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The Official Future Revisited

Thoughts on China's Consumer Landscape in 2015

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A few short years ago, the Chinese consumer goods landscape was relatively un-developed, with consumers less sophisticated, local competitors offering basic products and modern trade channels limited to a handful of large cities. However, so much has changed since then across all of these dimensions, with the speed and extent of change surprising even those in the consumer goods industry. For example, who five years ago would have expected luxury fashion brand Zegna to be present in almost 50 cities in China, including in Hefei, Changsha and Jinan or Japanese fast-fashion retailer Uniqlo to generate as much revenue from its on-line store on Taobao as from one of its high-street outlets? And who would have projected the market for chocolate to almost double in value, herbal tea brand Wang Lao Ji to grow its share of the Ready-to-Drink (RTD) tea segment from 1% to 21% or personal care brand Bawang to create a new market in male shampoo?

Projecting the future is a complex and difficult task in any environment. Prognosticators desire to use what they have observed most recently as the basis for developing trend lines often ends with a fairly conventional or 'official' view of the future. This approach can produce reasonably reliable results in developing a picture of the more immediate future, but is inadequate when it comes to planning beyond that timeframe.

The purpose of this paper is to stimulate thinking about how key aspects shaping China's consumer landscape might evolve over the next five years and beyond. The emphasis is not on aspects such as the growth of the middle class or the expansion of modern trade, which, short of massive economic, social or similar upheaval, are fairly certain in their trajectory. Instead, the focus is on key 'uncertainties' or 'wild cards' which are less clear in terms of their direction and shape of development, but which can have significant impact on the evolution of China's consumer landscape. The 'lens' we are using to focus our analysis is the Chinese consumer, i.e., we have identified 'uncertainties' that impact where consumers will live, how they will behave and who will compete for their spending.

Where will China's consumers live? Much of China's consumption is linked to the evolution of its urban environment. While urbanization itself is a clear trend, there are several critical uncertainties that may create differently shaped urban landscapes in China:

- Will China's population become more concentrated, with seven to ten core mega-cities that are expanding the fastest, or will migration and investment patterns create a more regionally dispersed urban landscape?
- How will the boundaries between different city tiers and those between urban and rural areas evolve?

What will drive Chinese consumers' behavior? With urbanization and rising incomes, consumer exposure and sophistication have risen dramatically over the past few years. While both are expected to continue their trajectory, there are several factors that may shape consumer behavior in different ways than expected:

- How will consumer behavior be impacted when the 4-2-1 family structure is 'turned on its head', as China ages and 'one-child-policy' couples need to support their retired parents and grandparents, in addition to their own child?
- How will environmental issues shape what consumers buy and how they make their buying decisions?
- How will the shift from saving to spending, and perhaps borrowing, evolve and impact consumer behavior?

Who will be the players competing for China's consumers? Many typical drivers of consolidation such as rising costs to compete and proliferation of modern trade have emerged in China in the past several years. At the same time, domestic consumer goods companies have started to play a more significant role in the market. However, there are several uncertainties:

- How will China's consumer goods sectors evolve, given that there are many factors that enable a "long tail" of competitors to remain in the market?
- Which of the Chinese consumer goods companies that have made their mark in the past few years will be able to move beyond their initial success and create a business that is sustainable in the longer term?

The views expressed in this document are based on a combination of conversations with more than 40 executives from foreign and domestic consumer goods companies in different sectors in China, inputs from

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experts from other relevant fields such as sociology, ethnology and urban planning and the perspectives that Monitor Group has gained from working with consumer goods companies in China for more than 20 years.

This document neither lays claim to providing a complete list of 'uncertainties' nor does it try to 'predict' what their outcome will be. Its main purpose is to serve as a starting point for businesses to reflect on the assumptions underlying their own strategies and plans by thinking about how key aspects shaping China's consumer landscape might evolve over the next five years and beyond.

Where Will China's Consumers Live?

Much of China's consumption is linked to the evolution of its urban environment, but while urbanization itself has relatively little uncertainty, its overall shape is less clear.

Mega-cities vs. Regional Centers

The shape of China's urban landscape could evolve in several different ways:

- In a more concentrated model, a smaller number of mega-cities, each with a population of over ten million, will grow fastest. These include Beijing and Shanghai, as well as regional centers such as Chongqing, Tianjin and Chengdu. A second set of cities, with a population of over five million each, and including Guangzhou, Nanjing and Xi'an, will also increase in both number and size.
- In a more regionally dispersed model, mid-sized and smaller cities with populations between 0.5 million and five million such as Langfang (Hebei), Taiyuan (Shanxi), Lanzhou (Gansu), Yinchuan (Ningxia), Lijiang (Yunnan) and Panzhihua (Sichuang), will grow fastest. Current mega-cities, while not shrinking, will remain relatively flat in terms of growth.

