

K. J. SOMAIYA INSTITUTE OF MANAGEMENT STUDIES AND RESEARCH

Program: PG EXEC / 5TH TRIMESTER

Subject: Corporate Strategy and Implementation

(Final examination)

Maximum Marks: 50

Duration: 3 hours

Date: 28 Dec 2018

Notes:

Answer any 1 out of questions 1 to 2 ONLY. Each question carries 20 marks. Question 3 on the Xiaomi case is COMPULSORY and carries 30 marks.

1. Explain under what conditions companies should use vertical integration for corporate advantage.
2. What explains the high failure rate in acquisitions? What are the rules for making successful acquisitions?
3.
 - a. Explain the attractiveness test and better-off test. Apply the tests to Xiaomi's diversification from mobile phones to other devices.
 - b. Explain the 4 concepts of corporate strategy: portfolio management, restructuring, sharing activities and transfer of skills. What synergies for Xiaomi come from portfolio management, sharing activities and transfer of skills?

[Luna Yue Yuan](#)

Voyager

Jul 10, 2017

Deep Dive into Xiaomi's Strategy to Dominate the Connected Home

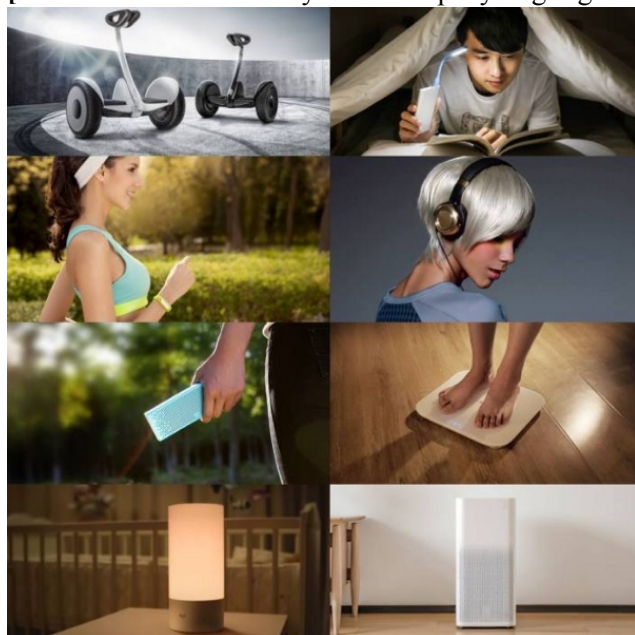
“Invest in 100 Mi Ecosystem Companies”:

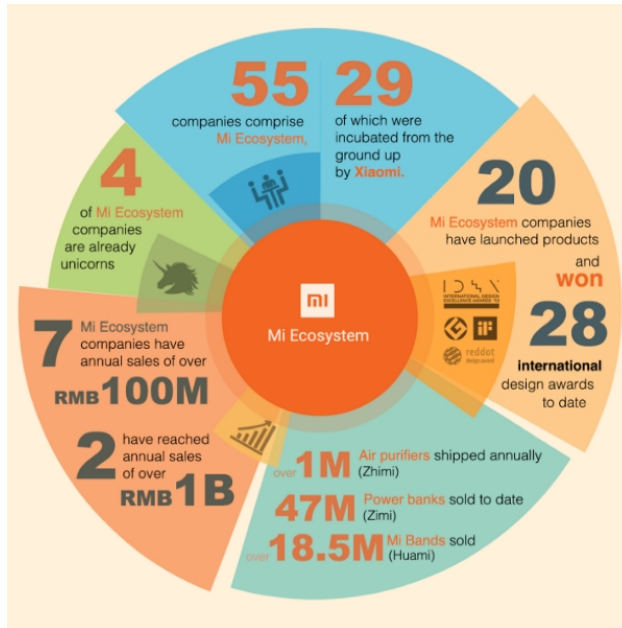
Assessing Xiaomi's Strategy to Dominate the Connected Home

I. Introduction

In late 2013, Xiaomi, a Beijing-based smartphone-maker that has been frequently touted as the “Apple of China”, initiated the Mi Ecosystem Companies strategy. The CEO Lei Jun announced that Xiaomi would invest in 100 companies in 5 years to aggressively expand into new hardware fields. By March 2016, Xiaomi had invested in 55 Mi Ecosystem companies making products from power banks to air purifiers. Of these companies, 29 were incubated from the ground up by Xiaomi, 7 have annual sales of over RMB 100M, 2 have reached annual sales of over RMB 1 Billion **[Exhibit 1]**, and 4 are already unicorns worth with over \$1 Billion. One of Xiaomi's Ecosystem Companies Ninebot even bought out Segway—the American maker of the world's most recognizable self-balancing scooter. The early success of Xiaomi's Ecosystem Companies seems to suggest that Xiaomi's diversification strategy is working. Very pleased with the portfolio success so far, Lei Jun launched a new Mi Ecosystem sub-brand called “MiJia”, under which all their Internet of Things/smart home products would be promoted. Mijia Smart Rice Cooker is their first product announced in this new Mi Ecosystem. This sub-brand separates Xiaomi's own products (under Xiaomi's main brand) from its Ecosystem Companies' products, and could hopefully avoid brand dilution from its Ecosystem Companies if their products have quality issues.

