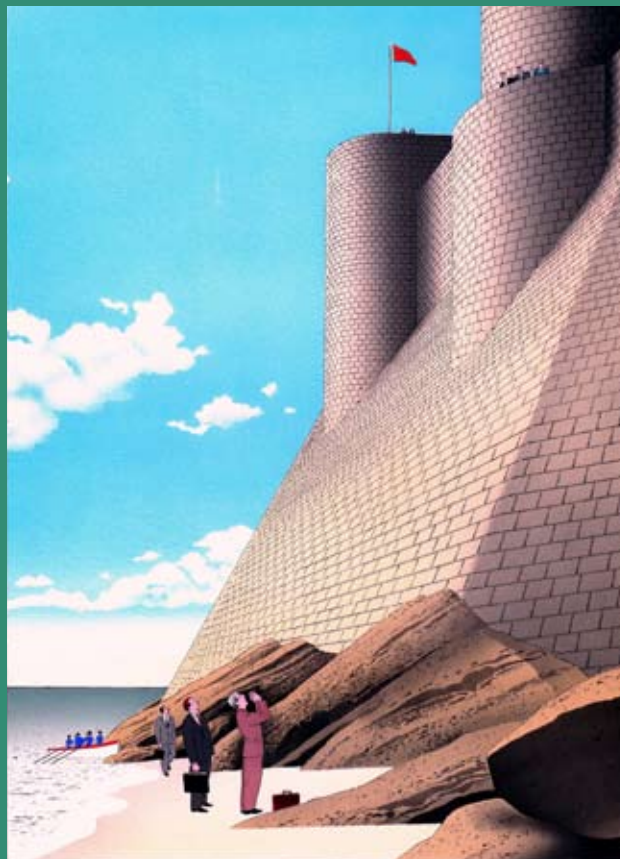


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## The Quest for Defendable Scale in China



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# The Quest for Defendable Scale in China

**T**he supreme art of war, wrote the ancient Chinese general Sun Tzu, is to subdue the enemy without fighting. But that's not possible for players in China's consumer industry.

To survive in today's environment, competitors must bring world-class skills to do battle with committed global giants and resourceful Chinese companies, as well as with highly competent Taiwanese and Korean powerhouses. And if they expect to come out on top, they must also adapt their business models to China's unique market, target the new segment of value-seeking consumers in the emerging middle class, and, above all, create the right kind of scale economies.

But scale alone won't be enough. To achieve sustainable profitability, these companies must also go for defendable scale—which means securing a strong competitive position in large and profitable categories. To understand why that is the case, we must first look at what the contenders in China are up against.

## Sizing Up the Competition

Why is the competition so intense? Global companies consider China to be a must-win market because of its exceptional combination of size and rapid growth, which offers tremendous opportunities for both the short and the long terms. Multinationals are joining the campaign with deep pockets, established global brands and products, and a commitment to stay the course over the long haul. Initially targeting the highest-income consumers and working down to the emerging middle class, packaged-goods companies such as L'Oréal, Nestlé, PepsiCo, Procter & Gamble, Wrigley, and Yum! Brands have leveraged their global brand-building skills and marketing know-how to establish successful brands throughout the country.<sup>1</sup>

Pepsi, for example, became what some consider to be the leading brand among China's youth after PepsiCo applied its insights into consumers in remarkably successful marketing campaigns. P&G employed its global scale and brand portfolio to become a leader in the lucrative hair-care and skin-care categories, and Wrigley leveraged its world-class

front-of-store merchandising skills to achieve the number one position in chewing gum. Other global giants have drawn on their brand names and product development capabilities to accelerate the launch of new products and capture an even wider consumer base. With cumulative investments representing billions of dollars so far, international competitors have gained positions in the Chinese market that are hard to ignore.

Local players, too, have become strong contenders in consumer goods. Packaged-goods companies such as Heng'an (tissues, sanitary napkins, and diapers), China Huiyuan Juice (fruit juices), Tsingtao Brewery (beer), and Inner Mongolia Yili Industrial Group Company and China Mengniu Dairy Company (dairy products) have done well in the mass-market segment by appealing to value-conscious

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1. Income segments in China are defined as follows: poor = less than RMB 2,000 per month; aspiring middle class = RMB 2,000 to RMB 3,000 per month; emerging middle class = RMB 3,000 to RMB 5,000 per month; middle class = RMB 5,000 to RMB 8,000 per month; affluent = more than RMB 8,000 per month.

consumers with low-cost products and highly recognized brands. They have also become very good at quickly reproducing the successful products of both local and global competitors and selling them at home—a clever approach to launching innovations with minimal spending on R&D. Considering their ruthless focus on cost along the entire value chain, it's no wonder that local companies often enjoy as much as a 30 to 40 percent cost advantage over their global competitors.