There are plausible drivers for both models, as well as for a combination of the two, e.g.:

- From a government and administrative perspective, the scale and concentration of a 'mega-cities' model makes investments in public services and infrastructure more meaningful. From an individual's and business' perspective, larger cities are generally viewed as providing more opportunities, i.e., their scale becomes self-reinforcing.
- On the other hand, a regionally dispersed model is more suitable in promoting a balanced development of China and may therefore be favored by the government. In addition, mega-cities are considered more complex to manage; hence the government may limit their growth.

There are several potential implications:

- Different compositions of China's urban landscape will create a different picture of where and how consumers will live and what environment they will consume in. This will impact their beliefs and attitudes about consumption in general as well as their views of certain products and brands.
- This in turn will require companies to make different decisions about how to expand. For example, a China dominated by 'mega-cities' would require companies to 'go deep' in a limited number of locations rather than expand across a much broader range of geographies as in a 'regionally dispersed model'.

From City Tiers to 'Urbanized Countryside'

Many consumer goods and services companies' in China share an expansion approach that involves prioritizing cities based on tiers, assuming a correlation between city tier and 'affordability' as well as consumer sophistication. Several factors could make this correlation less clear:

- In particular for 'daily goods' categories such as packaged food or personal care, affordability is no longer a fundamental barrier for many urban consumers, regardless of whether they live in top- or lower-tier cities, although income will still influence the type of product or brand they buy.
- Similarly, consumer sophistication or 'readiness to buy' has evolved, as many consumers have been exposed to new product categories through the media, in particular the Internet. For example, almost half of all Internet users (and 60% of mobile subscribers) live in Tier 3 cities and below. In the next five years, this ratio is expected to increase to more than two-thirds of Internet users (and 70% of mobile subscribers). And of Taobao's approximately 100 million registered users, more than 70% are estimated to be from non-Tier 1 cities.
- New consumer segments with similar beliefs and behaviors are forming, regardless of city tiers. This is particularly noticeable among China's most prolific Internet users, high-school and college students, but not restricted to them.

Similarly, a number of factors may also start to erode the boundaries between what is considered urban and rural, leading to what could be called the 'urbanization of the county-side':

- Migrants returning from China's industrial zones are bringing back slices of city life to their villages, with some of those coming back permanently opening small shops and trading businesses, creating non-agricultural income and helping to modernize rural channel infrastructure.
- Complementing these efforts, the government, via its Ministry of Commerce, plans to build 150,000 retail outlets and 1,000 distribution centers in rural areas throughout 2009.
- Internet access (in particular through mobile phones) will give rural consumers the same product and brand information as their urban peers.

While the erosion of boundaries among city tiers and between what is considered urban and rural will not happen overnight, it has a number of implications:

- For some product categories, the opportunity to penetrate so-called lower tier and rural markets could be increasing at a faster pace than expected, requiring brands to invest in building awareness and preference earlier.
- At the same time, there is a risk that new players will occupy the space, if demand is not fulfilled by established brands.
- If the distinction among city tiers is no longer relevant as a way to understand consumer behavior and segment the market, a much more granular segmentation model that includes a broader set of behavioral, attitudinal and psychological drivers may be required.

What Will Drive Chinese Consumers' Behavior?

With urbanization and rising incomes, consumer exposure and sophistication have risen dramatically over the past few years. While these are likely to continue their trajectory, there are several key uncertainties that may shape consumer behavior in unexpected ways.

From 'Little Emperors' to 'Taking Care of Aging Parents'

China's demographic changes are a well-known phenomenon. With generally falling birth rates of about 12.4 per thousand, a gender imbalance of about 120 new-born boys to every 100 girls and an increasing life expectancy from 68 years in 1949 to 73 years today, China's society is aging at a rate similar to that in many developed nations.

The 'first-layer' implications of this are relatively clear, ranging from increasing demand for health- and aging-related products to changes in communication and interaction preferences with brands. However, China's changing demographics may have a more fundamental impact on how China's urban middle class consumes.

