



Spotlight on China

Understanding the Chinese Consumer

Within the next few years, China is expected to overtake the U.S. as the world's largest retail market. With a population of 1.3 billion, the nation's sheer scale makes it an enormous prize that international retailers cannot afford to ignore. While many foreign companies have focused on Beijing and Shanghai, China has as many as 27 cities with populations larger than New York City. These include Chengdu (with about 14 million people) and Guangzhou (13 million). These are among the world's largest urban retail markets, yet many foreign companies are still not selling there.

China is the World's Largest Country in Terms of Population, and 2nd Largest Economy

Overview of China



- Consists of 22 provinces, 5 autonomous regions, 4 municipalities (Tier 1 cities), and 2 special administrative regions
- Capital is Beijing, while Shanghai is the largest city in terms of population

Source: World Factbook, L.E.K. analysis

Key Facts About China

Population	1.35 billion <i>largest country in terms of population</i>
Largest cities (population)	Shanghai: 23 million Beijing: 20 million Chengdu: 14 million Guangzhou: 13 million <i>Tier 2 cities only constitute 5% of the total population</i>
GDP	\$7.3 trillion <i>2nd largest economy in the world</i> \$6,075 per capita <i>90th in the world</i>
Economic development	<ul style="list-style-type: none"> • Historically, East Coast of China has been the most economically developed <i>key cities such as Beijing, Shanghai are located along the east coast</i> • Economic development in the recent years has been moving more inland

As China grows wealthier, it is also giving rise to an expanding consumer class. More than 25% of Chinese households earn at least \$10,000 a year, up from less than 5% just five years ago. According to China's National Bureau of Statistics, the per-capita disposable income of urban families grew by 9.1% in the first half of 2013. The country now boasts over a million U.S.-dollar millionaires, who have helped to transform China into the world's leading consumer of luxury goods. By 2015, China is expected to account for 20% of the global consumption of luxury goods.

Historically, Chinese consumers were conservative pragmatists, loath to make impulse purchases. But cultural attitudes are changing as they grow richer and more international. This is reflected by a sharp rise in the use of credit. China has nearly 400 million credit cards, and that figure is expected to surpass 1.1 billion by 2025. This should drive a continuing shift toward more free-spending habits. The government is also looking to rebalance the economy by boosting consumption. In 2011, it set a goal of increasing consumer spending from 35% of GDP to 50% by 2015.

Given the opportunities created by such trends, it's important for international retailers to develop a more nuanced understanding of Chinese consumers and the unique challenges of this huge market.

Understanding A Complex, Fast-Changing Retail Market

Retailers in China face significant challenges, including the extraordinary diversity and complexity of the retail landscape. Consumer preferences vary dramatically, depending on everything from income level to location, with a particularly striking gap between urban and rural populations. Spending patterns also vary among different age groups: while wealth is more concentrated among an older generation in the West, the majority of luxury consumers in China are younger than 45 years old.

The dynamics of the Chinese retail market are also changing at a remarkable speed, and international retailers need to be sensitive to these shifts. For example, China had 538 million Internet users in June 2012. By 2015, that number is expected to hit 800 million. As the nation becomes more wired and tech-savvy, e-commerce is booming. According to the Financial Times, online sales soared by 50% in 2012, and China will soon be the world's largest online market. As recently as 2010, online shopping represented only 3.3% of China's retail sales; that figure is expected to reach 8% by 2015.

At the same time, competition is heating up. International brands continue to pour into China, but domestic brands are also becoming increasingly sophisticated. The winners will be companies that understand how consumers think and what they want in this complex, fast-changing market.

