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How Xiaomi Became an Internet-of-Things Powerhouse

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Summary.

When you think about Xiaomi, you mind probably goes to smartphones, but what's less known is that the company originally entered the fiercely competitive smartphone market without offering a phone. When Xiaomi launched in 2010, it only offered a free Android-based OS. But within seven years, it became one of the world's largest smartphone makers, reaching \$15 billion in revenue. In this article, based on interviews with top executives, the authors discuss how Xiaomi was able to grow so explosively, the strategies it used, and what other companies can learn from Xiaomi's rise.

When Xiaomi entered the fiercely competitive smartphone market in 2010, it did so without even offering a real phone. The company only offered a free Android-based operating system (OS). Yet, within seven years, Xiaomi became one of the world's largest smartphone makers, reaching \$15 billion in revenue. Accelerating its growth rate, Xiaomi transformed into the world's largest consumer IoT (Internet of Things) firm by 2020, with its revenue surpassing \$37 billion and more than 210 million IoT devices (excluding smartphones and laptops) sold across more than 90 countries.

How was Xiaomi able to grow so explosively and what lessons can other companies learn from Xiaomi's rise?

We sought answers via an in-depth, multi-year study of the firm, including extensive interviews with 12 top executives (including cofounders, chairman, CEO, president, senior VPs, and executives leading R&D, distribution, and marketing), as well as the founder and CEO of Smartmi, Xiaomi's largest ecosystem partner. Our research also involved analyzing more than 100 hours of conversations and reviewing more than 5,000 Xiaomi documents (from 2010–2020) as well as 470 external reports and data sets.

We learned that the secret to Xiaomi's growth lies in what we term as "strategic coalescence." The word "[coalesce](#)" originates from the Latin words *co* ("together") and *alescere* ("to grow"). Strategic coalescence thus refers to a process through which a firm intimately connects with demand and supply-side stakeholders, bolsters tangible benefits for all, and triggers exponential market growth. Let's first understand the key aspects of strategic coalescence at Xiaomi.

Coalescence with consumers

Xiaomi entered its first market — China — by offering a smartphone OS, called MIUI, for free. At the time, there were several strong domestic (e.g., Huawei, Lenovo) and international players (e.g., Apple, Samsung) battling over every tier of the market, from economical to premium. Most Chinese manufacturers simply slapped the Chinese version of Android on their smartphones, with little customization.

Instead of competing head on, Xiaomi courted tech-savvy smartphone users by offering them free software and building a fully-fledged online community to engage with them and understand which features they craved and which they disliked. This segment of consumers loved the unprecedented attention from a tech firm and were highly motivated to interact and contribute suggestions.

Xiaomi released a new OS version for download every Friday afternoon, as its tech-savvy consumers were heading home for the weekend. Its engineers followed up on user suggestions as soon as they were received, often corresponding with users to resolve issues together. This co-development process enhanced Xiaomi's brand awareness and likability and prepared a segment of potential consumers for the entry of Xiaomi's phones, without spending money on traditional advertising.

When it introduced its first phone in August 2011, Xiaomi positioned itself as offering "quality technology at an affordable price." It sold directly to consumers, through its own website, at a margin of below 5% — the thinnest margin in the industry. Because of its direct engagement with tech-savvy consumers, Xiaomi was able to trim out all intermediaries — the many tiers of national, regional and local wholesalers and retailers, each of which charged a markup. Its direct-to-consumer approach created a significant cost advantage — the phone's feature to price ratio was far more favorable than anything else on the market — and increased the speed at which Xiaomi could reach its consumers. Target consumers responded: Demand outpaced production so much that the firm could only open its e-commerce site one day per week and stocks sometimes sold out within minutes. The constant and instant sell-outs led to social media storms, spreading the brand to an ever-wider audience, stimulating further demand.

Coalescing operations around the core value proposition

After gaining a foothold in the tech-savvy, value-conscious segment in the top cities, Xiaomi began to expand into other segments — consumers who were less tech savvy, as well as those residing in smaller cities. Many of these consumers preferred an offline shopping experience, wanting to discuss their needs with a staff member or get a demonstration.

To serve these new customers, Xiaomi built an offline retail infrastructure, setting up hundreds of stores spanning major metros and small cities. Unlike other smartphone makers, who co-located their stores at the "telecom street" (an area dedicated to telecom stores), Xiaomi set up its stores in locations with high foot traffic, like malls, where its new target consumers were likely to shop. Importantly, Xiaomi chose malls where existing "high value at a reasonable price" anchor stores could help reinforce its own positioning. It also started offering different sub-brands (Redmi as an economical product

line and Mi MIX for more advanced tech seekers), always ensuring that the features-to-price ratio of each new phone was more appealing than competing products.

In sum, during its initial phase, Xiaomi focused on quickly building a large smartphone consumer base across value-seeking consumer segments along with an appropriate on- and offline distribution infrastructure, always keeping its promised low margin on hardware. This enabled it to achieve massive volumes. Xiaomi expanded the share of wallet of this huge and growing customer base, with higher margin post-purchase services (commissions on music, videos, or game purchases), to help attain profitability. These laid the foundation for Xiaomi's subsequent IoT endeavors.

Leveraging coalescing synergies

Xiaomi's expansion into the IoT sphere was further empowered by four coalescing synergies.