- China's urban family structure today is based on '4-2-1' units, i.e., four grandparents and two parents focusing their energies and resources on a single child, making significant investments in the child's education and well-being. This includes the expectation that the child will "return the favor" when parents are old.
- Between 2020 and 2025, the parents of the 18 to 20 million 'first wave' one-child generation children, born in the early 1980s, will reach retirement age.
- While the majority of these are expected to have some basic health coverage, this is unlikely to include caretaking services for elderly suffering from Alzheimer's or similar conditions.

This scenario has several potential implications, with those directly affected estimated to be several million couples as early as 2015, rising exponentially as more one-child-policy parents retire:

- As they reach their late 30s or early 40s, i.e., their peak earning and consumption power, their spending structure will change to cope with this new responsibility. This may require reducing spending on discretionary items to afford a more spacious apartment. Obviously, the one-child-policy generation has no siblings to share these responsibilities with.
- Related to this, more women might leave the workforce or suspend their career progression (and salary increase) to focus on supporting their parents, in-laws and child(ren), further reducing disposable income. While aging-care services may fill this gap, their short-term impact on income is likely to be nearly the same.
- Providing this type of support not only places financial, but also a tremendous psychological burden on families, affecting the way they think about their future and shifting their consumption priorities.

From 'Paying for Plastic Bags' to 'Becoming Green at Heart'

Much has been said and written about the state of the environment in China and the impact of environmental degradation on China's limited natural resources such as drinking water and arable land. So far, the impact on consumer behavior has been quite moderate both on the supply and demand side, aside from superficial measures such as a recently-introduced plastic bag levy and a smattering of 'eco-products' largely sold in Beijing and Shanghai. Several factors could change this:

- Out of sheer necessity, environmental regulations may start to impact how products are marketed and sold, with the government leaping ahead of similar initiatives being considered in other markets; for example, the General Administration of Quality Supervision, Inspection and Quarantine (AQSIQ) and the National Development and Reform Commission (NDRC) have jointly drafted regulations to limit

excessive packaging, with products not to have more than three layers of packaging and packaging costs not to exceed 15% of the product's price.
- Similarly, regulations could shift to 'taxing' consumers for buying products that use resources in short supply for their production.

From a demand perspective, interest in sustainable or 'green' products and services is starting to increase:

- 90% of respondents to a recent survey by Xiaokang Magazine claim that aspects such as low pollution and high energy efficiency form part of their purchasing considerations.
- These changes in attitude are particularly strong among people born in the 1980s and 1990s. Recent research indicates that many of them have strong views about preserving the environment and are acting upon these beliefs when making buying decisions. Movements such as LOHAS (Lifestyle of Health and Sustainability) are being embraced by a small, but influential group of young urbanites. Even domestic sportswear leader Li Ning released the 'Green 001' eco-friendly shoe earlier in 2009 to cater to this demand.
- While not strictly an 'eco' or 'environmental' theme, recent food quality issues, in combination with greater awareness of the connection between food and health, also contributes to changing views.
- Other related themes such as domestic success in developing electric cars may also act as a catalyst for broader behavior changes.

There are several potential implications:

- Given the urgency of China's environmental issues and their direct impact on consumers' daily lives, it is unlikely to be a passing 'fad'.
- If some of the proposed (or other, even stricter) environmental regulations are approved and implemented, they will have a significant impact on how consumer goods are made, bought and used in China.
- While it is unclear how much of a premium consumers are willing to pay for 'green' choices, the time might be right to use environmentally sound and less resource-intensive products and services as a way to differentiate. This may take the form of new business models or pricing mechanisms such as online travel services provider Ctrip's has carbon offset program.

From Saving to Spending to Borrowing

China is often described as a nation of savers and the reasons for this behavior have been cited extensively in a broad range of reports. However, there are a number of factors that are starting to change this picture:

- The savings rate of more than 30% that is often quoted is an average. Even today, many members of the middle class are saving much less than this figure suggests. This applies in particular to those born in the 1970s, growing up in a more stable environment, and with a view that their incomes will increase with each passing year. Some research suggests that the savings rate among some of these households is as low as 10% of income.
- However, while members of this generation spend what they earn, and only borrow money for big-ticket items such as new homes or cars, those born in the 1980s are starting to spend more than they make, taking advantage of consumer credit. Credit card penetration among young consumers below the age of 30 for example is rising rapidly with an estimated two-thirds of credit card applicants falling into this age group. Banks are actively encouraging this, holding credit card promotions at university campuses, specifically targeting those they feel will not be held back by the cultural barriers that

consider saving so critical. As a result, credit card circulation is expected to more than double from 160 million today to around 400 million by 2015.

