

China Consumer Market Strategies 2011

How MNCs and Chinese companies are competing
in the world's fastest growing market



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It's not breaking news to say that the Chinese consumer market is dynamic and expanding rapidly. That's a given; after all, China is forecast by most analysts to become the second-largest consumer market in the world by 2015, not far behind the United States, with enough purchasing power to buy 14 percent of the world's products, up from five percent today. In short, the consumer environment in China five years from now – or even next year – will by all measures be markedly different than today.

But different in what way? Which trends are meaningful and which are likely to have a lesser impact on the future of China's consumer market? How can Western multinationals (MNCs) and Chinese companies best take advantage of the vast opportunities that the emerging Chinese middle class, the increasingly prosperous urban areas and the improving lot of the rural consumer offer? Perhaps most importantly, what should companies be wary of in this rapidly expanding competitive market?

The American Chamber of Commerce in Shanghai (AmCham Shanghai), in cooperation with

Booz & Company, a leading global management consulting firm, explored these questions in a first of its kind survey of 135 predominantly Chinese and Western multinational companies that do business in China (only two percent of the companies surveyed were non-Chinese Asian organizations). The results were eye-opening in what they revealed about the likely evolution of the Chinese consumer market over the coming years and, equally intriguing, in what these companies – both Chinese and Western – said about how well they are prepared for the changes that are certainly on the way and about the capabilities they still need to develop to compete effectively in China.

AmCham Shanghai and Booz identified six fundamental trends that are impacting the Chinese consumer market today and asked the companies participating in the survey to rank them in order of importance: Greater External Exposure (called External Exposure in the survey questionnaire); Access to the Internet and Mobile Communications, or Information Technology (IT); Increased Awareness of Healthy Living and Nutrition (Health and Nutrition); Evolution of the Family Unit; Mobility; and Work/Life

Exhibit 1

The survey tested six Chinese consumer trends

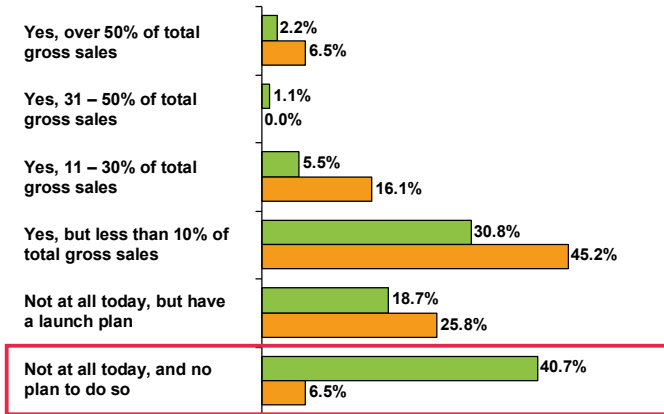
Trends	Description
External Exposure	<ul style="list-style-type: none"> ▪ Consumer expectations driven by an increase in choices <ul style="list-style-type: none"> – More and more Chinese consumers are being exposed to different types of lifestyles as they travel beyond their immediate surroundings and electronic media becomes ubiquitous. This level of exposure opens the eyes of what is available globally and is driving new and higher consumer expectations for what they desire to buy here in China.
Information Technology	<ul style="list-style-type: none"> ▪ Improved access to information and new consumer channels <ul style="list-style-type: none"> – As China continues to modernize, Chinese consumers increasingly are adopting and using new technologies in their daily lives including Internet, PC, mobile communications and gaming. Online platforms also create the opportunity to utilize an e-commerce channel to compare product/prices and ultimately buy. Over the next 3-5 years, the growth in e-commerce in China will significantly change the way in which consumers access information, interact and shop.
Health & Nutrition	<ul style="list-style-type: none"> ▪ An increased scrutiny on what is consumed and how time is spent <ul style="list-style-type: none"> – Awareness of healthy living/nutrition is just now emerging as a focus of the Chinese consumer in China. The next decade will witness a heightened awareness and concern around health, nutrition and sustainability in their lifestyle. As this trend takes hold, all sectors will be impacted – food & beverage, apparel, travel and leisure – as more scrutiny is placed on what is consumed and how time is spent.
Evolution of Family Unit	<ul style="list-style-type: none"> ▪ Changing demographics will impact purchasing decisions <ul style="list-style-type: none"> – The Chinese family unit, as we know it today, will evolve dramatically in the face of changing demographics and economics. These changes could affect purchasing behaviors in many ways including product innovation, packaging sizes, packaging design, access and delivery, etc.
Mobility	<ul style="list-style-type: none"> ▪ Changes in the how, where and why of consumption <ul style="list-style-type: none"> – Major investments in infrastructure (train, road, etc.) will increase Chinese mobility and blur distinctions between city tiers. Wealth will be more geographically dispersed and employees will trade off shortened commute times with their residence location. This will affect how and where consumers will buy products.
Work-Life Balance	<ul style="list-style-type: none"> ▪ An increased emphasis on quality of life purchases and leisure activity <ul style="list-style-type: none"> – As standards of living and incomes rise among China's middle and upper classes, there will be a greater focus on quality of life and achieving an adequate work-life balance. As wealth continues to grow, people will begin to focus more on enjoying the fruits of their labor, increased attention to leisure activity, domestic travel, interest in arts/science and self betterment.

