

Succeeding in China's Multi-Layered Consumer Products Market

The landscape for consumer products in China is undergoing radical change. Market based economic policies and significant per capita income growth have facilitated the rapid development of upper and middle classes with modern purchasing habits. World Trade Organization (WTO) removal of trade restrictions has attracted top global retailers that have invested in the modernization of retail and distribution networks, thus promoting access to consumers who have previously been underserved. Expanding a consumer products business within this highly dynamic environment can be a complex undertaking. This issue of Executive Insights explores a number of major complexities to successful expansion in this diverse marketplace: a multi-tiered socioeconomic landscape, a diverse consumer base, and the practical difficulties of a systemically underdeveloped distribution infrastructure. We offer insights into navigating these challenges and capitalizing on the enormous potential of this emerging market.

The Consumer Opportunity

With 1.3 billion people, China is the world's most populous country and commands the fourth-largest economy in real terms after the U.S., Japan and Germany. It has experienced the world's highest average GDP growth rate over the past 25 years and is today one of the world's leading recipients of foreign direct investment (FDI). China's low per capita income (under USD 1,000 per year) masks the wide disparities in income and the emergence of an upper and middle class, as evidenced by significant pockets of economic development and concentrated wealth in coastal cities and a limited number of metropolitan areas further inland.

While the rise of the upper class and subsequent boom in spending on luxury goods is noteworthy, it is the rise of the modern middle-class consumer and their aspirational purchasing attitude that is the most exciting story for global consumer products companies. Delineating and quantifying this group is a critical challenge, given its scale and commercial

potential, and as a result is the subject of some debate. In an emerging market like China, defining the middle class is typically not just about sufficient disposable income – although this is an indispensable component. It is also about education levels and evolving purchasing habits and attitudes. China today has approximately 60 million urban residents with household incomes over USD 5,000. The majority of these urban residents have adopted “modern” purchasing habits and have real purchasing power more than twice that of their nominal income.

This sub-group of “modern” consumers increasingly embraces brands as part of China's upwardly mobile urban society and is willing to “spend on myself,” whether it be for a designer handbag at the high end or for an upscale shampoo on the low end. By most estimates, the size of the modern Chinese middle class is expected to quadruple to over 200 million in the next 10 years, eventually comprising 15% of the population and becoming a critical factor in the overall global consumption of consumer products.

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Increased Access to Accepted Brands

The modern Chinese consumer desires lower-cost Western goods and services, which are often seen as attainable luxuries. There are many examples of foreign brands that have invested in creating – and who now dominate – entire categories, ranging from P&G in shampoo and skincare with brands such as “Rejoice” and “Olay,” KFC in fast food, Hennessey and Remy Martin cognac, and Dove-brand premium chocolate.

China’s entry into the World Trade Organization (WTO) in 2004 resulted in the removal of restrictions on foreign investment in retailing and distribution. This has prompted a large wave of foreign investment in both sectors and has resulted in more modernized distribution networks, has encouraged competition, and has allowed for an increased range of consumer goods and retail outlets – all factors benefiting the growth of consumer goods businesses in China.

Market Complexities

The consumer products opportunity in China clearly offers tremendous upside to those companies that understand and plan for the complexities inherent in such a dynamic environment. L.E.K. Consulting has identified three types of complexity that in our experience shape the outcome for success in China: a multi-tiered socio-economic landscape, a widely diverse consumer base, and underdeveloped distribution networks.

Complexity #1: Multi-tiered socio-economic landscape

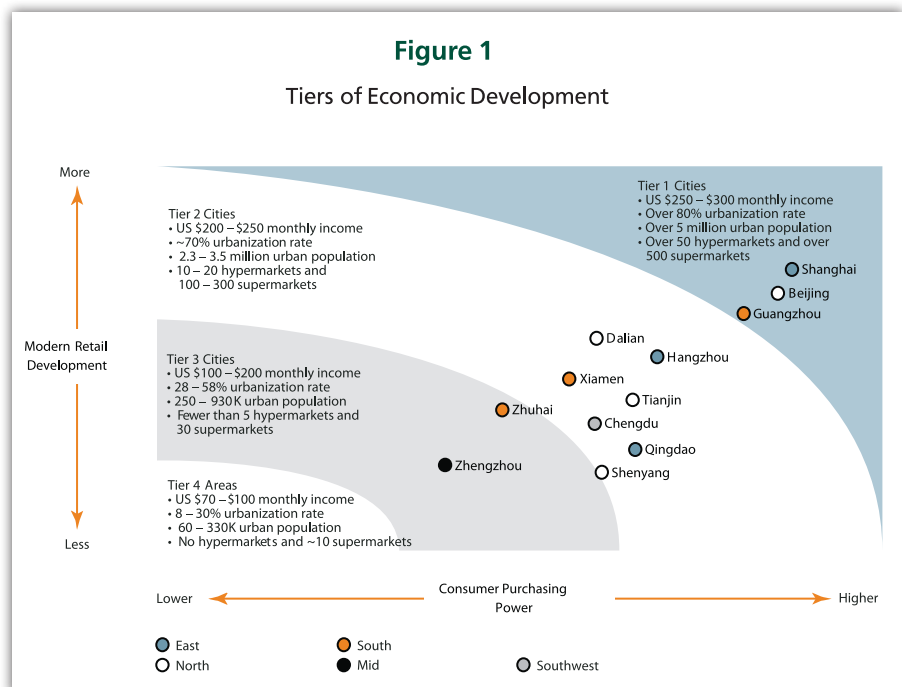
China’s unrivaled path toward economic development has been based on policies encouraging export-oriented enterprises and foreign investment in select coastal urban centers. However, China’s 20 years of aggressive growth, coupled with an underdeveloped infrastructure and insufficient transportation routes inland, has resulted in wide disparities in the pace and nature of development throughout the country.