- Other consumer credit options are also emerging. The China Banking Regulatory Commission recently approved the launch of consumer finance companies in four cities, including Beijing and Shanghai, on a trial basis. These will help finance purchases of consumer goods by providing small, flexible loans that require less security and are specifically designed for durable consumer goods, educational services, but exclude purchases of cars and houses.
- Retail store cards are starting to form another wave of consumer credit. Already, some chains such as Bailian Group (百联集团) and TESCO (乐购) are issuing pre-paid debit and loyalty cards, which can easily be upgraded to include some form of credit.

There are several ways in which this could shape China's consumer landscape in 2015:

- Overall, a rise in the use of consumer credit to buy discretionary items would be a significant cultural and behavioral shift that will further fuel a consumerist lifestyle in China.
- As examples from other markets have shown, there are negative side-effects to a sudden boom in consumer credit options. It is uncertain therefore to what extent the government (or the lenders themselves) may control the volume of credit cards issued or set spending limits.
- Related to this, an expansion of consumer credit will likely lead to the establishment of a credit system that might allow tracking and analysis of consumption records and pattern. This type of data will in turn enable better targeting of brand building and promotion activities.

Who Will Compete for China's Consumers?

Many typical drivers of consolidation, such as rising costs to compete and proliferation of modern trade, have emerged in sectors such as beverage, food and consumer electronics in China in the past several years. At the same time, domestic consumer goods companies have started to play a more significant role in the market. While this suggests that the evolution of China's consumer industry sectors will be quite 'linear', there are several uncertainties:

Too Many Barriers to Consolidation?

As mentioned, many of the typical drivers of consolidation have emerged in China in the past several years.

- Key 'costs to compete' continue to be high. For example, the costs of advertising time slots right before the main CCTV evening news has increased by 13% per annum between 2004 and 2007.
- The size of the market and its fragmentation will continue to require significant investments into distribution and "sell-through" capabilities given that most distributors lack merchandising and in-store activation skills.
- At the same time, the expansion of modern retailers, as well as their continued professionalization, would reduce the shelf-space available for B- or C-tier brands.
- Finally, the ability to attract the right management talent continues to be a key contributor to these rising costs to compete.

Some sectors will indeed follow a path similar to beer and soft drinks, where the top five players account for 56% and 60% of the market, up from just 33% and 38% respectively just five years ago. However, for most sectors, China's market characteristics create barriers to further consolidation, at least in the medium term.

- "Regional" markets are sizeable enough in terms of demand and diverse enough in terms of trade and media structure to support regional brands; for example, even in the highly concentrated RMB 1.5 billion beer brand Niulanshan (牛栏山) has been growing at 35% per annum over the past five years by selling exclusively through 4,500 restaurants, serving Beijing's 17 million-strong population.
- Related to this, China's size means that in some sectors, particularly in food, a regional supply chain can be a key source of advantage: While Mengniu (蒙牛), Yili (伊利) and Bright Dairy (光明牛奶) together hold more than two-fifths of China's fresh dairy market, RMB 1.9 billion Wandashan (完达山) has been growing at 28% per annum in the past three years, focusing exclusively on Heilongjiang, Jilin and Liaoning provinces, a market with a total population of 107 million.
- China's regional characteristics are reflected in its trade structure, e.g., Wandashan's key accounts include regional retailers such as Jingkelong (庆客隆), Jilin Baixing (百姓), and China Sun (中国红).
- For sectors where there is no clear market leader, the high costs to compete at a national level can also form "barriers" to consolidation as expansion beyond the home market is 'unaffordable'.
- Underlying market growth, in combination with consumers' tendency to buy substitutes if certain products or brands are not available in their market or considered too expensive, also enables new players to enter.
- Finally, the Internet will continue to reduce barriers to entry, in particular for companies that have built good product development and manufacturing capabilities from serving overseas customers, but lack domestic distribution. For example, Gainreel (歌瑞尔), a Guangdong-based RMB 3 billion former clothing OEM, successfully built their brand via Taobao.

Moving forward, this will shape China's consumer landscape in several ways:

- While concentration is likely to continue to increase among the top 'national' players in most sectors, a 'long tail' of competitors with strong 'regional niche' positions is likely to remain in the market for the foreseeable future.
- Competitive strategies, including consumer marketing and go-to-market activities, therefore need to continue to be both national and regional.

'One-Hit Wonder' or 'Sustainable Business'?

