Schumpeter | Think different

Xiaomi's forthcoming IPO in Hong Kong shows how the rules of business are changing

IN 1987, when Lei Jun was a computer-science student in Wuhan, on the banks of the Yangtze River, he read a book about Steve Jobs and vowed to emulate him. If all goes to plan, this summer Mr Lei will take a leap towards that dream with the flotation of his firm, Xiaomi, at a valuation of $50bn-75bn. It is set to be the world's largest initial public offering (IPO) since Alibaba in 2014.

Xiaomi is probably China's most successful consumer brand, but ever since it started selling smartphones in 2010 it has also been difficult to categorise. Yes, Mr Lei sometimes dresses in black, as Mr Jobs did, but it has never been clear if Xiaomi is China's Apple or if it is more like Samsung, Sony, Nokia, or even Costco, a bulk-discount retailer.

Schumpeter's answer is that Xiaomi does not resemble any rich-world firm. For decades a particular American ideal of the public company has dominated: focused, widely owned and predictable. Xiaomi is a supercharged champion of a new Chinese model that is the opposite: deliberately sprawling, tightly controlled and hyperactive. Edward Tse, of Gao Feng, a consultancy, calls these firms "China's disrupters". Xiaomi's IPO is a test of how valuable investors believe the model is.

Xiaomi is above all a creature of its environment, which in China means rock-star bosses, ambiguous rules, intense competition, proximity to the world's manufacturing hub, and fast-changing consumer behaviour. The firm is what Charles Darwin might call a perfect adaptation. It also seems to live in dog years, packing more into the past seven years than American firms do in 49. Almost three-quarters of its $18bn of sales last year came from selling smartphones, where it has a global market share of 7%, but there is lots of sprawl, which is by design.

As well as smartphones, Xiaomi has hundreds of other products, from vacuum cleaners to electric bicycles, and even owns 30% of a small bank. It incubates new hardware suppliers by buying small equity stakes in them. The cost of this ate up a fifth of its free cashflow in 2016-17 and could spiral further. Ferocious competition at home, meanwhile, has meant erratic performance. In 2015 it made an underlying loss and in 2016 sales stagnated after its handset market share in China dropped.

A small but rising number of American firms, including Alphabet and Facebook, have dual voting classes. But Xiaomi takes tight control to a new level. Mr Lei has majority voting control. Like the BAT firms—Baidu, Alibaba and Tencent—Xiaomi has a "variable-interest-entity" structure to get round rules on having foreign shareholders. The firm's holding company, in the Cayman Islands, has contracts with operating entities in China. The contracts give it control and profits but not ownership, which in several cases remains in the hands of Mr Lei. He is also the personification of the brand, which appeals to younger customers.

Xiaomi's faults are also its virtues. Tight control means rapid decisions, and intimacy with many suppliers means products can be sourced out of thin air. The firm is quick on its feet. Between 2014 and 2017, while many multinationals would still be searching for Uttar Pradesh on the map, it went from zero to being the biggest smartphone firm in India. Sales of its potpourri of consumer electronics tripled over this period. And a new range of smartphones has led to a comeback. In 2017 sales rose by 68%. Underlying operating profits this year should hit $1.5bn-2bn.

Does all this justify a high IPO valuation? In frantic fashion, Xiaomi says that it is in the middle of another reinvention, from a hardware firm into an internet one. It is obvious why: with the exceptions of Apple and Samsung, the industry's profitability is terrible. Xiaomi's handset operating margin is about 1% (its cute pledge to customers that it will never exceed 5% is irrelevant).

Other hardware firms, from Sony in 1999 to Nokia in 2007, have tried similar pitches over the years with dismal results. Now, unlike then, however, the shift to services is tangible. Services are the new engine of Apple, which sells apps, payments and content to its installed base of 1.3bn iPhone, iPad and Mac users. It made sales of $26 per device in the past year, or $33bn.

Xiaomi has an installed base of 190m smartphone users, who spend 54 minutes a day using its services, equivalent to 20% of the total time on their phone. It makes $9 per user per year, from advertisements and commissions on selling apps and games. Margins are high. If Xiaomi can maintain its market share of new smartphone sales—thereby adding new internet users—and if its service revenue per user rises to $20 over a decade, this business could be worth $35bn—supporting a chunk of its IPO valuation.

There are glaring risks. Xiaomi's smartphone market share could plummet again, eventually dragging down the number of internet users. It is unclear if its services will travel across borders: sales per user in India are still very low. And the BAT firms are expanding their ecosystems of services and could win a bigger "mindshare" of Xiaomi's device users. To stay in the race Xiaomi will probably reinvest most of the expected $10bn IPO proceeds.

The X factor

Xiaomi is therefore an opaque bet on constant reinvention. But it is only the most extreme example of a national trend. There is a second wave of tech firms waiting to IPO, including Didi-Chuxing, which does ride sharing but is diversifying into payments, and Meituan-Dianping, which is expanding from food delivery into ride sharing. Each of the BATs used to have a neat identity. Alibaba did e-commerce, Tencent did games and Baidu did search. These barriers are collapsing in a giant investment boom.

China's acrobatic, high-stakes, sprawling champions are the antithesis of what investors have been taught to admire. But Xiaomi's IPO may show how no one cares much about that any more, at least for as long as the internet boom rages on. Mr Lei has not created China's Apple. If he succeeds in floating his firm, he will instead have imitated Mr Jobs by breaking all the rules. ■