Exhibit 2

A greater number of Chinese companies use or plan to use the Internet as a selling tool

Question: To what degree has your company adopted e-commerce as part of your selling channel?

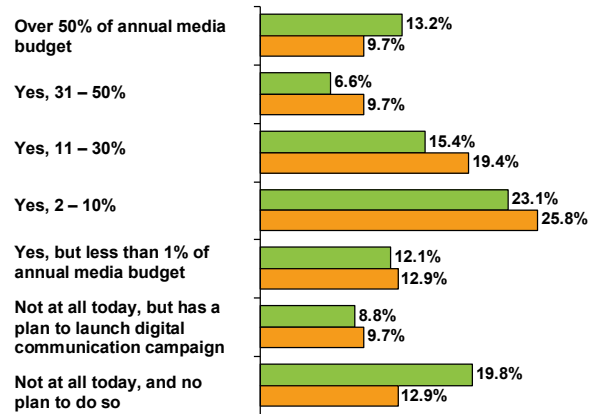
N = 91 Western MNCs, 32 Chinese Players



Western MNC Chinese Players

Question: To what degree has your company used Internet or mobile as part of your communication channel?

N = 91 Western MNCs, 32 Chinese Players



Source: Business Response to Trends in China's Consumer Market; joint study of The American Chamber of Commerce in Shanghai and Booz & Company; Booz & Company analysis

Balance. (For a detailed description of these categories, see Exhibit 1.)

No. 1 Trend: Information Technology

On the whole, companies participating in the survey identified Information Technology (IT) as the most significant trend impacting consumer behavior in China. But this result came about because IT was the overwhelming choice of the Chinese companies. By segregating the responses of Western MNCs, which comprised 70 percent of the surveyed companies, a far different, more telling outcome is arrived at. Instead of IT, the multinationals as a single group chose External Exposure, which includes increased familiarity with Western products in leading Chinese cities, as the most meaningful trend. An examination of the implications of both IT and External Exposure more closely offers some insight into the strategic approaches that these companies plan to deploy as their operations in China mature.

IT – essentially, shopping on the Internet and cell phones as well as gaming and social media – was portrayed by both MNC and Chinese respondents as very much a market trend that will influence the widest swath of China's emerging consumer class. Nearly 50 percent said people under 20 would be impacted and 90 percent expected the trend to have an effect on 20- to 40-year-olds. In addition, more than any other trend, IT is anticipated to alter the shopping activities of lower-income groups (<10k RMB per month) and will result in more demanding consumers; that is, consumers who

“...more than twice the number of Chinese respondents than MNCs reported that at least 11 percent of their revenue comes from technology-enabled transactions.”

are less loyal to specific brands and less willing to pay more for the same quality. In many ways, this group of consumers dovetails well with the high-volume, low price, lower marketplace differentiation approach that many Chinese companies have embraced to tap the hundreds of millions of new customers in their backyard.

The survey uncovered a decided difference between MNCs and Chinese companies in their use or potential use of the Internet as a sales channel. Remarkably, 41 percent of MNCs said that they have not yet implemented an online shopping strategy and don't plan to do so, whereas 93 percent of their Chinese competitors said that they are already or will soon be involved in e-commerce (see Exhibit 2). Moreover, more than twice the number of Chinese respondents than MNCs reported that at least 11 percent of their revenue comes from technology-enabled transactions.