[Exhibit 1: Xiaomi Ecosystem Company Highlights by March 2016]





Source: Xiaomi Global VP Hugo Barra’s Twitter <https://twitter.com/hbarra/status/714856062369669120>
 On the other hand, the lion’s share of Xiaomi’s revenue (~ 85% according to CounterPoint Research[1]) still comes from sales of smartphones, which have been declining in the past two years. According to the research firm IDC, Xiaomi saw sales of its smartphones drop by almost 40% in China during the second quarter of 2016 when compared to the same period in 2015 while Xiaomi’s competitors Huawei, Oppo and Vivo, all saw significant growth. An independent research producer Radio Free Mobile claimed the firm’s valuation had gone from US \$45 Billion to less than US \$4 Billion in just two years[2]. This led BBC News to question if the “Apple of the East” has lost its shine. [3]

Even though smartphones have always been the lead product for Xiaomi, the company always calls itself an “Internet services company”, sees its future more broadly as an e-commerce company for a whole variety of products, and aspires to be the center of connected home. What is the basis for Xiaomi’s aspiration and is diversification the right path forward? Given Xiaomi’s status as a young start-up company and the context of its declining smartphone market share, is Xiaomi spreading itself thin as it expands its scope? What products should Xiaomi develop internally and what could be acquired through investments? What is the investment criteria for the Mi Ecosystem Companies, and how they fit into Xiaomi’s current organization?

This paper will address the questions by first looking into the background of Xiaomi and its Ecosystem Companies, inferring about Xiaomi’s corporate strategy, and finally, assessing CEO Lei Jun’s strategic decision to invest in “100 Mi Ecosystem Companies”.

II. Company Background

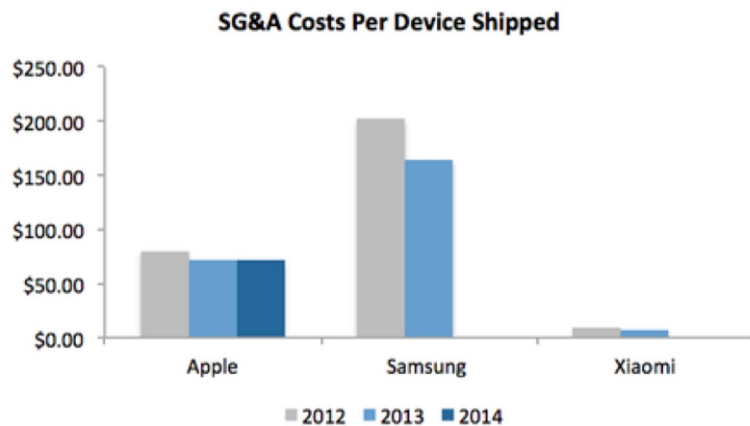
Xiaomi is a privately-owned Chinese electronics company founded in 2010. The core products Xiaomi designs and develops include: mobile phone, TV and router. Xiaomi’s mobile phones are shipped with its Android-based firmware MIUI. Since the release of its first smartphone Xiaomi Mi1 in August 2011, Xiaomi has quickly gained market traction by making budget smartphones with strong specifications. It

released a new smartphone model each year. In 2014, Xiaomi's smartphone market share jumped up to close to 15% and it overtook Samsung as the №1 smartphone vendor in China. Meanwhile, Xiaomi became the world's most valuable tech startup with a private valuation of over \$46 Billion. Starting 2015, global smartphone sales stalled and Xiaomi's smartphone sales started plummeting, falling faster than its rivals. It shipped only 71% of its sales goal in 2015 and suffered a 26% year-over-year decline . In Q1 2016, Xiaomi fell out of top 5 largest smartphone manufactures in China[4].

Business model

Xiaomi was able to quickly gain market share initially thanks to its innovative business model to sell top-of-the-line products at almost bill-of-material prices. Xiaomi sees the phones as just delivery devices for software and Internet services, which the company also develops and profits from. By making its operating system MIUI available to download on other Android phones, Xiaomi increases the accessibility of its apps and content to reach more users. To control the cost of the phones, company did not own any physical stores and sold exclusively from its online store in the first four years. It also spends very little on conventional marketing and distribution. The SG&A expenses per device shipped is \$7 compared to Apple's ~\$70 and Samsung's \$160 [Exhibit 3]. Xiaomi relies heavily on social networks like Weibo and its own forums to communicate with users. Xiaomi's limited availability flash sales on one hand avoid large upfront production costs like other traditional OEMs and allow Xiaomi to place cheaper batch orders as demand dictates, on the other, help promote the products as being highly on-demand. Unfortunately, Xiaomi's user hype marketing tactic is no longer working so well in the past two years as more competitors like Vivo and Oppo emerge to offer similar value proposition, making it more and more difficult for Xiaomi to differentiate itself and sustain users' brand loyalty.

[Exhibit 3: Xiaomi's SG&A cost per device shipped compared to Apple and Samsung]



Tech-Thoughts ©

Expansion and Ecosystem companies:

Xiaomi started the international expansion in 2014, first to Singapore, then to India and Brazil in 2015. Its products lines also expanded to smart TV, smart set-top box for TV, tablet, network router, external battery charger, and smart wristband. It also started the Personal Transport product series such as electric bikes and electric scooters, and Smart Home product series including blood pressure monitor, air purifier, smart webcam, action camera, smart scale, water purifier, smart rice cooker, and robotic vacuum. Some company officials predicted that sales of everything from Xiaomi fitness bands to Xiaomi rice cookers

could equal their smartphone sales five years from now^[5].