The past few years have seen an increase in the sophistication of domestic Chinese consumer goods companies. Where ten or even five years ago, many were barely more than packaged goods manufacturers, several have taken the lead in certain categories, in particular those that require an extensive local supply chain such as dairy or satisfy uniquely Chinese demand characteristics such as Ready-to-Drink (RTD) tea.

With RMB 24 billion in revenue last year, Mengniu (蒙牛) is now among the top 20 dairy companies globally. Similarly, Master Kang (康师傅), including its tea, instant noodle, bottled water and snack food businesses, generated sales of RMB 30 billion in 2008.

A number of domestic brands have also built a successful position in sub-categories that have previously been dominated by foreign players. Shampoo brand Bawang (霸王) is a well-known example, increasing its revenue almost five-fold in the past two years, from RMB 300 million in 2006 to almost RMB 1.4 billion in 2008. Bawang expanded its share in part by creating a new herbal ingredient-based male shampoo sub-category. Similarly, Guangzhou-based home care and laundry products maker Liby (立白) is now the top detergent brand in China, leading P&G and Unilever with a 23% share to their 22% and 11%, respectively.

Many of these recently successful Chinese companies are typically at an earlier stage of development and more entrepreneurial than their foreign competitors, with decisions made quickly by a small number of individuals. This structure allows them to place 'big bets', e.g., by making significant investments into a new product launch, that generate immediate 'hits'.

However, it is unclear which of these companies can move beyond the entrepreneurial stage and build a successful business in the longer term. Some have started to strengthen their capabilities by leveraging external advisors, such as product design companies, flavor houses and branding agencies and by tapping into the growing pool of people with ten to fifteen years of sales and marketing experience at MNCs in China. However, few have institutionalized processes that are critical for long-term success, such as consumer understanding, product development and life cycle management or trade marketing.

A good illustration of how quickly initial success can disappear comes from the mobile handset sector: Chinese players had captured about half of this market between 2000 and 2004, leveraging the ready availability of quality components and responding to demand from, at the time, less sophisticated consumers. Investing heavily in above- and below-the-line marketing, brands like TCL, Bird (波导) and Konka (康佳) in particular, rose rapidly to industry-leading positions in China and were even heralded as future global players. Today, foreign competitors, with their global scale, advanced products and more sophisticated marketing, have taken the lead again, holding 70% of the market, and some of the former top Chinese brands have all but disappeared.

The above developments will shape China's consumer landscape in a number of ways:

- Most consumer goods sectors will remain in a state of flux for some time to come, with players emerging, building initial success, and then disappearing again.
- This will continue to create disruptions, as new players often place 'big bets' when building their business or act 'irrationally' when their performance is weak.
- At the same time, there may be models of co-petition between domestic consumer goods players, i.e., companies exploring "shared platforms" of innovation or distribution.
- While ultimately, there will be strong Chinese players in most, if not in all consumer goods sectors, many of these are likely to be different from the ones on top today.

What Next?

As mentioned in the introduction, this paper neither covers all uncertainties, nor are those included equally relevant to different sectors in China. However, it can be a useful starting point in reflecting on the assumptions that drive a company's key strategies and business plans, in particular the extent to which these are based on a conventional or 'official' view of the future.

Key questions that should be addressed in this context include:

- How robust are the assumptions underlying critical business plans, looking beyond a one- or two-year timeframe? How could these change in ways that have not been considered yet and what would that mean for the business?
- What other changes could affect the business, e.g., how will current competitors evolve and how will their behavior impact the sector and different players? Who are potential competitors that are not yet visible?
- What is the best way to prepare, both to recognize any of these changes early on, but also to make the strategy and plans more robust and resilient in the first place?

Beyond looking at these uncertainties as risks, it may also be useful to assess whether the current view of the future limits identifying and pursuing new growth opportunities, e.g., in the so-called lower-tier cities.

About MONITOR

Founded in 1983 by Harvard Business School professor Michael Porter, author of Competitive Strategy, Competitive Advantage and Competitive Advantage of Nations, Monitor is a strategy consulting firm with over 1,000 professionals in 23 offices worldwide. More than 150 of these professionals are based in our eight offices in Asia, including Shanghai, Beijing and Hong Kong.

Monitor Group works with the world's leading corporations, governments and social sector organizations to drive growth. We deploy leading edge yet practical ideas and methods, and adopt a highly collaborative intervention approach, enabling clients to make choices, commit to actions and follow through to get results.

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