“...Chinese companies are focusing on manufacturing low-cost products with limited effort on building up brand awareness and loyalty. When consumers “trade up”, they could lose significant market share to branded and high quality products.”

- Executive of a Chinese apparel company

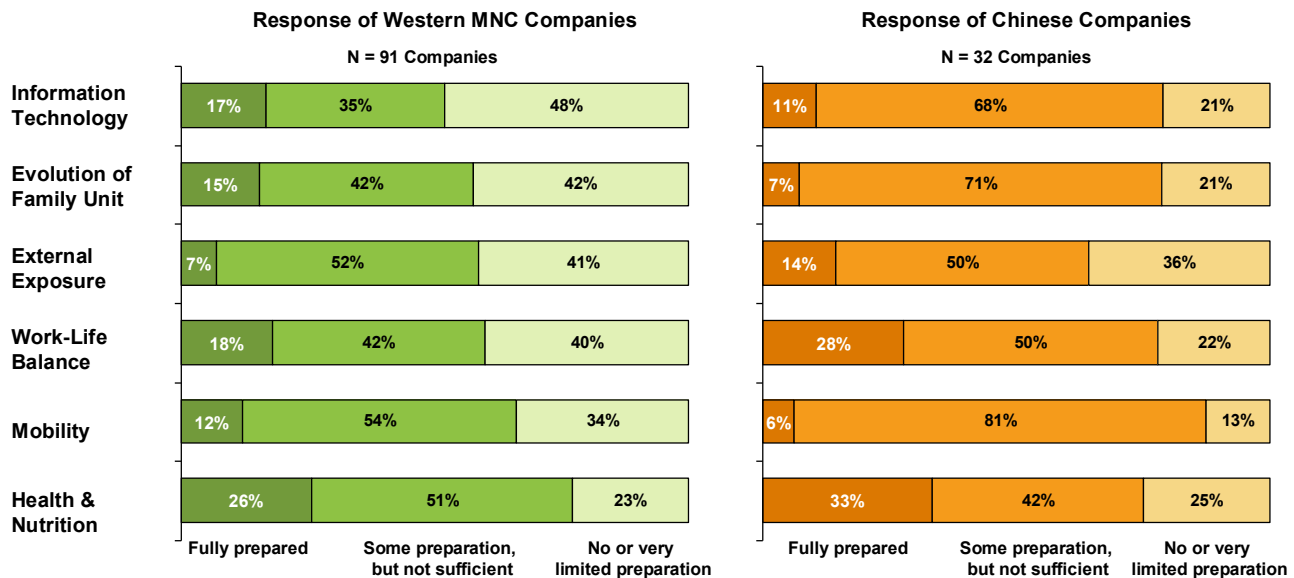
“In the old days, Chinese companies had a cost advantage while western companies had high quality and better brand awareness. The gap is more and more small.”

- Executive of a Chinese Auto company

Exhibit 3

Neither Chinese companies nor MNCs believe that they are fully prepared for any of the consumer trends, though the Chinese companies are a bit more optimistic

Question: To what extent is your company responding to this key trend?



Source: Business Response to Trends in China's Consumer Market; joint study of The American Chamber of Commerce in Shanghai and Booz & Company; Booz & Company analysis

Interestingly, despite these sharply different sales thrusts, the MNCs and Chinese companies both overwhelmingly agree that the Western companies could most effectively respond to IT as a trend (apparently, even if they choose not to). More than anything, this is probably a nod to the decade or more head start that Western companies have had in e-commerce in their home markets.

MNCs Eye Consumers With External Exposure

Somewhat in contrast to IT, External Exposure can be viewed as a trend that leads to more discerning and demanding consumers, whose expectations have been whetted by what they have seen is available in other parts of the world through travel, in new Western stores in big Chinese cities, and in electronic media. Survey respondents believed that External Exposure will most impact wealthier Chinese in Tier 1 cities and consumers aged 31 to 40. External Exposure trails Work/Life Balance and Healthy Living and Nutrition in affecting Chinese consumers earning more than 25,000 renminbi per month. By and large for MNCs, these are the types of consumers who they understand best and hope to reach in droves in China, particularly with higher-priced items that are distinctive in quality, features and often international cachet.

Indeed, the potential impact of External Exposure on brand loyalty, which many MNCs view as a critical factor in their success in China as they also

do around the world, is extremely high, according to the survey. More than 70 percent of respondents felt that this trend would increase consumer allegiance to specific brands, placing it at the top along with Work/Life Balance and Healthy Living and Nutrition – two areas that obviously depend heavily on repeat customers for specific products.