But that's not all. The ability of local companies to navigate China's complex wholesale networks has strengthened their coverage in the country's lower-tier cities, where

their strong brand legacies and recognition sometimes minimize the need for advertising.<sup>2</sup> And considering the difficulties of transportation across China's vast distances, regulatory barriers (which local players can more easily negotiate because of their access to government officials), and differences in tastes from region to region, it's not hard to appreciate just how competitive local players can be.

### The Fight Is Far from Over

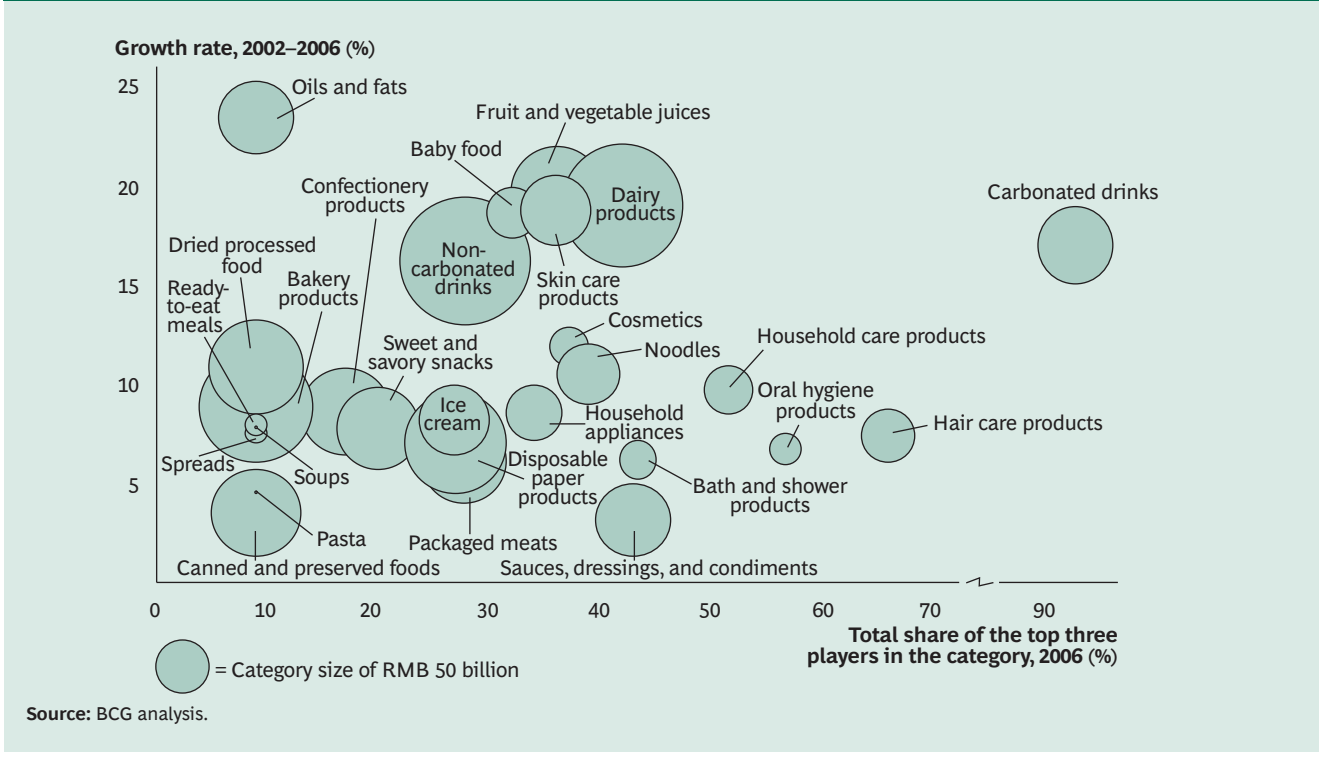
Multinational and local players in China have been going after one another with an intensity unequaled in other emerging markets. Yet despite the competition, the end-game is far from over in such

categories as noncarbonated drinks, household appliances, food products, and personal-care products. The size and the potential for fast growth of these categories in a field of fragmented competition have opened up many opportunities for late entrants and companies trying to catch up to the market leaders. (See Exhibit 1.)

Much of this potential stems from the fact that disposable income is rising much faster in China than in any developed country. That has

2. BCG has segmented China's 651 cities into six groups on the basis of their population and per capita disposable income. In order of decreasing size and income, they are the top three cities of Beijing, Shanghai, and Guangzhou, followed by the country's first-, second-, third-, fourth-, and fifth-tier cities.