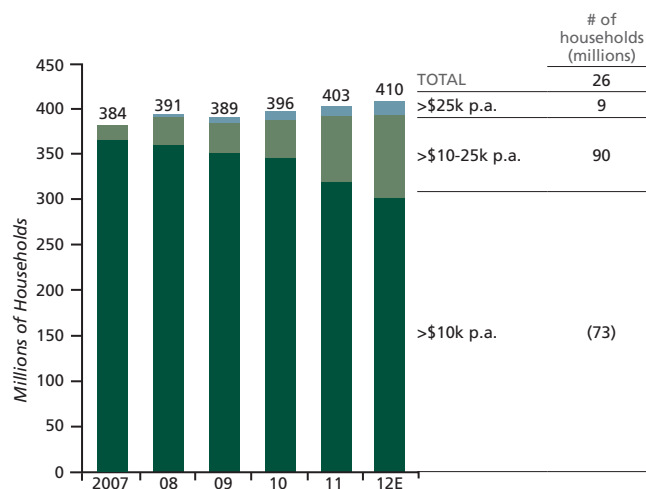
The Quest for New Chinese Markets

One of the key challenges for many retailers lies in knowing how deeply to venture into China's mainland regions – a difficult decision, given that 171 Chinese cities have a population of more than one million. The majority of China's emerging middle class resides outside Tier 1 cities such as Beijing, Shanghai and Guangzhou. As a result, foreign retailers have begun to broaden their search for growth by expanding into less-developed provinces, including Sichuan, Chongqing and Yunnan.

Many less-established urban areas are growing faster than the Tier 1 cities. However, the scale of the retail market is much smaller in less-developed cities, which lag far behind in terms of GDP per capita, retail spending, infrastructure and the number of large department stores.






It's important for foreign companies to understand the socio-economic differences between cities. Consumer behavior can vary considerably, depending on the specific urban environment. Few retailers succeed by approaching China in a uniform manner, simply transporting their business model wholesale to a wide range of cities without acknowledging these differences.

Figure 1
China Household Breakdown by Annual Income* (2007-2012E)



Note: *Current year exchange rates used by the Economist Intelligence Unit for each year to calculate brackets in U.S. dollars
Source: IMF, Economist Intelligence Unit, L.E.K. research

Figure 2
China City Tier Overview (2012)

City tier		Tier 1	Tier 2A	Tier 2B	Tier 3A	Tier 3B	Tier 4
Example city		Shanghai	Chengdu	Haerbin	Changzhou	Mianyang	Xinle
Number of cities		4	12	16	158	97	370
Definition		Most economically developed cities	Provincial capitals with annual GDP per capita* >\$10k	Provincial capitals with annual GDP per capita* <\$10k	Prefecture-level cities with annual GDP per capita* >\$5k	Prefecture-level cities with annual GDP per capita* <\$5k	County-level cities
City landscape							
Basic economics	Population (k)	23,470	11,562	9,926	3,618	5,426	868
	Annual GDP per capita* (US\$)	17,803	12,118	8,877	11,684	5,756	4,140
Retail development	Total annual retail sales (US\$bn)	109.1	37.5	27.3	15.1	3.1	0.9
	Total # of commercial zones (2012)	c.10	c.7	c.5	c.3	c.2	c.1
	Total # of dept stores/shopping malls (2012)	c.80-100	c.40-60	c.20-40	c.20-30	c.5-15	c.1-10

Note: *Annual GDP per capita in 2010
Source: China City Statistic Yearbook

For example:

- **In the Vitamin, Mineral & Supplement (VMS) industry**, buyers in Tier 1 cities are typically looking to enhance their family's overall health and well-being. They tend to buy from premium channels, including large department stores, and they have a relatively high awareness of foreign brands such as Centrum.
- **By contrast, customers in Tier 2 and 3 cities typically purchase VMS products to treat specific ailments.** They often buy from pharmacies, not department stores, and they tend to favor domestic products that are cheaper than foreign brands.

As with attitudes to health, there are also pronounced differences from city to city in attitudes to leisure time. For example, residents of Chengdu tend to place more value on enjoying their free time than residents of many other Chinese cities. This affects their buying patterns in significant ways:

- **A Guangdong-based property company had trouble selling a new development in Chengdu** until its executives realized that consumers there wanted a mah-jong room in each unit.
- **People from Chengdu often drive out of the city at the end of the work week, while Shanghai residents tend not to leave the city on weekend jaunts.** As a result, there is a thriving market in Chengdu for luggage carriers that attach to car roofs.

How Do You Like Your Fruit Juice?