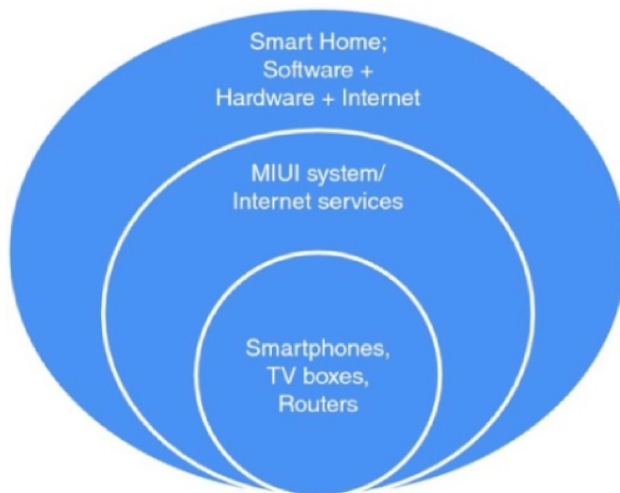
The secret to Xiaomi's quick expansion to new product categories is its Ecosystem Company strategy. Of all the products Xiaomi released under its brand, only smartphones, smart TV, smart TV set-top box and network router are designed and developed by Xiaomi ("Xiaomi" itself is actually more than one company—it consists of 30 business entities focusing on different business lines controlled by Xiaomi H.K. Limited, which is wholly owned by Xiaomi holding company). The rest are produced by Xiaomi's Ecosystem Companies, which are typically invested by Beijing Xiaomi Technology Co., Ltd (Xiaomi's largest business entity that focuses on manufacturing and selling mobile phones), Xiaomi's investment funds (Shunwei and Jinxing), CEO Lei Jun himself, or a combination of those^[6]. For example, one of Xiaomi's Ecosystem Companies specialized in producing external batteries for mobile phones, Zimi, was invested by Xiaomi's investment arm Shunwei back in 2012, which then transferred the shares to Lei Jun, who now owns 15% of Zimi. Beijing Xiaomi Technology Co., Ltd also owns 19.32% of Zimi. After Zimi was invested, Xiaomi sent an executive with rich hardware experience to be the new CEO. Zimi saw over a billion RMB in revenue in its first year after the investment and its valuation increased by 7–10 fold. Xiaomi distributes some of Mi Ecosystem Companies' products through Xiaomi's own e-commerce store, and split the profit half-half with them.

III. Xiaomi's Corporate Strategy

Although Xiaomi is first and foremost in the phone business, its ambition goes far beyond. The CEO Lei Jun considers the mobile phone to be a converged system of "software + hardware + internet", instead of a simple device for communication. The same "internet thinking" could be applied to many other smart devices. Xiaomi's aggressive entry into the phone market with competitive pricing and its quick expansion into other product categories are not by accident, but rather, as part of the well-thought-out plan.

In Lei Jun's vision, there are three layers of product offerings in Xiaomi's ecosystem **[Exhibit 4]**. At its core, are its well-established products of smartphones, smart TV, TV set-top boxes (HRD streamer), and routers. As elaborated in the previous section, Xiaomi is a late entry into the competitive smartphone market in China, but has gained substantial market share through its innovative business model. However, China's smartphone market is quickly getting saturated: IDC estimates it to grow between 1% and 2% in 2016 while not long ago, the market was doubling every year.^[7] Globally, smartphone shipments are expected to slow to 3.1% in 2016, from 10.5% in 2015 and 27.8% in 2014.^[8] Further complicating the matter is the changing consumer preference. One hypothesis behind Xiaomi's decline is that once first-time buyers get a taste of life with a smartphone, they look upstream a bit when it's time to buy a new device—and Xiaomi's value proposition no longer appeals to them.^[9] On the other hand, despite Xiaomi's strong market positions in smart TV, and TV set-up box, the profitability is low given the immaturity of the market segment and the regulatory uncertainties. Xiaomi's Wifi router has earned №1 market position with 9 million accumulated sales since 2015—good record but like smart TV, it's still in an early market and its sales only represent a small segment compared to Xiaomi's phone business of 70 million sales in 2015 alone.

[Exhibit 4: Xiaomi's three layers of ecosystem]



Source: Winston Ma (2016), Book China's Mobile Economy: Opportunities in the Largest and Fastest Information Consumption Boom.

The next level up is the Internet services based on Xiaomi's MIUI system that supports the hardware products. According to Lei Jun, smartphones serve as a distribution channel and not a source of profits. Selling phones is Xiaomi's strategy to get access to users so that Xiaomi could "milk the cow" later on. As Xiaomi's smartphone sales slowed down in growth, Lei Jun said in early 2015 that Xiaomi would make Internet services such as smartphone games and mobile finance an increasing part of its business, and expected the revenue from Internet services to triple to nearly \$1 billion^[10]. In June 2016, Xiaomi's App store hit the 50 billion download mark^[11]. Xiaomi's Internet service—primarily games, but also payments and cloud storage, rose 150% to \$564 million in 2015. The growth was impressive, but represented less than 5% of the company's total revenue and far short of Xiaomi's internal target of \$1 billion.^[12]

The third layer coincides with Lei Jun's ultimate vision for the future of Xiaomi—to become an important player in the "internet of things" and the "smart home". A family of smart home devices will be seamlessly connected under the Xiaomi ecosystem. Despite the sharp drops in smartphone sales, Xiaomi will not take a big hit as its profit growth will be driven by sales from smart home devices. In April 2016, one of Xiaomi's senior executives predicted the sales of smart home devices to double to \$1.5 billion this year.^[13]

After analyzing the three layers of Xiaomi's intended ecosystem in the context of changing industry landscape and Xiaomi's sales performance in recent years, it becomes clear why Xiaomi would want to move into the space of Internet services and Smart Home. Perhaps more accurately put, Xiaomi understands where majority of values will be created along the value chain of the connected home and has prepared itself from day 1 to become an Internet service provider and a software platform that connects user-to-user, user-to-device, and device-to-device. However, this space is already filled with dominant players from both big Internet firms such as Baidu, Tencent and Alibaba, as well as established home appliance manufacturers that are looking to transform themselves such as Gree and Midea. Thus Xiaomi decided to enter the space through smartphone market to avoid direct head-on competition from big players, while effectively acquiring and locking in users by building an ecosystem integrating software and hardware around their needs. Indeed, Xiaomi has done a terrific job in engaging its users.

