to gain cloud-computing products in its first acquisition of a software vendor. It didn't disclose terms.

M&A Growth

Lenovo spent $845 million in five purchases in 2011, including 466 million euros ($671 million at the time) to take over Essen, Germany-based PC maker Medion AG, according to data compiled by Bloomberg.

Lenovo boosted cash and equivalents an average of 30 percent in the past five quarters to $3.8 billion in the three months ended March 31, in line with Samsung's 31 percent average gain, according to data compiled by Bloomberg. Apple's cash and equivalents dropped an average of 18 percent average across the three quarters, peaking at $1.3 trillion in the three months ended March 26, 2011.

Still, buying competitors in emerging markets and spending on research and development may not be enough to allow Lenovo to achieve in the mobile market what it has in PCs, where second- quarter shipments shrank 0.1 percent, according to Gartner Inc.

Software Ecosystem

Unlike the iPhone and iPad, which operate on Apple's proprietary software and can access online media through i- Tunes, Lenovo and smartphone leader Samsung run devices on Google's Android operating system.

As more manufacturers compete for tablet sales, control of the operating system will offer an increasing advantage, said Lafayeedney of JI Asia. Companies including Samsung and Lenovo, which mostly depend on Android for mobile devices, will have a more difficult time distinguishing their products, he said.

"The edge has to come from control of the ecosystem, or part thereof," Lafayeedney said in an interview. "That will be the real challenge, in my view. Progression from a pure hardware player will be a most difficult leap to make for Lenovo."

ZTE Corp., China's second-biggest maker of phone equipment, said Sept. 19 it plans to release a new mobile operating system with the developer of the Firefox web browser to compete with Google Inc.'s Android software.

Shenzen, China-based ZTE is expanding in mobile devices and cloud computing where sales growth is faster than its traditional equipment business as the pace of new network rollouts slows.

TV Convergence

In televisions, where Japan's former world leaders Sharp Corp., Panasonic Corp. (6752) [13] and Sony Corp. are reeling from losses blamed on a demand slump and the strong yen, Lenovo says it expects to benefit as consumers shift to smart TVs that blur the distinction between television and PC.

"We have seen and we will see a lot of convergence," Yang said by phone from the company's headquarters in Beijing. "The smartphone is converging with tablet. The tablet is converging with the notebook. The all-in-one desktop is converging with the TV. This will be the trend."

Investors have pushed Lenovo's shares up 25 percent this year in Hong Kong trading, while analysts see a potential pay off from Yang's mobile push. The stock is now rated [1] buy by 22 analysts tracked by Bloomberg, compared with three who rate it sell and five hold.

The 12-month average price forecast of HK$7.33 for the shares would mean a gain of 14 percent from HK$6.45, yesterday's price at the close in Hong Kong.

U.S. Market

Lenovo has yet to set a timeframe for its rise to the "four-screen" top in the U.S., the largest market outside China.

"For phones, we have a strong presence in China but we're not ready for it in North America [14], and my job is to get us ready," David Schmoock, Lenovo's president for North America, said in an interview at his office in Morrisville. "You only get once chance to launch a product and we want to make sure we launch it right."

Lenovo's timing for entry in the U.S. smartphone and tablet markets underscores the company's challenges in taking on the likes of Apple and Samsung in the mobile business, said Alberto Moel, an analyst at Sanford C Bernstein & Co. in Hong Kong

"Some people believe Lenovo can take their PC brand and extend it into smartphones, but that's not their business," said Moel, who rates Lenovo shares the equivalent of hold. "Lenovo is an incumbent in the PC business, but it's not even close in handsets. They are going to have to pay for that, spending a long time to get to scale in a business it perhaps shouldn't be in."

Mobile Move

Yang has said remaining primarily a PC maker isn't an option for the company, given the shift in consumer preference for smartphones and tablets.

To that end, Yang established Lenovo's Mobile Internet Digital Home division last year, which covers the company's thrust into phones, tablets and televisions.

The division in May began selling smart televisions in China that run Google Inc.'s Android 4.0 operating system. The company in August unveiled three new tablets in its Ideatab product line that also run Android 4.0.

After one year in operation, the digital home unit reported that sales almost tripled to $587 million during the first fiscal quarter, comprising 7 percent of the company's total revenue.

"Every PC company has to expand its portfolio to smartphones and tablets and, ideally, even smart TVs, because that is the future of devices," says Kirk Yang [15], managing director for technology research at Barclays Plc in Hong Kong. "Besides Apple and Samsung, Lenovo is probably the most successful in broadening their product portfolio. Lenovo is getting close to their level."

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