Consumer preferences and buying habits also vary significantly from region to region in this enormously diverse country. In general, Cantonese-speaking consumers from the South have different tastes than Mandarin-speaking consumers from the North. This affects their preferences for everything from food flavors to the color and style of apparel. For example:

- **Fruit Juice:** In southern China, consumers favor more diluted juice than in the north.
- **Palm Oil:** While it's commonly used in the South, palm oil isn't popular in the colder climes of the north, since it congeals in lower temperatures.

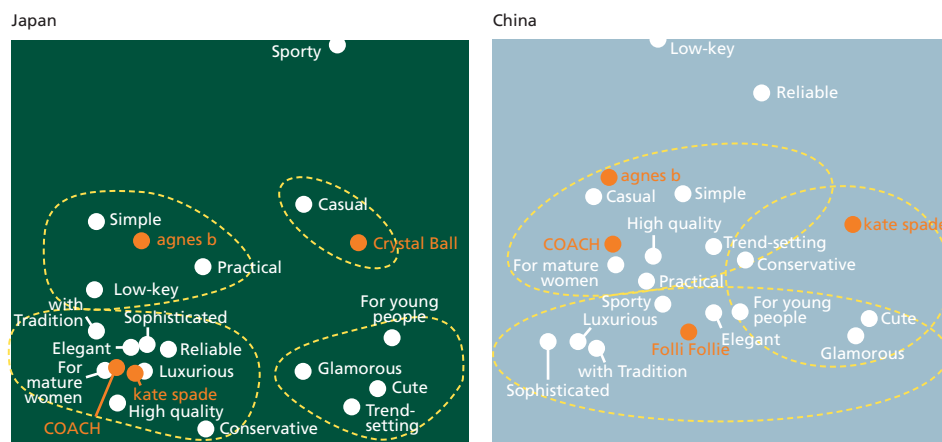
Recognizing that strong regional differences exist, many of China's national retailers adopt a decentralized approach, empowering local employees to make appropriate buying decisions. These companies have the flexibility to provide a broad selection of competitively priced products to suit a specific region. Foreign retailers, which typically have a more centralized structure, can find it difficult to compete in this localized manner. For foreign companies looking to enter the Chinese retail market, it's crucial to recognize that regional differences create this added layer of complexity.

Know Your Customer

As the country has grown richer, its consumer base has become more fragmented. Many Chinese consumers are increasingly well-informed and worldly, while others have been left behind. Various types of Chinese shoppers have emerged, each with distinctive characteristics. For example:

- Flush with newly gained wealth, a growing number of shoppers are drawn to the flash of fashionable brands, which can provide social recognition and a way to pamper themselves.
- A discerning group of shoppers has emerged that focuses more on quality than logos.
- Others buy products to express their individuality, enabling them to feel unique or different.
- Many shoppers still buy products primarily for practical purposes.

Figure 3
Brand Perception Map for Handbag Brands



Source: L.E.K. survey and analysis

For retailers, it's important to understand that there's a broad spectrum of consumer priorities and motives. The days of being everything to everyone are numbered. A key challenge for companies is to define their brand identity without alienating other segments of this diverse consumer base.

Adding to these complex challenges, Chinese society continues to change at an unprecedented rate. For example, consumers are turning to the Internet in ever-greater numbers to compare prices, share product reviews, and snap up bargains. Alibaba Group, which owns China's dominant online marketplace Taobao, reported that revenues in the first quarter of 2013 alone surged 71% year-on-year. Already, same-store sales at traditional brick-and-mortar outlets are struggling. As Internet use and disposable incomes rise, more and more people will change the way they shop.

Against this fast-changing backdrop, foreign retailers face an array of difficult decisions. For example, should they sell their products in China's popular malls or in its declining department stores – or should they risk an online price war against Taobao? For now, many foreign brands are taking a wait-and-see approach, since the dynamics of this market are in such flux. Still, for all these challenges, there is little doubt that China is one of the world's most enticing retail markets.

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December 2, 2013. (Photograph, Figure 2 – Mianyang). dailin / Shutterstock.com

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