Xiaomi's product managers can spend half their time browsing through the company's user forums, analyzing user feedback, picking up suggestions and quickly passing them to engineers to be incorporated as new features. [14] As a result, the average Xiaomi user spends 7% more time in apps than iPhone consumers [Exhibit 5]. [15] Given Xiaomi's resource constraint as a startup itself, in order to meet the consumer demands once they become ready, Xiaomi needs to acquire/invest in companies that could potentially offer the products consumers are looking for in advance. What they could offer to these Mi Ecosystem Companies in return, are immediate cost reduction benefiting from Xiaomi's global supply chain network, and sales bump-up as being associated with Xiaomi brand.

[Exhibit 5: Xiaomi's mobile app store screenshots & download growth from 2014–2016 (reaching 40 billion in 2016.03)]

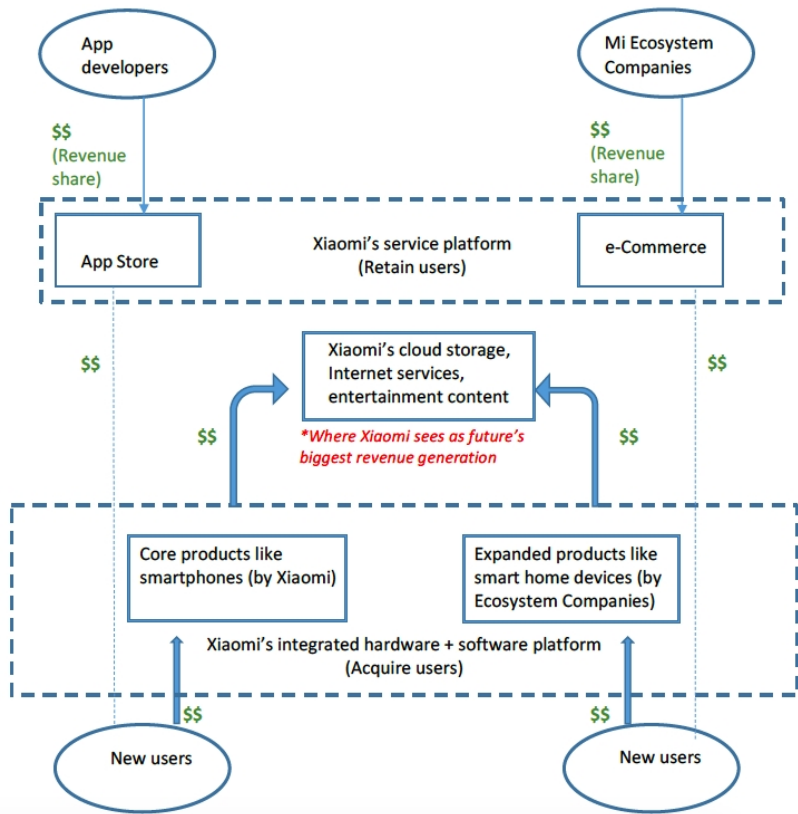
Therefore, Xiaomi's corporate strategy could be inferred as the following:

To seize large market share, pursue high growth and profitability, and dominate the connected home by 1) growing its three layers of ecosystem simultaneously with a combination of in-house core product development and investments in smart home devices, 2) acquiring users aggressively with a large catalog of affordable and high-quality products of its own and those of its Ecosystem Companies, and 3) retaining users through active engagement and competitive internet services, in self-contained divisions that share the brand association, supply chain relationships, and distribution channels.

IV. Assessment of Lei Jun's Strategic Decision

Having understood Xiaomi's Corporate Strategy, CEO Lei Jun's decision to invest in "100 Mi Ecosystem Companies" in 5 years can be seen as a diversification strategy for Xiaomi to quickly enter new product categories under the "Smart Home" layer. In China, technology innovations are not sustainable enough—copycats could quickly follow after a successful product. Xiaomi has to always defend its access to users who sustain the entire ecosystem, which supports Xiaomi's direct (product sale) and indirect (revenue share from its partners, and charging consumers for cloud storage/internet services/entertainment content) monetization. Please see **Exhibit 6** for a complete illustration on Xiaomi's monetization model. I will explain the various aspects in more details in the following "Businesses" section.

[Exhibit 6: Graphic illustration of Xiaomi's monetization model]



Source: author's original creation

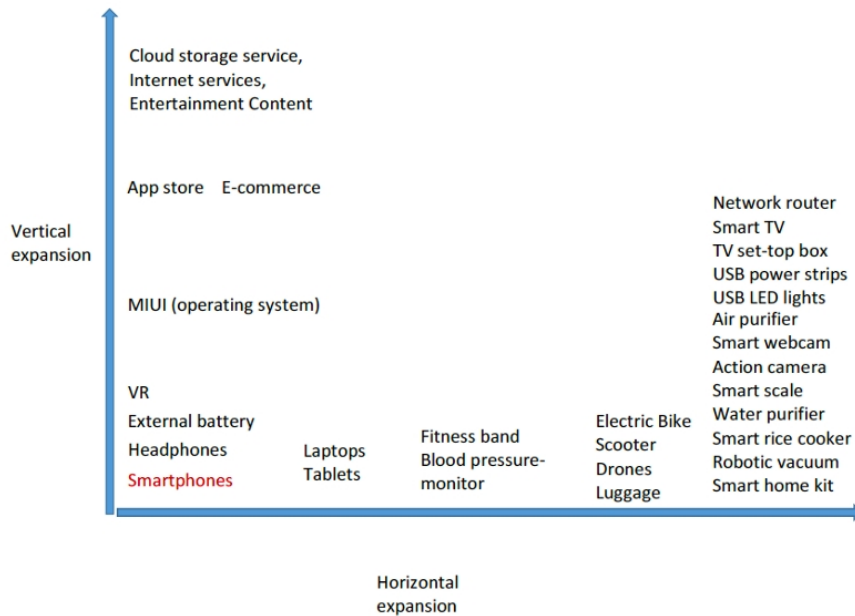
Therefore, the question is not whether Xiaomi should expand to new product categories—it has to, otherwise it will soon lose its power engine being stuck in a declining smartphone industry. The question is, how. Specifically, how does Xiaomi decide which products to develop internally and which to “outsource” to its Ecosystem Companies? How does Xiaomi come up with the investment criteria for the potential Ecosystem Companies? And lastly, how to implement the strategy successfully?