## Exhibit 1. Rapid Growth and Share Fragmentation Create Opportunities in Many Categories



enabled consumers in many regions to move quickly up the socioeconomic ladder. In fact, millions of consumers each year cross the threshold into the middle class and trade up to better branded products. Companies that market to the middle class and the emerging middle class are especially likely to derive benefits from the trading-up trend. As annual household income grows by an estimated 9.5 percent over the next eight years, the pace of spending will continue to increase.

Although just a few top players control more than half the sales in some categories, most categories are wide open. In fact, the top three consumer-goods players combined account for less than 30 to 40 percent of market share in most categories. (A few exceptions are carbonated drinks and hair-care, household-care, and oral-hygiene products.) In this competitive environment, market share can change very quickly. Indeed, the current front-runners will have to be on their toes if they hope to fend off the players lining up to engage them.

Examples abound. Pepsi surpassed the entrenched youth-market leader in cola drinks with well-planned endorsements from local music, sports, and pop-culture stars. Pernod Ricard took the lead in China's whiskey market by launching a "Chivas with green tea" campaign targeted to the new Western-style bars and supported by exceptionally strong planning and execution. And in 2007, Adidas surpassed the leader in sports apparel by leveraging its strong global brand, superior franchisee partnerships, fast-paced

store openings, and management team continuity.

## **Why Scale Is King in China**

The intense competition between local and multinational players has

**Disposable income is rising much faster in China than in any developed country.**

created several sources of pressure that together make scale advantage an imperative for competing in China. First, there is more pressure on prices in China than in developed countries. Although income is rising rapidly, per capita disposable income in the top-tier cities is only one-tenth that of such developed markets as Germany, Japan, and the United States. That limits how much companies can charge for their products. At the same time, local players' unwavering focus on cost competition likewise puts a ceiling on prices. In order to maintain profitability, multinational companies, which tend to operate with a higher cost base, must seek scale advantages to compete with low-cost local players.

Second, the costs of media are increasing. Spending on media in China has consistently outpaced consumption—and spending on advertising as a percentage of consumption is approaching U.S. levels. Overall advertising costs are rising rapidly, and advertisements on regional television are no less expensive than on national TV.

The cost of television ads is expected to jump by 50 percent during the Beijing Olympic Games of August 2008 and by 25 percent immediately before and after. Because of these mounting costs, global players will need to find scale economies for their category-branding approach, whereas local players will be able to leverage their well-known brand names and extend them into different categories through umbrella branding.

Third, human resources costs are increasing, making it more expensive to build and sustain a capable organization. More than half of all companies doing business in China are reporting increases in turnover of professional staff, with the average tenure for 25- to 35-year-olds falling from three to five years in 2003 to just one to two years in 2005. Although middle managers' salaries at multinational companies throughout China have increased 8 to 9 percent per annum over the past couple of years, executives claim that the percentage is actually much higher because managers "just throw more money and promotions" at key employees when they threaten to walk out. Indeed, for many years now, senior executives have identified a shortage of managerial talent as a major hurdle to doing business in China.

Finally, suppliers face a very fragmented trade structure in China. Consider the fact that the top 100 retailers in the United States account for 60 percent of total retailer value, whereas the top 100 retailers in China contribute less than 20 percent. Moreover, modern trade