The confidence that MNCs have in targeting this trend is apparent by the number of multinational survey respondents – a whopping 64 percent – who claimed they are more effective than their Chinese counterparts in understanding and responding to this trend. But the Chinese companies displayed a bit of daring of their own. Fifty-eight percent said that they believe they were better suited to attract consumers influenced by External Exposure.

Still, although both MNCs and Chinese companies expressed some confidence about being able to address certain individual aspects of the Chinese consumer market, overall the survey found that neither Western nor Chinese companies thought they were sufficiently prepared for any of the key trends (see Exhibit 3). This is primarily a manifestation of the structural and organizational handicaps that both MNCs and Chinese companies concede they have and uncertainty about the precise direction that the rapidly evolving Chinese consumer market will take.

Mobility Gains Buoy Consumers

The extraordinary dynamism of the Chinese con-

“...the survey found that neither Western nor Chinese companies thought they were sufficiently prepared for any of the key trends.”

sumer market was highlighted by the second most important trend identified by all respondents – namely, Mobility or the ability of China’s population to get around more easily. As infrastructure modernizes at a remarkable clip, distinctions between small and large cities and even rural and urban areas become blurred, and the types of retail outlets Chinese consumers can shop in expand. Surveyed companies felt that Mobility will primarily affect newly minted middle-income consumers in Tier 3 cities and countryside communities, which are expected to take advantage of improved roads and rail lines by commuting to Tier 1 and Tier 2 cities for jobs and shopping but continuing to live and frequent a variety of retail outlets in their current home regions. In other words, Mobility could help develop and expand Tier 3 cities and what could pass as Chinese suburbs near the biggest of the Tier 1 cities. Chinese companies appear to be in a better position to profit from this trend, in particular from

emerging consumers in more far-flung parts of the country. The survey found that Western MNCs believe they lag in go-to-market strategies for the wide range of retail outlets that are peppered across China’s many regions, reflecting in part the higher comfort level of Chinese companies with the predominantly third-party distribution model in which wholesalers and face-to-face distribution relationships play a big role.