To further assess Lei Jun’s strategic decision to invest in 100 Mi Ecosystem Companies, and to address questions above, we will dive deeper into the synergies between Xiaomi and the potential portfolio companies through the lens of “Attractiveness Test”, “Better-off Test”, and “Ownership Test”, given the context of Xiaomi’s businesses, resources and organization structure.

Businesses

Though seemingly difficult to track, Xiaomi’s businesses could be seen as being expanded both vertically and horizontally [Exhibit 7].

[Exhibit 7: Xiaomi’s business expansion]

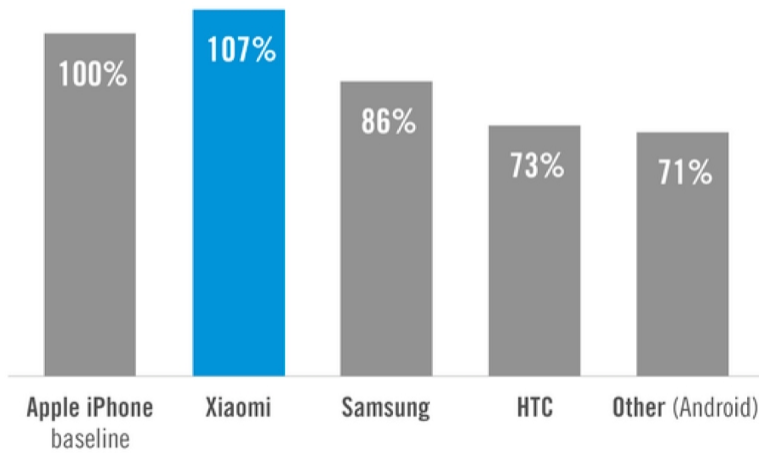


Source: author's original creation

Along the vertical line extended from smartphones, Xiaomi offers phone accessories like headphones, external battery, and recently, Xiaomi's Virtual Reality headsets. Xiaomi's own operating system MIUI is integrated with its hardware. Further above is Xiaomi's App Store, which has grown dramatically in user downloads in the past two years [Exhibit 5] and seen more time spent in Apps by average Chinese smartphone users than other competitors, including Apple [Exhibit 8]. Next to it, is Xiaomi's e-commerce platform (available in forms of a website and an app), which aggregates catalog information from product lines that expand horizontally [Exhibit 9a]. It has recently become one of the world's top 10 largest e-retailers, right after Apple [Exhibit 9b]. Then lastly, Xiaomi provides cloud storage service (Mi Cloud), Internet services (mobile finance and mobile games), and entertainment (through its \$1bn investment to produce its own TV and video content [16]). The businesses along the vertical expansion are owned by Xiaomi and become part of Xiaomi's resources to entice potential app developers and Mi Ecosystem Companies. The more popular Xiaomi's app store and e-commerce store becomes, the more powerful they become as distribution channels for Xiaomi's partners. It is also worth noting that these businesses, when tightly integrated, become a virtuous cycle that spans user acquisition (smartphones and peripherals), user retention (MIUI, App Store, E-Commerce), and the biggest value capturing along the value chain (Cloud storage service, Internet services, and Entertainment Content).

[Exhibit 8: Xiaomi's app user engagement compared to other smartphones]

Time Spent In Apps by Average Chinese Smartphone Users (iPhone Used as Baseline)



Flurry Analytics, sample of 23,000 Chinese mobile devices

Source: <http://www.iphonhacks.com/2014/07/chinese-smartphone-maker-xiaomi-tops-apple-customer-engagement.html>

[Exhibit 9a: Xiaomi's e-commerce store]

小米手机 红米 平板 笔记本 电视 盒子 影音 路由网关 智能家居 配件 社区

小米年货节
12.15-12.22 剁的不只是5折

小米手机 1599元起
小米电视 3999元起
小米空气净化器 399元起

2017年, 你想要什么新年礼物?

产品	价格
小米手机 1599元起	888元
小米手环 2 149元起	149元
小米盒子3 399元起	399元
小米移动电源 10000mAh	79元
小米空气净化器 399元起	888元

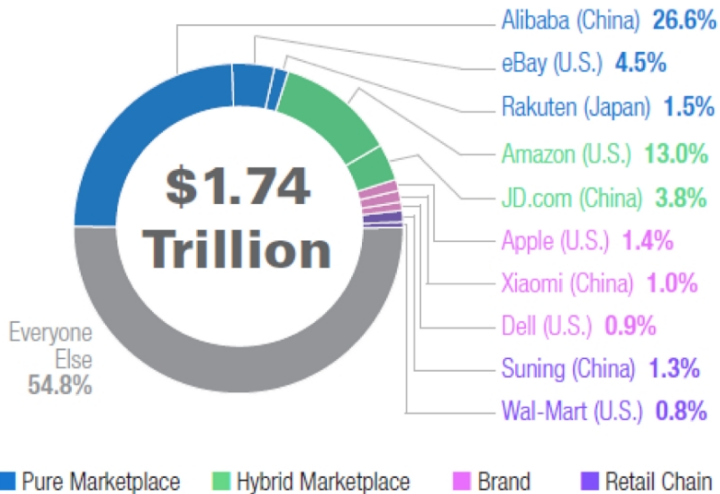
挑个好礼物, 送给新年的自己

产品	价格
净水器厨下式	1999元
小米空气净化器 399元起	399元
小米净水器 (桌上式)	1299元
小米空气净化器 (便携版)	799元
小米空气净化器 (便携版)	799元