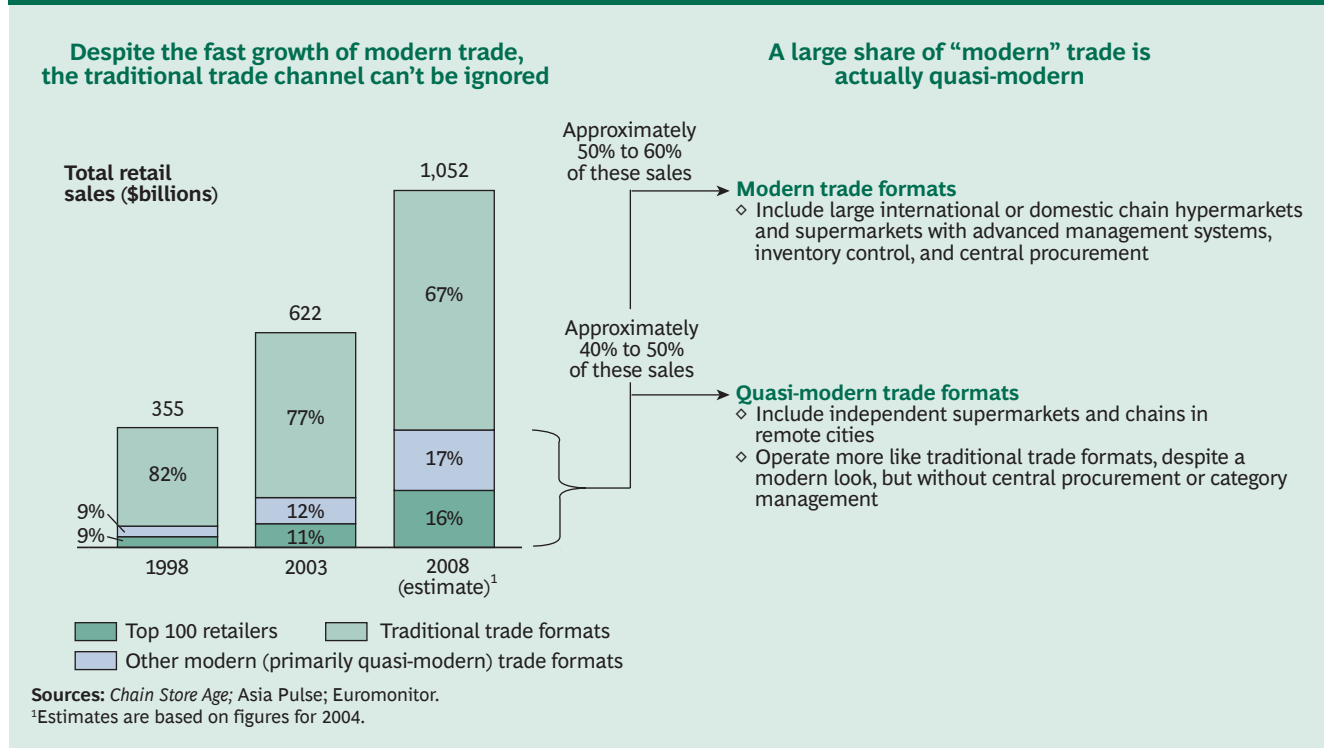
formats, such as hypermarkets and supermarkets, are not well developed in China. Although these sales channels are expected to increase rapidly, in many small cities they still account for less than 10 percent of all retail sales. What's more, most of the "modern" trade formats that do exist are modern only on the surface. In fact, these stores operate much like traditional channels—marketplaces or bazaars that house many small mom-and-pop stores—with no centralized planning, procurement, or inventory management. Some are just franchisees sharing the same banner. We use the term *quasi-modern trade* to describe these trade formats, since they are modern in name only. (See Exhibit 2.)

This environment presents both a challenge and an opportunity. On the one hand, it means that suppliers in China must create their own capabilities and infrastructure to serve the fragmented retail landscape. On the other hand, once a supplier has acquired critical mass, its fixed-cost investment becomes very scalable. Distributors in China are small, regional, and less sophisticated than those in the West, and they carry products in many categories, from food and beverages to personal-care and household products. Therefore, a large supplier can exert its clout in many ways, such as by gaining the support of a distributor when it wants to rapidly launch new products or expand into new categories. Furthermore,

because many of China's retailers are also small and don't follow the category-management and centralized purchasing practices that are typical of retailers in the West, large suppliers can use their power to negotiate better terms and shelf space more easily than they can in the West.

Given the pressure on prices in China's emerging markets and the rapidly rising costs of media and human resources, the advantage of scale is obvious. But when you add to those factors the benefits that a fragmented trade structure offers to large players, it's not hard to appreciate why scale is one of the most important sources of competitive advantage in China.

## Exhibit 2. Quasi-modern and Traditional Trade Formats Dominate China's Retail Landscape



## The Importance of Defendable Scale

How big do you have to be to achieve sufficient scale? Size, of course, is crucial to covering fixed costs, but it is also an important lever when negotiating with smaller retailers and distributors. Most of the companies in China with operating margins greater than 10 percent have revenues of \$200 million or more. Those with less than \$200 million are struggling to sustain high profit margins.<sup>3</sup> And size isn't the only driver of profitability. Having the highest relative share in your categories is also important.<sup>4</sup> (See Exhibit 3.)

But now it gets a little more complicated. Defendable scale—the kind

of scale that we believe is necessary to win in China—isn't solely a matter of absolute size or high relative market share. It also depends on securing an unassailable relative market share in categories that are large and profitable. In fact, of two companies with equal revenues—both in excess of \$200 million—the one with the higher relative market share in the more attractive categories will enjoy greater profitability.

Once a company has reached the \$200 million revenue threshold, relative market share is most responsible for its sustained profitability. It is imperative that companies focus not just on scale but on the *quality* of their scale.

## The Right Share in the Right Categories.

To understand the importance of selecting the right categories for attaining defendable scale, consider a global household-products manufacturer that enjoyed a high relative market share and leadership positions in the few categories in which it participated.

3. In fact, large players in China have outstripped companies with revenues under \$200 million by as much as 8 percent in annual growth over the last few years. For companies trying to catch up, it's important to reach the \$200 million mark quickly or risk being left behind, especially since that threshold is expected to rise owing to increasing costs and continued growth and competition.