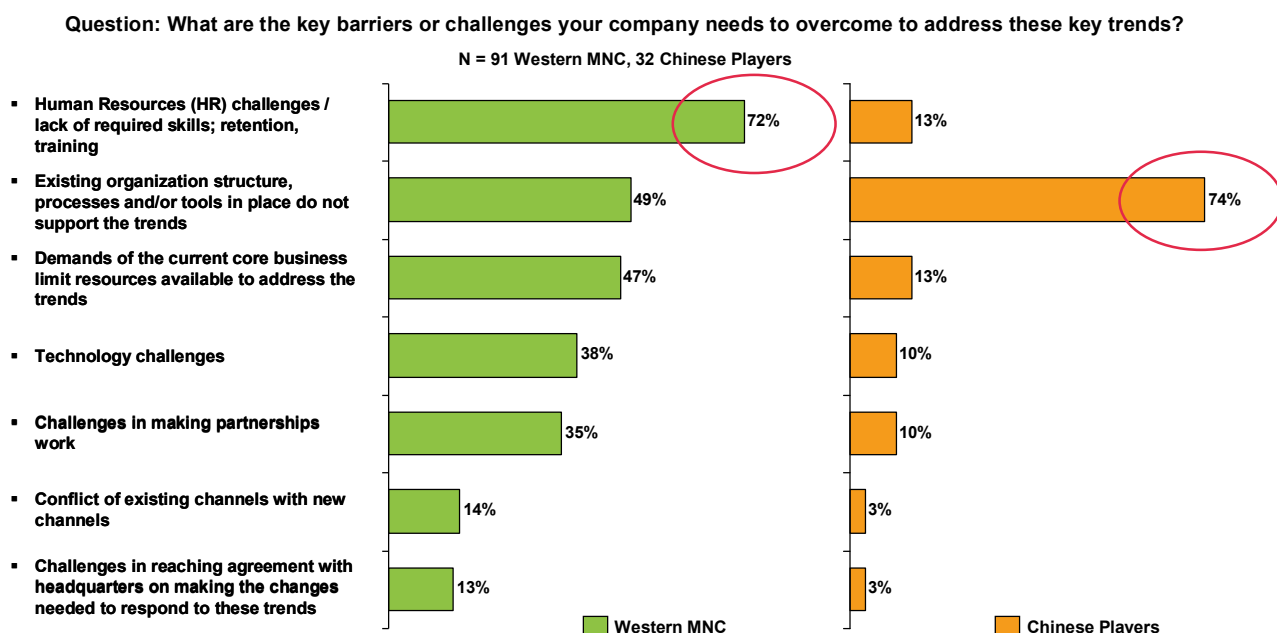
Where They Fall Short

In each group of companies, there was remarkable accord on the largest structural hurdles that they must overcome to address the six trends (see Exhibit 4). More than 70 percent of MNC respondents said that human resources challenges – chiefly, lack of required skills and the inability to adequately develop and retain talent – are their greatest concern. This mainly grows out of the difficulties MNCs are having in finding sufficient numbers of Chinese workers with the leadership capabilities and conceptual and communication talents they are seeking.

By contrast, only 13 percent of the Chinese companies viewed human resources as an impediment. Instead, they were far more wary about their organizational structure, processes and tools. Having become so adept at low-cost manufacturing and mass-market product development, these companies are clearly anxious about their ability to scale up their business model for a diverse group of consumers at home and for export to overseas locations.

Exhibit 4

The barriers that MNCs and Chinese companies say they must overcome to face critical consumer trends are starkly different



Source: Business Response to Trends in China's Consumer Market; joint study of The American Chamber of Commerce in Shanghai and Booz & Company; Booz & Company analysis

Exhibit 5

MNC and Chinese companies believe that revenue side, rather than operational, actions are the most critical to address Chinese consumer trends

Top 3 actions chosen by companies while being asked “What are the important actions to address the impact of this consumer trend?”

Information Technology	Mobility	External Exposure	Work-Life Balance	Health & Nutrition	Evolution of Family Unit
Develop new products & services	Adapt the brand strategy	Conduct research to better understand the trend	Develop new products & services	Develop new products & services	Develop new products & services
Adapt the marketing communication strategy	Conduct research to better understand the trend	Adapt the brand strategy	Adapt the brand strategy	Adapt the brand strategy	Conduct research to better understand the trend
Conduct research to better understand the trend	Develop new products & services	Develop new products & services	Conduct research to better understand the trend	Adapt the marketing communication strategy	Adapt the brand strategy

Source: Business Response to Trends in China's Consumer Market; joint study of The American Chamber of Commerce in Shanghai and Booz & Company; Booz & Company analysis

“...only 13 percent of the Chinese companies viewed human resources as an impediment. Instead, they were far more wary about their organizational structure, processes and tools.”

Strikingly, the Chinese companies virtually ignored all of the other possible levers that could pose problems in creating a strong and fluid consumer market presence. It is quite possible that the lack of organizational structure among these companies is profound enough that it impacts their ability to clearly see the potential weaknesses in other parts of their business model.

While much in the survey separated MNCs and their Chinese competition, there was unanimity in the steps that they plan to take to tackle these consumer trends. Four broad tactics stood out: conduct research to better understand the trend; develop new products and services; adapt the brand strategy; and adapt the marketing communications strategy (see Exhibit 5).

Interestingly, each of these tactical steps is a revenue-side activity, focused primarily on attracting consumers and revving up sales. Operational actions – lean factories, cost-cutting, improved supply chain management, better logistical programs and the like – were not given as much urgency.

Portrait of the Chinese Consumer

Viewed with a broad brush, the survey provided an interesting profile of the Chinese consumer who will be most impacted by the six highlighted trends taken as a whole, and in so doing identified the core customer for many domestic businesses and MNCs that hope to thrive in China. Simply put, he or she will be between 21 and 40 years old, live in Tier 1 or 2 cities and earn a middle-class income between 10,000 and 50,000 renminbi per month (See Exhibit 6). In addition, the new Chinese consumer is Internet-savvy and will have grown up in the era of market liberalization and globalization, while having avoided the hardships of previous generations. As a result, he or she is more confident and bold, more self indulgent and indulged (if they are under 30, they probably have no siblings and were the focus of family life in their homes) and more likely to spend money on travel and leisure pursuits than their parents, who probably viewed such activities as unaffordable luxuries.