[Exhibit 9b: Xiaomi became one of the world's top 10 largest e-retailers]

The World's Top 10 Largest Retailers Hold Nearly Half the Global Market

Global E-Retail Market Share, Company Type



* Hybrid marketplace means they sell their own products, and those owned by other sellers. Market share amounts represent global GMV of each merchant.
Source: Company reports, ChannelAdvisor, Internet Retailer

Source: Internet Retailer, August 5 2016. <http://www.internetretailer.com/2016/08/05/global-1000-spotlight-top-10-e-retail-players-dominate>

Along the horizontal expansion, Xiaomi moves aggressively into consumer electronics, smart devices and IoT devices. This is where Xiaomi's Ecosystem Companies add value, by bridging the knowledge gap of a new product line that Xiaomi lacks experiences in and contributing towards the variety of Xiaomi's product offerings—which in turn, feeds into the success of Xiaomi's e-commerce store. Lei Jun's announcement to "invest in 100 Mi Ecosystem Companies" could accelerate this horizontal expansion. To decide which companies to approach, Xiaomi needs to apply the "Attractiveness Test."

"Attractiveness Test"

According to a talk^[17] given by the Xiaomi's cofounder Liu De, in early 2013, Xiaomi recognized that the time of Internet of Things (IoT) was coming, that one day all devices around us could be connected to the Internet and be controlled by phones. Xiaomi didn't want to miss one of the biggest opportunities of our time, thus decided to catch the trend through a combination of investments and incubation of target companies in the space. That was the origin of Xiaomi's 100 Ecosystem Companies strategy. A little research revealed that this industry is indeed attractive: Cisco predicts the global IoT market will be \$14.4T by 2022^[18]; BI Intelligence forecasts that there will be 34 billion devices connected to the internet by 2020, up from 10 billion in 2015. Among the connected devices, IoT devices will account for 24 billion, while traditional computing devices such as smartphones and tablets will comprise 10 billion. Lei Jun was right to focus the majority of Xiaomi's Ecosystem Companies investments on ones making smart devices with potential to be connected. Most of these Ecosystem Companies are early-stage startups. On one hand—they are cheaper to invest; on the other—they are more flexible to and agile to

adapt to the consumer needs, and are more eager to succeed in this new industry.

Resources

Xiaomi's resources include the following:

- Tangible: distribution channel including its e-commerce platform and App store
- Intangible: brand, loyal fan-base, large user-base, culture, global supply chain, technology ecosystem, economies of scale, sales/marketing know-how, best practices on making consumer products with low price/performance ratio
- Capabilities: speed of product development, operational efficiency, R&D, speed of bringing product to market and scaling, industrial design

Given that Xiaomi's users are spending more time in Apps than any other competitor, and the fact that Xiaomi could grow to the №1 market leader in Chinese smartphone industry in just three years, it is safe to say that Xiaomi's resources provide competitive utility benefits (low cost, high quality, great internet services) to its users and pass the "Test of Current Demand". Thanks to Xiaomi's business model innovation, it sells smartphones in many aspects similar to phones from Apple and Samsung for less than half the price. Xiaomi's global supply chain is managed directly by CEO Lei Jun is one of Xiaomi's biggest competitive advantages. Xiaomi could make almost any hardware cheaper compared to competitors'. It is hard to control an extensive supply chain and many hardware startups fail to ensure enough manufacturing capacity. However, Xiaomi is able to leverage its innovative limited flash sales to turn disadvantages into advantages. Moreover, Xiaomi coordinates its industrial design to ensure that Xiaomi's products do not risk running into manufacturing shortage or low throughput yield. Xiaomi's economies of scale, knowledgebase on marketing and product development, and defensible technology ecosystem are not easy to copy by competitors, leading to sustainable corporate advantage ("Test of Future Scarcity"). Xiaomi target the young people in fast-growing, nascent and immense middle class who aspire to buy products next to top brands at an affordable price. This group became Xiaomi's large user-base that fueled its growth. Xiaomi's brand especially appeals to a niche group of smartphone power-users who are constantly tweaking their phones for richer features and the newest experience. Xiaomi engages a lot with their power-users through forums and social media, even providing some off-site "jobs" for them such as bug reporters, beta testers etc. These power-users become enthusiastic salesmen for Xiaomi, promoting products to their friends and family for free. The large user-base and loyal fan-base are Xiaomi's valuable resources. Lastly, as analyzed earlier, Xiaomi's vertical expansion allows it to effectively create and capture values within its ecosystem. Its direct access and trust relationships with end customers allow it to disintermediate the channels along the value distribution chain and claim a large amount of profit sharing from the vendors (either app developers or Ecosystem Companies) on its platform, therefore passing the "Test of Appropriability". To assess whether investing in "100 Mi Ecosystem Companies" strategy improves the competitive advantage of individual business units, we need to apply "Better-off Test".