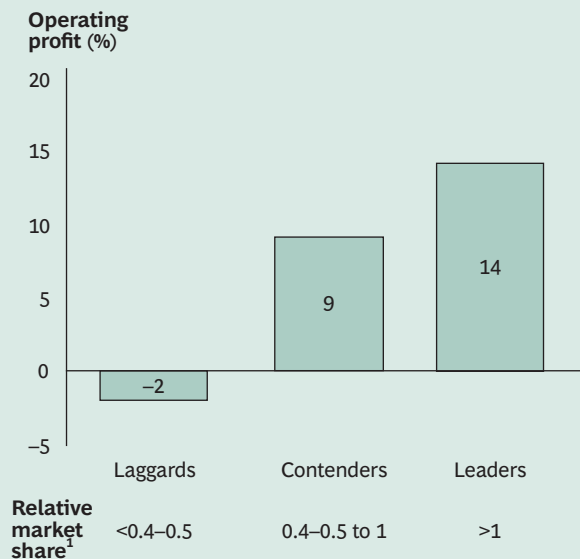
4. Relative market share is the ratio of the company's market share to that of its largest competitor.

### Exhibit 3. Companies Need at Least \$200 Million in Revenues and Category Leadership for Sustainable Profitability

Most players in China with healthy margins (greater than 10%) have more than \$200 million in revenues



The relative market share of these players is also an important driver of profitability



Source: BCG analysis.

<sup>1</sup>Relative market share is based on the weighted average for all the categories in which these companies participate.

Yet its operating margin was only 1 percent and its revenues were less than \$100 million. The problem was that the categories were small and slow growing, and consumers rated them very low in trading-up appeal. Leadership is important, but if it is limited to weak categories, the company will find it difficult to achieve the threshold required for scale advantage and higher profitability.

The converse is also true. Another global manufacturer, in personal care and apparel, had revenues of more than \$200 million, yet its operating profit was negative because its relative share of the market—fifth in two categories and eleventh and twelfth in two others—was too low.

So despite sufficient revenues and attractive product categories, the manufacturer lacked the leadership position necessary for defendable scale and sustainable profitability.

**Assessing Categories for Defendable Scale.** How does a company know whether a category is right for achieving defendable scale in China? First it must look at the same factors it assesses in other countries:

- ◇ The size and growth of the category
- ◇ Its potential for profitability, which is driven by competitive dynamics and consumers' intention to trade up
- ◇ Its fit with the company's product portfolio

But there are other factors in China that must be taken into account: the dominance of local players at the low end of the market and the value that adds to a category's trading-up potential. Because of the extremely low-cost business models of local

**Leadership only in weak categories won't yield scale advantage and higher profitability.**

companies, very few global players have successfully penetrated this market segment. Low-end players often represent 50 percent or more of sales in many categories, so multinational players must consider whether consumers of these products are likely to trade up in the foreseeable future and, if they are, whether the gross margin on more expensive products will be high enough to sustain the brand investment.

Finally, for a company with a portfolio of brands, it is important to achieve leadership in at least one category in order to secure an anchor position from which to launch new products and enter new categories. Procter & Gamble and Chinese food manufacturer Tingyi (Cayman Islands) Holding Corporation have both done very well with this strategy over the years. Their first step was to achieve success in an attractive category and then parlay that success into other categories by leveraging established distribution networks, good insights into consumers' needs, and, in some cases, umbrella branding.

## Sustaining Defendable Scale

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To achieve lasting scale advantages in China, players must commit themselves to three ambitious challenges. First, for companies targeting the emerging middle class, building scale will require expanding their geographic footprint beyond the top-tier cities. By 2015 nearly 60 percent of the emerging middle class is expected to be located in China's third-, fourth-, and fifth-tier cities.