In addition, by large majorities, respondents said that all six trends would motivate consumers to be willing to pay more for higher quality products

“...respondents said that all six trends would motivate consumers to be willing to pay more for higher quality products and services as long as they have sufficient information to make an intelligent decision...”

and services as long as they have sufficient information to make an intelligent decision about what to buy. This would seem to favor MNCs that put a premium on more attractive brands.

However, IT – generally seen in the survey as a potential strength and focus of Chinese companies – could provide a counterweight to the “three mores” that some Chinese consumers are embracing: more variety, more quality, more loyalty. IT’s greatest effect is on younger, less wealthy consumers, who by and large seek to use the pricing transparency of e-commerce, the peer-to-peer communication capabilities of online shopping and social networking sites and the vast amount of information available on the Internet to find the best prices for similar quality products or services.

Indeed, surveyed executives said that most of the trends would encourage greater use of the Internet and mobile apps as a sales channel; only Work/Life Balance and Health and Nutrition, which tend to be of interest to older, wealthier consumers, appear to increase the importance of the bricks and mortar shopping experience.

Anticipation of the makeup and behaviors of the Chinese consumer market, whose direction could be altered by any number of macro- and micro-economic variables, requires continuous analysis and ongoing research and development (R&D) to support the varied demands of the market. Chinese companies have much more ambitious R&D plans, according to the survey. More than 60 percent of Chinese companies said that they plan to expand R&D centers in the country, compared to only 26 percent of Western MNCs. From the MNC perspective, there are a number of logical explanations for this. For one thing, many MNCs have already built R&D centers in China. On the flip side, the persistent lack of sufficient protection for intellectual capital in China constrains some MNCs from enlarging their R&D facilities. But regardless of the reasons, more than likely there will be a proliferation of Chinese-developed products in the home market in the coming years.

Critical Challenges

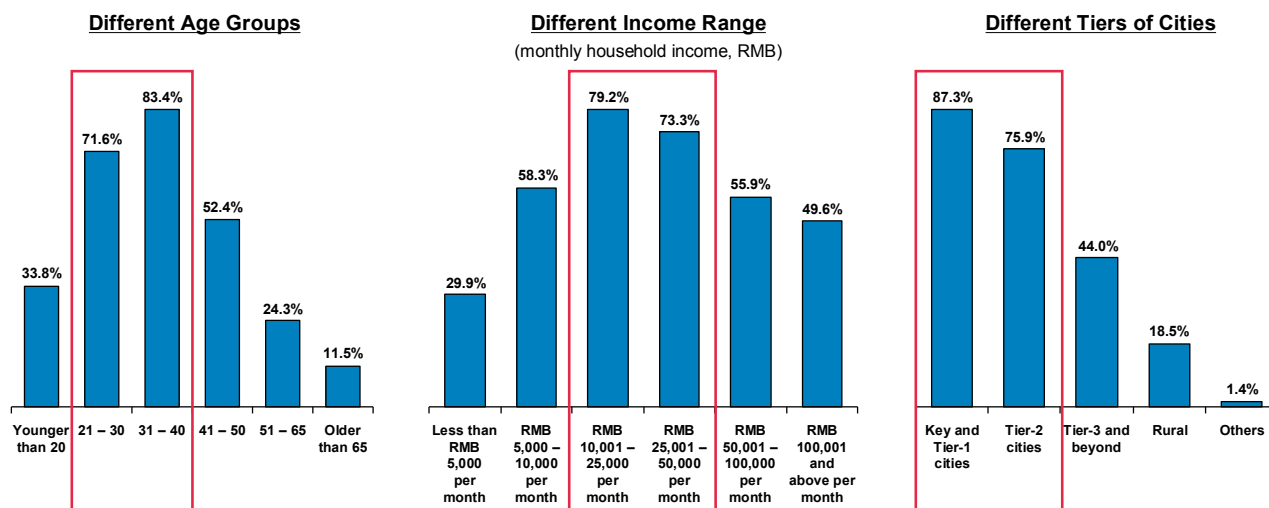
Given what is at stake – a share of the fastest growing consumer market in the world – the obstacles to puzzling out the rules of the road in China are well worth the effort. Few businesses

Exhibit 6


The demographics of the new Chinese consumer

Question: Which consumers do you think will be most impacted by this consumer trend?