"Better-off test"

Through investments, Xiaomi adds significant value to its Ecosystem Companies through resource transfers which translate to revenue and cost synergies. Xiaomi imparts to these companies its best practices to making quality products and bringing the product to market, therefore improving the Mi Ecosystem Companies' competitiveness. Xiaomi seems to favor Ecosystem Companies whose technology adoption lifecycle is in between adopters and the mainstream—products in this phase are best positioned to take advantage of Xiaomi's supply chain and increase success rate. Xiaomi's in-house design team would ensure consistent aesthetics across different products. Xiaomi's brand is associated with high quality, affordable price, sleek design, and geekiness. The consumers' impressions of Xiaomi smartphones get passed on to the products of Mi Ecosystem Companies. This increases customers' willingness-to-pay for the otherwise unknown products. Moreover, Mi Ecosystem Companies also benefit from Xiaomi's loyal fans, large user-base and established online distribution channel, and see immediate revenue growth. Mi Ecosystem Companies also benefit from Xiaomi's robust supply chain with more bargaining power. Together, the large orders to suppliers from increased scale on one hand lower the production cost, on the other, allow Xiaomi to ask for longer accounts payable days—enhancing Xiaomi's healthy cash flow. With a shared focus on “smart device” and “connectivity”, Xiaomi's Ecosystem Companies also have the potential of supporting each other on the product level. For example, when one of Mi Ecosystem Companies Ninebot needs customized, high-efficiency battery for its self-balancing scooter, another Mi Ecosystem Company Zimi specialized in making batteries (their signature product, Mi Power Bank, is the world's most popular external battery for smartphones with over 55 million units sold in three years) could offer the needed support. Overall, Lei Jun's Mi Ecosystem Companies initiative passes the “Better-off Test” as new units could gain competitive advantages from their links to Xiaomi.

Organization:

Structure

Xiaomi has a decentralized, business unit-based corporate structure. There are eight co-founders of Xiaomi, each tasked with the operations of their own business units according to their specialties and has much autonomy in decision-making. These business units are divided with a combination of functions and divisions, including: strategic partnerships, e-Commerce & marketing, MIUI, Wifi/cloud/router, smartphone hardware & supply chain, industrial design & ecosystem, and smart TV/smart set-top for TV/content. Inside each of the business unit is the flat management system (with only three layers). The setup of business-unit-based corporate structure with Xiaomi's co-founders sharing the responsibilities helps incentivize innovation, maximize efficiency, and achieve a delicate balance between freedom and interdependency. The business leaders communicate with CEO Lei Jun directly and frequently, to ensure a consistent corporate strategy and avoid unhealthy internal competition. Within each business unit, there are few hierarchies and little bureaucracy, thus effectively boosting the communications efficiency and productivity which are very important for Xiaomi to react quickly to market changes and remain competitive.

The loose, decentralized structure also has its drawbacks. It is hard for Xiaomi to simultaneously push for multiple large-scale product lines in-house, unless Xiaomi hires more people and becomes a large corporation. However, becoming too big would ultimately doom Xiaomi to the typical innovators' dilemma and lose its creativity, agility, and adaptability. That's another reason why Lei Jun decided to expand Xiaomi's product lines through investments on Ecosystem Companies—so that Xiaomi could quickly scale in a new segment while remaining flexible in case of changing consumer demands.

Control & Coordination

Lei Jun is involved in “two ends” of the business: strategy and product details, and has the final decision power in all major decisions. The speed of change is very fast in the market, requiring the company to quickly adjust if needed. Xiaomi has gone through three major strategic adjustments in the past five years (abandoning “MiTalk Messenger”—launched around the same time as Wechat and but ultimately lost to it; pushing smartphone, smart TV and router as blockbuster products; investing in ecosystem companies to expand the product lines). Each time, Lei Jun would set the new direction for the company, align goals with his co-founders/business-unit leaders, and decide on the resource allocation to each business unit. Lei Jun is also involved in ultimately deciding which potential Ecosystem Companies to include to the portfolio.

Given the business-unit setup with a combination of functions and divisions, it can be speculated that both financial control and operating control are used to monitor and reward the unit performance. For divisional business-units such as smart TV/set-top business unit in relatively stable industries, quantitative and results-driven financial control is probably used to drive sales and market shares. For functional business-units such as industrial design & ecosystem, qualitative and operations-focused control is probably used to build in flexibility for innovations. It can be further speculated that the control mechanism for Mi Ecosystem Companies is also through results-driven financial control to drive product sales and market share. A flyer posted on Xiaomi’s social media after the “2016 Tmall Double 11” (China’s largest online shopping festival) highlighted the products that achieved the №1 sales in their respective categories.

Lei Jun also infuses the company culture with a sense of urgency and hunger and leads by example. According to one early employee, “Xiaomi is running with red eyes, and Lei Jun is always the one charging forward.^[19]” It is said that Xiaomi’s employees typically work from 10am to 10pm. If they fall behind the development speed of the company, they are labelled as “bottlenecks”. Xiaomi has an effective central HR function that makes sure the company culture, core values and best practices are passed to new members and transferred across different business units. The company is obsessed with creating “blockbuster” products and delivering extreme user experiences. Xiaomi’s products emphasize on simplicity, practicality, approachability, user-centered design and attention to details. When evaluating potential Ecosystem Companies, Xiaomi looks for ones that share similar values and have highest potential to dominate the respective market segment.

“Ownership test”

Xiaomi’s cofounder Liu De, who is tasked with overseeing Xiaomi’s ecosystem development, once shared the types of deals Xiaomi would consider for investments^[20]:

- 1) The company makes peripheral products to smartphones such as ear buds and power banks.
- 2) Wearable devices such as smart wristbands or smart watches for health or sports purposes
- 3) Home appliances that have potential to become “smart” and “connected”, such as water purifiers and

air purifiers

4) Geek products that young people like—such as self-balancing scooters

5) Lifestyle products that may be hard to notice but have big impact, such as power strips

Liu De's expectation for each product by the portfolio companies is to become the No.1 player in the respective market segment in China and ideally worldwide, and that the annual unit sales should reach at least 1 million.