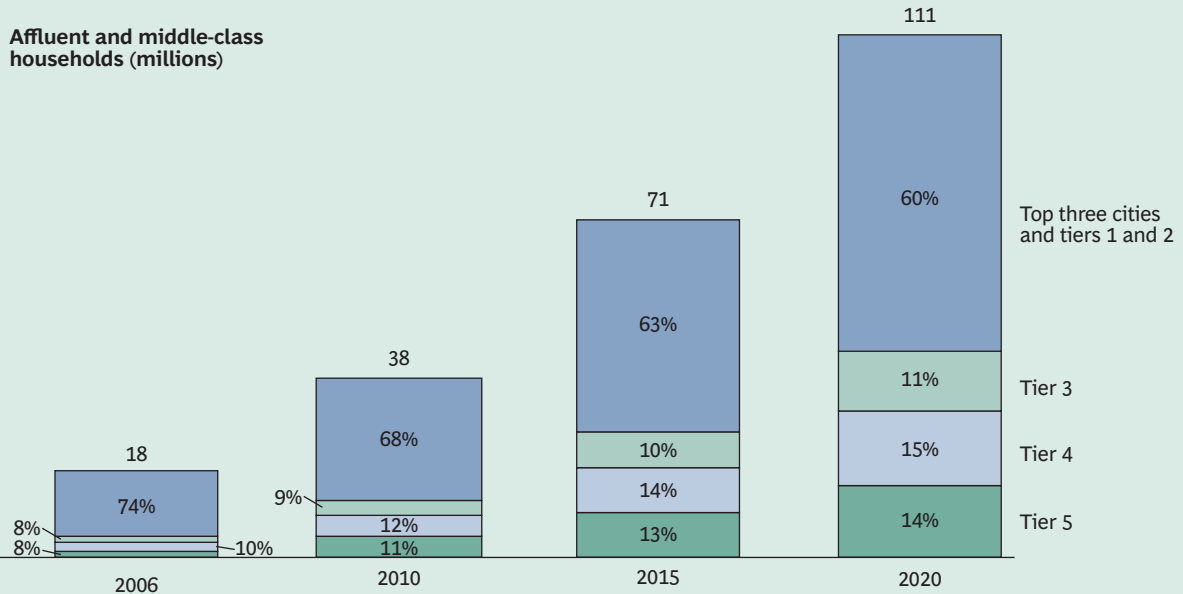
Indeed, China's most successful players—including P&G, Tingyi, and Wrigley—have already ventured into the smaller cities, whereas less successful players have been slower in taking this step. Moreover, moving out beyond the top-tier cities brings other advantages besides a larger market. These companies can leverage the reputation of the strong brands they have created, as well as realize higher profits, because the costs of distribution and marketing are lower in traditional trade channels, which dominate in smaller cities to an even greater degree than they do in large cities.

For companies producing premium products, however, it will be most strategic to remain primarily in the top-tier cities, because the majority of affluent and middle-class households (the two highest income classes in China) will continue to concentrate in Beijing, Shanghai, and Guangzhou, as well as in first- and second-tier cities, for the foreseeable future. (See Exhibit 4.)

Second, because household incomes in China's third-, fourth-, and fifth-

## Exhibit 4. Affluent and Middle-Class Households Will Continue to Concentrate in the Top-Tier Cities

By 2015, approximately 63 percent of affluent and middle-class households will reside in China's top three and first- and second-tier cities



Source: BCG China demographics database.

tier cities will continue to lag behind those of the larger cities for the next several years, companies that expand into the country's smaller cities must provide consumers in the emerging middle class with products that they can afford. (See Exhibit 5, page 8.)

However, with the global giants securing the market for premium products and local players maintaining an unassailable position at the low end of the market, competition for the large and growing middle and emerging middle classes will be particularly intense. Indeed, that is precisely where the coming battles between multinational and local companies will take place, as global players with superior brands,

technology, and marketing capabilities go up against local players' low-cost business models. In large categories—such as skin care products—the middle classes already account for more than half the sales; in other categories—such as hair-care and oral-hygiene products and vegetable and fruit juices—the middle-class segments are growing faster than the affluent segment.

Third, many companies will also benefit from entering adjacent categories. Although such a move can be challenging, it has a couple of important advantages. Because most traditional retailers in China's lower-tier cities don't practice category management, successful players in multiple categories will have an

advantage that they don't have in dealing with Western retailers. Furthermore, a presence in several categories brings economies of scope in leveraging distribution networks and brands.

### Expanding Beyond the Top Cities.

There are vast disparities across China in consumers' tastes and living conditions, in their ability to afford products, in their exposure to Western ways of thinking, and in their access to media channels. Moreover, although traditional trade dominates everywhere in China, it is especially prevalent in the lower-tier cities, where sales of traditional and quasi-modern retailers are nearly five times what they are for top retailers, despite the growth of modern

trade. In this very different trade and operating environment, companies must do more than simply replicate the business models they have been employing in the large cities.

The complexity of expanding from 30, 50, or even 100 cities to 300 or 500 cities cannot be overemphasized. Finding the right balance between control on the one hand and depth and breadth of the sales system on the other, determining the appropriate organization model, scaling up management systems while maintaining the visibility of product flow and pricing, and ensuring consistent execution in sales, promotions, and marketing all become daunting challenges when companies have to cover a wide geographic territory.

But once an organization has found the right model and scale, the leverage it gains with retailers will pay off handsomely.