In-Home IoT Synergy

Xiaomi leveraged its smartphones as an "omni-remote control" and began launching products that could be linked to and controlled by its phones (such as, TVs, air conditioners, air purifiers, smart lamps). In addition to developing its own products, Xiaomi sought partners who could help the firm quickly expand the range of its IoT offerings. The products from the partners were easily integrated into Xiaomi's in-home system as they were built on its IoT protocol. This meant that once consumers acquired their first Xiaomi IoT product, they were more likely to seek out other products from Xiaomi. In other words, it became progressively harder for competitors to lure customers away in an IoT category.

Design Aesthetics Synergy

To further strengthen the bond between Xiaomi and its customers, the firm ensured that all Xiaomi-branded IoT products, including those manufactured by ecosystem partners, followed similar design aesthetics. So, if a consumer purchased another Xiaomi product, that item would be more aesthetically congruent with the Xiaomi products they already owned, creating synergy through design congruency and visual gestalt.

Product Portfolio Synergy

A key challenge associated with offline distribution is the high and ever-increasing square footage cost, especially at prime locations. Non-smartphone products (including those by partner firms) could yield much higher margins than smartphones, making the opening and running of offline stores more financially viable. Also, selling a variety of products in the stores attracted consumers who were not specifically looking for smartphones, creating opportunities to promote Xiaomi smartphones and, more generally, to cross-sell its entire portfolio. Furthermore, a broader product portfolio encompassing items with shorter replacement cycles (such as fitness bands and smart light bulbs) created higher foot traffic, leading to additional unplanned purchases and cross-selling opportunities in store.

Multi-Channel Synergy

To maximize returns on its brick-and-mortar stores, Xiaomi leveraged online sales data, using analytics to inform which products to sell offline and how to optimize the product mix at the store level. Offline stores were leveraged to offer potential consumers demonstrations for more experiential products (such as vacuum cleaner robots or AI speakers), moving those potential customers along the decision process whereby the demonstration could either seal an immediate purchase or nudge the consumer towards a later online purchase. The latter provided an additional multichannel synergy, from offline to online.

These four synergies coalesced together, amplifying each other's effect. Consequently, Xiaomi was able to attract a growing number of potential customers to visit its stores (as opposed to smartphone competitors' stores) and enhance the likelihood that they make purchases within Xiaomi's ecosystem. This propelled rapid adoption of Xiaomi's IoT products, with customers frequently visiting Xiaomi stores and purchasing multiple items.

Coalescence with partners

To effectively expand into categories outside Xiaomi's expertise and bolster the four synergies, Xiaomi implemented a unique process for identifying and developing partnerships. These yielded some advantages:

1. Partners were hand-picked by Xiaomi cofounders and top executives through their personal networks. Because of the close personal connections, executives at Xiaomi had in-depth knowledge about each partner. They understood the capabilities and values of the management team, enabling Xiaomi to better assess the likelihood of collaboration success.
2. Leveraging personal networks meant that Xiaomi executives were also well connected to the social network of each partner. If some partners performed poorly or violated the partnership agreement, there would be an immediate and direct reputational cost to them, making it harder for them to leverage their social network for further business endeavors, a crucial success factor, particularly in the Chinese business context. This social cost complemented the economic incentive for partnering, bolstering the likelihood of successful collaboration. Certainly, this cherry-picking approach also had drawbacks — it limited the number of potential partners from which Xiaomi could select. However, in the case of Xiaomi's IoT transformation, its executives believed the pros outweighed the cons.
3. Xiaomi invested in the partner firms but did not acquire controlling shares. While the investment incurred a risk, it created significant benefits. The "co-owner" relationship facilitated communication and increased trust. Xiaomi was able to gain access to information about each partner's cost structure and operations, as well as participate in their business decisions. Because partners retained majority shares, they were motivated to develop and sell successful products. As a shareholder, Xiaomi benefited from the growth of its partner firms and the profits they made. Simply put, this form of co-ownership created a win-win outcome for both Xiaomi and its partners.

4. Xiaomi purposefully selected firms that were small or startups, so that partnering with Xiaomi offered significant value to them. These firms typically focused on a single category of products, and this specialization meant higher likelihood of producing great products. One important benefit Xiaomi offered to its partners was “incubation”: It assisted them with R&D by sending in teams of its own engineers, and it helped its partners identify key suppliers and negotiate contracts. Xiaomi’s investment and operational involvement brought brand awareness and prestige, making suppliers more willing to offer favorable terms to partner firms (compared to a “nobody” startup). Importantly, by ensuring that partner firms had access to solid designs and used quality inputs at reasonable cost, Xiaomi safeguarded the quality and price attractiveness of their final products.

These approaches enabled Xiaomi to effectively manage the partner network and offer an ever-growing portfolio of products consistent with the Xiaomi brand in design, aesthetics, quality, and technology/price ratio. Xiaomi’s coalescence with partners laid another foundation for the firm to become a global IoT giant.

Xiaomi’s growth path differs from conventional strategic thinking. While we are often taught that a firm’s strategy should be based on either cost leadership *or* differentiation and must serve either a few needs of a broad segment *or* broad needs of a narrow segment, Xiaomi is clearly an outlier. It differentiated on multiple frontiers and at the same time attained cost leadership. It achieved these through strategic coalescence — by coalescing with consumers and partners, which erected and continuously fortified barriers to entry on both the demand and supply sides. This resulting sustainable competitive advantage catapulted Xiaomi forward at warp speed.

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