One may question what ear buds, power banks or power strips have to do with Xiaomi's grand vision of dominating the connected home. It is possible that Xiaomi sees them as low hanging fruits that can simply "plug into" Xiaomi's network and benefit from Xiaomi's supply chain, distribution channel, and 100 million active users. They bring in additional revenues while enhancing Xiaomi's established relationships with its partners and customers. The premise is, the combined synergies should be greater than Xiaomi's added cost of ownership. The same principle also holds true for other types of investments that are more aligned with Xiaomi's corporate strategy.

In evaluating Xiaomi's cost of ownership, there are two pieces: financial cost and governance cost. Xiaomi invests in the Ecosystem Companies strategically to form industry alliance. The investment amount is typically around several million RMB, owning 20–40% of shares. Its primary concern is not to pursue high ROI or big exit, but rather, help portfolio companies make great products that complement Xiaomi's ecosystem. Xiaomi sees its own role as an incubator and does not intend to interfere with the future prospects of the portfolio companies—they could get acquired, or go public, or merge with other Mi Ecosystem Companies. But even as a financial investor, Xiaomi's investments seem to pay off—4 out of 55 Mi Ecosystem companies have become unicorns as mentioned in the opening of this paper [**Exhibit 1**] and the total revenues from Xiaomi's Ecosystem Companies are expected to reach over RMB 10 Billion (~\$1.44 Billion) in 2016.^[21] Remember that Xiaomi also takes half the profit from its ecosystem companies that sell through its distribution channel.

The financial cost of ownership for Mi Ecosystem Companies is almost non-existent. What about the governance cost? Xiaomi's portfolio selection criteria on the basis of "adding synergies to its ecosystem" helps save much governance cost. According to Liu De: the invested companies should have large product market, the market should have strong pain points and solve specific problems, the products target Xiaomi's user-base and have the blockbuster potential, and the founders should highly identify with Xiaomi's values: low price/performance ratio, market dominance on a single product, affordability and reasonable margin, and geek spirit.^[22] In meeting the selection criteria, the portfolio companies are almost guaranteed to integrate smoothly into Xiaomi's ecosystem. Xiaomi's organization structure and control mechanism are set up to support autonomy as long as the business units are strategically aligned. The governance cost of ownership is low internally, and expected to be even lower for its portfolio companies.

Post investments, Xiaomi's typically owns 20–40% of shares of their portfolio companies. Unlike acquisition, Xiaomi's investments leave enough incentives for the founders to drive for the upside without Xiaomi's parenting. Xiaomi will then work with portfolio companies to define the new product positioning, strategy, design, specifications and pricing. Xiaomi hosts a meeting for the entire Mi

Ecosystem Companies every three months. Xiaomi shares its experiences in IP, registration, financial management and fundraising, as well as its observations on market trends, e-commerce, logistics, and maintenance services. Xiaomi's CEO Lei Jun usually comes to such meetings to share his knowledge. The system of Mi Ecosystem Companies becomes like an EMBA and a club, where members share resources, grow together, support each other and fight together as an alliance. [23] One could argue there is ownership cost associated with the activities above, but it is minimum and can be easily managed as the incubation process has been streamlined. For Xiaomi, once the mass market opportunity for IoT has arrived, Xiaomi is then well-positioned to connect the products (which are already out in the market) of its Ecosystem Companies (which are market leaders in their respective fields) through Xiaomi's own software platform.

V. Conclusion

As a startup itself, Xiaomi created a miracle by becoming the world's most valuable tech company in just four years and earned the №1 position in China's smartphone market with its innovative business model. It has built a reliable global supply chain, its popular distribution platforms for apps and consumer products, and 100 million active users. The company always sees itself as more than a smartphone company and has been actively expanding its businesses both vertically into internet services and horizontally into other product categories. It expects the majority of value creation to take place on the Internet services level, and intends to play at the center of the connected home. Rooted on Xiaomi's vision, its corporate strategy is to grow the ecosystem quickly to build defensibility, acquire user aggressively to seize market share, and lock in users through services and platforms for bigger monetization later on.

These all sound reasonable, except that Xiaomi is just a startup of six years old, and the majority of its revenues still come from its smartphone business—which has declined dramatically as a result of changing consumer preferences, fierce domestic competition and the slow growth of smartphone sales globally. As a result, Xiaomi fell out of top 5 largest smartphone manufacturers in China and its valuation shrunk by 90% according to an independent research producer. Under this context, the strategic decision of Xiaomi's CEO Lei Jun to “invest in 100 Mi Ecosystem Companies” and Xiaomi's continued expansion into new product lines through the Ecosystem Companies seem distracting.

However, careful assessment on Lei Jun's decision within the context of Xiaomi's businesses reveals that product diversification is not just about planning for the future, it is also the only way to defend Xiaomi's access to users who sustain Xiaomi's entire ecosystem. Through investments, Xiaomi could quickly move into the more attractive IoT industry with high growth potential, and leverage its rich resources to help the portfolio companies succeed. Xiaomi's selection criteria for the portfolio companies reflects its corporate strategy, core values, and emphasis on synergy creation, ensuring their successful integration into Xiaomi's ecosystem. Further, Xiaomi's post-investment incubation fits well into Xiaomi's existing organization structure and control mechanism, adding fuels to the growth of its Ecosystem Companies without bearing much ownership cost.

Taking all factors into consideration, I will conclude by saying that Xiaomi's strategy to dominate the connected home through active investments in Mi Ecosystem Companies is both bold (aggressive) and safe (defensive), and ultimately a wise one (achieving goals with least efforts).