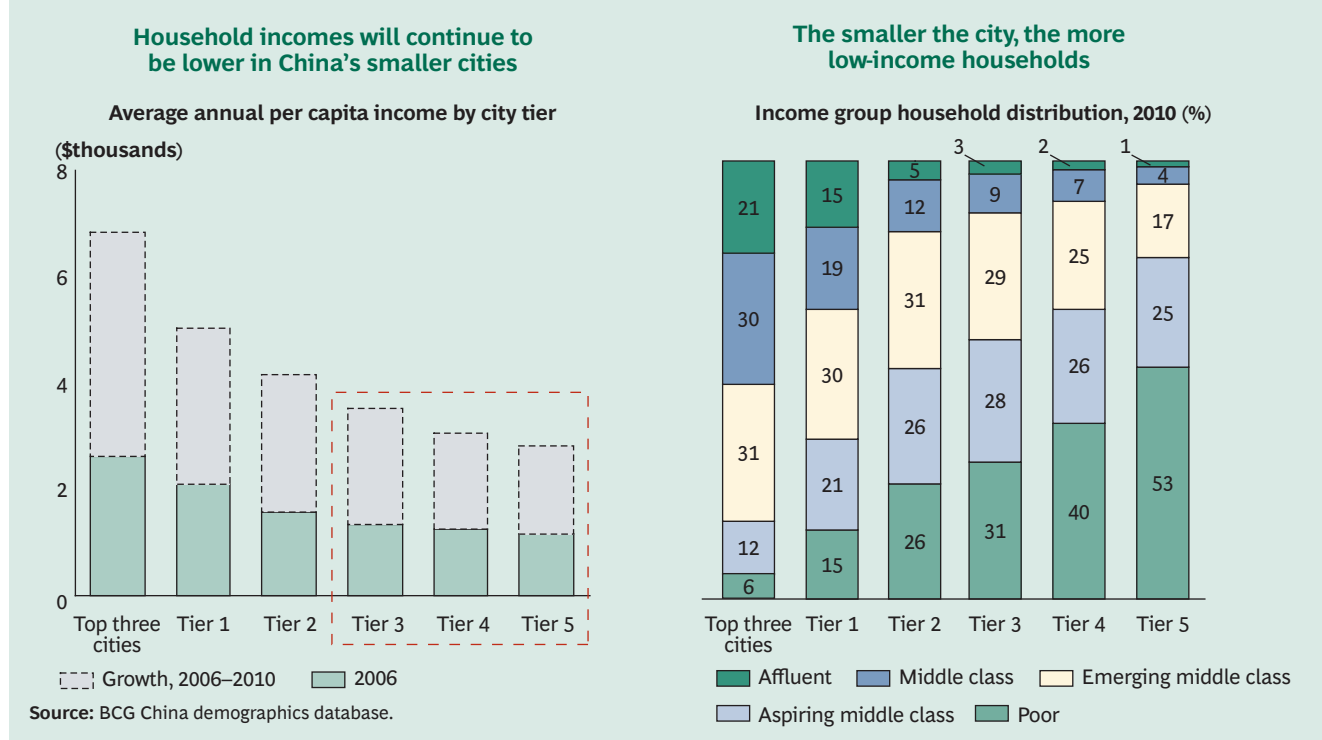
**Creating Affordable Offerings.**

Because annual per capita income is much lower in China’s smaller cities, players will have to come up with innovative approaches to keeping costs down in order to meet price and margin requirements. There are at least four ways to address the affordability issue.

First, companies can modify product formulations or package size to reduce costs. P&G, for example, brought out an affordable offering under its Olay brand at less than 30 RMB for 50 grams. By highlighting

the product’s “herbal essence” feature, the company prevents it from seeming like a cheap alternative to other Olay products, despite its less expensive packaging and formula. Similarly, P&G—whose Tide brand enjoys the number two market position for detergents in China—launched Tide Clean White in 2004. The company focuses on the product’s whitening formula (a benefit associated with the high-end Tide Triple Action product), but Tide Clean White comes in a smaller package and sells for about 25 percent less. Coca-Cola uses returnable glass bottles and locates recycling facilities in rural areas to reduce packaging costs, making the product more affordable to a broader population.

**Exhibit 5. Geographic Expansion Will Require Players to Provide the Emerging Middle Class with Affordable Products**



Second, companies can restrict their products' benefits (and associated costs) to those that consumers truly value by investing in R&D and in efforts to gain insights into consumer preferences. Coca-Cola is one of the few companies that have employed their understanding of consumers to succeed with China's middle-class segments. Its research indicated that Chinese consumers prefer pulp in fruit drinks, so the company launched a product with less juice and more pulp under its global brand, Minute Maid, thereby giving middle-class consumers a feature they value at an affordable price. Companies will also have to customize their products to meet the diverse needs of middle-class consumers in various regions. That will require well-researched insights into the tastes of local consumers.