For many global consumer products companies, when moving out of the most sophisticated cities of Shanghai, Beijing, Shenzhen and Guangzhou, the challenge lies in identifying which of China’s less developed cities are prime targets for expansion, and in knowing “how deep” one should go into China’s mainland regions. With nearly 180 cities with popu-

lations over 1 million, and with the bulk of China’s emerging middle class residing outside of more-developed cities, getting this question right is critical.

Figure 1 illustrates four “tiers” of urban economic development, each tier representing differing levels of consumer prosperity and retailer sophistication.

China is in the midst of a retailing revolution, with large old-fashioned “traditional trade” state-controlled stores and highly fragmented traditional retailers, such as mom-and-pop outlets, open-air markets and street stalls, giving way to “modern trade” hypermarkets, high-street chain stores and shopping malls. Residents of Tier 1 cities like Beijing, Shanghai and Guangzhou, for example, enjoy higher income levels, greater purchasing power, and can support the presence of “modern” retailing formats.



In Tier 1 cities, the share of these modern trade outlets relative to the Traditional Trade venues is already quite high, with many run by domestic or foreign-owned national or regional chains. The high concentration of chain stores allows consumer products companies to reach more outlets more efficiently, thus accelerating the pace of product growth and consumer adaptation.

Citizens of Tier 2, 3 and 4 cities are characterized by progressively lower income levels and purchasing power, and have access to a more limited selection of modern trade outlets – a supermarket, perhaps, or a regional department store. The ratio of modern trade to traditional trade drops significantly in rural Tier 4 areas, which are served almost exclusively by traditional trade.

Segmenting the market by stage of retail development allows for not only a strategic discussion around the channel and outlet mix, but also addresses both the nature of the competitive landscape and the relevance of the value proposition to consumers.

A large snack food brand with an ambitious multitiered rollout plan will encounter primarily higher-end local or large multinational competition in Tier 1 cities, but an entirely different form of competition in small, low-priced regional snack companies in Tier 2 and 3 cities.

A global consumer products business may spend significant advertising dollars in Tier 1 cities to encourage switching behavior within a consumer base actively

engaged in a category – soft drinks, for example. That same product would be considered an aspirational, luxury product in Tier 2 and Tier 3 cities, while Tier 4 consumers may not have had exposure to the category at all.

To penetrate the China market, all Tiers need a compelling value proposition.

Complexity #2: Diverse and price-sensitive consumer base

In a country as large and vibrant as China, it is no surprise that consumer preferences and buying habits are highly diverse. Consumer preferences are closely linked to the level of urbanization (i.e., the city tier), as described above. Geographic regionalism imparts an additional layer of diversity, with southern Cantonese-speaking consumers, for example, having tastes for product colors, food flavors, and apparel sizes that are distinct from their Mandarin-speaking northern counterparts.

In addition, Chinese consumers are generally very price sensitive. With many brands new to the marketplace – and more arriving daily – consumers exhibit an overall low level of brand loyalty and a strong willingness to try new products to get the lowest prices possible.

To be able to provide a broad selection of competitively priced, regionally specific products, many national retailers have adopted decentralized buying organizations, with much of the buying authority pushed down to the local level. This of course adds another layer of complexity for consumer products companies looking

to get product to market, with buying decisions further fragmenting an already diluted market.

Complexity #3: Limited Distribution Options

There are few national-scale businesses in China today. For a range of reasons – including historical provincialism and pre-WTO restrictions on foreign investors – internal distribution and logistics within China remain underdeveloped compared to the world-class port facilities serving China's export markets.

Like most things in China, this infrastructure is rapidly modernizing, driven largely by foreign investment in logistics as well as the efforts of consumer product companies to build their own networks. Currently, the majority of consumer product distribution networks is cobbled together, relying on a patchwork of regional distributors and/or multi-tiered networks, each with a unique business model. A working distribution network in this environment is seen as a significant competitive advantage. Distribution is generally a much higher percentage of total cost in China than, for example, in the U.S. or Europe. Gaining cost-effective access to customers, especially in Tier 3 and Tier 4 markets, continues to be a significant challenge for most consumer products companies operating in the China market.

Conclusion

What consumers buy and how they buy are highly influenced by regional preferences for certain products and services. Reaching each individual to tap into the potential of the market will require an understanding of modern trade evolution and a commitment to a highly customized approach. Those consumer products companies that emerge as leaders will be distinguished by their deep understanding of China's multi-tiered socio-economic landscape, their agility in adapting to its highly diverse and price-sensitive consumer base, and their skill in managing the practical challenges posed by China's underdeveloped distribution networks.

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded more than 25 years ago, L.E.K. employs more than 900 professionals in 20 offices across Europe, the Americas and Asia-Pacific. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns. For more information, go to www.lek.com.

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