Third, companies can optimize their production systems to reduce costs. Both Want Want Holdings and Tingyi, for example, locate their production facilities near target markets to reduce transportation and inventory costs. A number of players have reduced the cost of materials by developing strong networks of local vendors. They have also lowered costs by adopting similar packaging for different brands, thus reducing package complexity. And they've optimized production by identifying the least expensive alternatives among outsourcing, importing, and local production options.

Finally, companies can seek out creative approaches to marketing and branding in the lower-tier cities. In the top-tier cities, companies tend

to offer more expensive product lines in order to encourage consumers to trade up. They also emphasize their products' emotional benefits and rely more on TV advertising, expensive marketing events, and celebrity endorsements. In the smaller cities,

### **Many players find it advantageous to enter adjacent categories in order to build scale.**

marketing might stress a product's functional benefits and, instead of television ads, favor frequent price promotions and free samples to encourage consumers to try out or repurchase the product.

#### **Entering Adjacent Categories.**

Although some companies succeed with a dominant position in a single attractive category, many players find it advantageous to enter adjacent categories in order to build scale. This is a particularly effective strategy in China. Not only can companies leverage their clout in a fragmented traditional-trade structure and a traditional sales and distribution network, but they can also employ umbrella branding across categories. Unlike many Western consumers, Chinese consumers tend to associate favored brands with quality assurance rather than emotional appeal, which allows companies to more easily "stretch" a brand across categories.

Furthermore, since most traditional retailers don't practice category management to the extent that

modern retailers in developed countries do, large, powerful companies can leverage their scale and supply their trade partners with several categories instead of just one or two. The trick is to maintain consumer loyalty in the core business while taking advantage of umbrella brands to move across categories. Some companies have succeeded quite handily with this approach. Tingyi, for instance, leveraged its strong brand in noodles, along with its extensive distribution network, to expand into ready-to-drink beverages. It has continued to launch new products and now leads the growth in its categories.

The Chinese rice-cracker company Want Want fully leverages its strong umbrella brand to spread out its media costs and establish a presence across a number of categories, including dairy drinks and confections. This has worked very well for its Hot Kids brand of snacks targeted to children, because consumers associate the Want Want brand with high quality. However, companies in categories that require insightful segmentation strategies and have sophisticated consumers will find it difficult to stretch a single brand across very different categories.

### **Getting Started**

Few companies can achieve defensible scale overnight. Even large companies that have attained the minimal revenue threshold in some categories will need to redouble their efforts in those categories in which they are not leading contenders. The endeavor requires a generous time

horizon and a willingness to learn from mistakes. But the reward—sustainable profitability and a leading position against competitors—is certainly worth the effort. Companies that have stepped up to the challenge and succeeded have been able to reinvest their margins in even better sales and marketing capabilities, thereby reinforcing their scale benefits and increasing their lead over their closest competitors.

The questions below can help you plan the steps your company must take to secure a lasting advantage in China:

1. Is our company positioned to achieve sustainable profitability in China?
  - ◇ Are we in the right categories?
  - ◇ What is our relative market share?
  - ◇ How can we strive for category leadership in our portfolio's less successful businesses?
  - ◇ How are our key competitors positioned?
  - ◇ Is our business large enough?
2. What actions can we take to achieve the minimum scale required for sustained profitability?
  - ◇ Are we prepared to expand into other regions and into the middle-class and emerging-middle-class segments?
  - ◇ Do we have a strong “anchor” category to support expansion into adjacent categories?

3. Do we have the capability and infrastructure to succeed in China's lower-tier cities and with consumers from the emerging middle class?

- ◇ Do we have the systems and capabilities to regularly gather powerful insights into consumers in the lower-tier cities?
  - ◇ Can we develop products to meet their needs at competitive prices?
  - ◇ Can we manage our supply chain to meet cost pressures as we expand?
  - ◇ Can we use China's fragmented trade structures to our benefit?
4. Are we ready to expand into adjacent categories?
- ◇ What are the attractive growth opportunities?
  - ◇ To what extent can we leverage our existing capabilities and assets to expand?
  - ◇ Do we need to acquire new capabilities?
  - ◇ How will our expansion benefit our overall position in China?

confront extremely cost-effective local competitors, they will need to fight and win the battle for defensible scale. But long-term success will continue to be a moving target. Today's leaders must keep their eyes on that prize if they hope to claim ultimate victory in China's fast-growing and intensely competitive market.

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**T**he competition for China's \$3 trillion market is hotter than ever, and the emerging middle class has become the new battlefield. The outcome is far from certain, and the field is still open to all capable players. As well-financed global companies gird themselves to



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Readers of this report will be particularly interested in *Winning the Hearts and Minds of China's Consumers*. Published in September 2007, this report focuses on trading-up trends and consumer behavior in China's cities, both large and small.

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