Average results of 6 trends



Source: Business Response to Trends in China's Consumer Market; joint study of The American Chamber of Commerce in Shanghai and Booz & Company; Booz & Company analysis

A photograph of a person's lower body and hands. They are wearing blue jeans and a white shirt with thin black vertical stripes. They are holding a large red paper shopping bag with both hands. Several other shopping bags are on the ground around them, including a black one, a gold one, and a pink one with colorful vertical stripes. The background is a light-colored, textured surface, possibly a sidewalk or pavement.

“For my Chinese business partner, the most important qualities are loyalty and hard work, believing we can always slog through anything if we are willing to put in the time and devote the human resources, rather than implementing specific procedures and technical know-how. It’s a completely different mindset.”

- Executive of a U.S. manufacturer focused on China’s consumer market

“Chinese firms are confident, but it really depends on industry. Our industry[financial services] is a highly regulated industry so Chinese firms have a reason to be confident - they are backed by Chinese regulators.”

- Executive of a U.S. financial services firm

“Chinese companies appear to be taking much more aggressive steps than their Western counterparts to embrace the Internet [as a sales channel].”

are choosing to pass up the opportunity, and both MNCs and Chinese companies have their work cut out for them.

The major concerns for MNCs are:

- 1) Although the differences are not very pronounced, Chinese companies nonetheless are more confident than MNCs of being somewhat or fully prepared for each of the six consumer trends.
- 2) Considering the emphasis of Chinese companies on expanding R&D activities, which blends well with the survey's finding that product and service development is a primary path to success in China, Western MNCs may soon face more formidable Chinese competition. These stronger rivals likely will be competing not only on price but also on innovative features and offerings.
- 3) Chinese companies appear to be taking much more aggressive steps than their Western counterparts to embrace the Internet and take advantage of online sales channels, which emerged as the No. 1 consumer trend in the survey.
- 4) Western MNCs tend to downplay the value of Work/Life Balance as a consumer trend. This came in fourth in MNC rankings but second among Chinese company respondents. This could be an expensive oversight because consumers affected by Work/Life Balance are more demanding about the products they buy and are usually willing to pay more for high quality items, biases that match up well with MNC business models.
- 5) Human resources challenges, which were highlighted by Western MNCs in the survey, must continue to be addressed with urgency. The most innovative multinationals in fact are doing just that. Beyond talent recruitment, training and retention – significant issues on their own because MNCs must build strong workforces in China – Western companies are dangerously behind in local leadership. Only one-third of the CEOs of Western MNCs' China operations were born on the mainland.

Meanwhile, Chinese companies face their own challenges:

- 1) As incomes rise and the Chinese consumer becomes more mature, sophisticated and demanding – as shown by the importance of External Exposure as a trend – Chinese companies will have to become much more adept at capturing higher end markets with higher quality products.
- 2) Chinese companies must tackle shortfalls in organization processes, tools and governance. All of these are critical attributes for companies to scale their operating models to meet the needs of a varied and dynamically changing consumer base. Survey interviews revealed that as many private Chinese companies grow, decision-making naturally moves from the founder to a broader group of senior executives, who often lack the business acumen and instincts of the boss. Incoherent strategies are the unfortunate result. Hence, it is essential for these companies to install an organizational system that formalizes the decision-making process so that it can be vetted by key figures in the company and generate coherent market strategies with more consistent outcomes.
- 3) Chinese private companies see themselves as much more ready to take advantage of the six consumer trends than Chinese state-owned enterprises (SOEs). Not a single SOE said that it was fully prepared for any of the trends, while 11 percent to 50 percent of private Chinese companies claimed to be prepared, depending on the trend. Clearly, the SOEs must play catch-up quickly or risk missing critical tipping points in the consumer market.
- 4) Beware of overconfidence! Chinese company respondents were much less concerned than MNCs on key business challenges such as demands on human resources, technology challenges, partnerships and channel conflicts. Companies should review these issues to ensure they are not underestimating the impact on their strategic plans and their ability to respond to market trends.

The AmCham Shanghai/Booz & Co. survey was unique in its attempt to register the opinions of both leading multinational corporations and Chinese companies, both state-owned and private, about the most influential trends affecting the Chinese consumer. In essence, the findings provide both a snapshot in time of the conditions seen in the market today and an illustration of how these conditions will likely evolve over the coming years. Indeed, it is the way Western MNCs and Chinese players navigate the distance between today and the near future that will determine where they land in the race to the top of this vital marketplace.



Survey Background

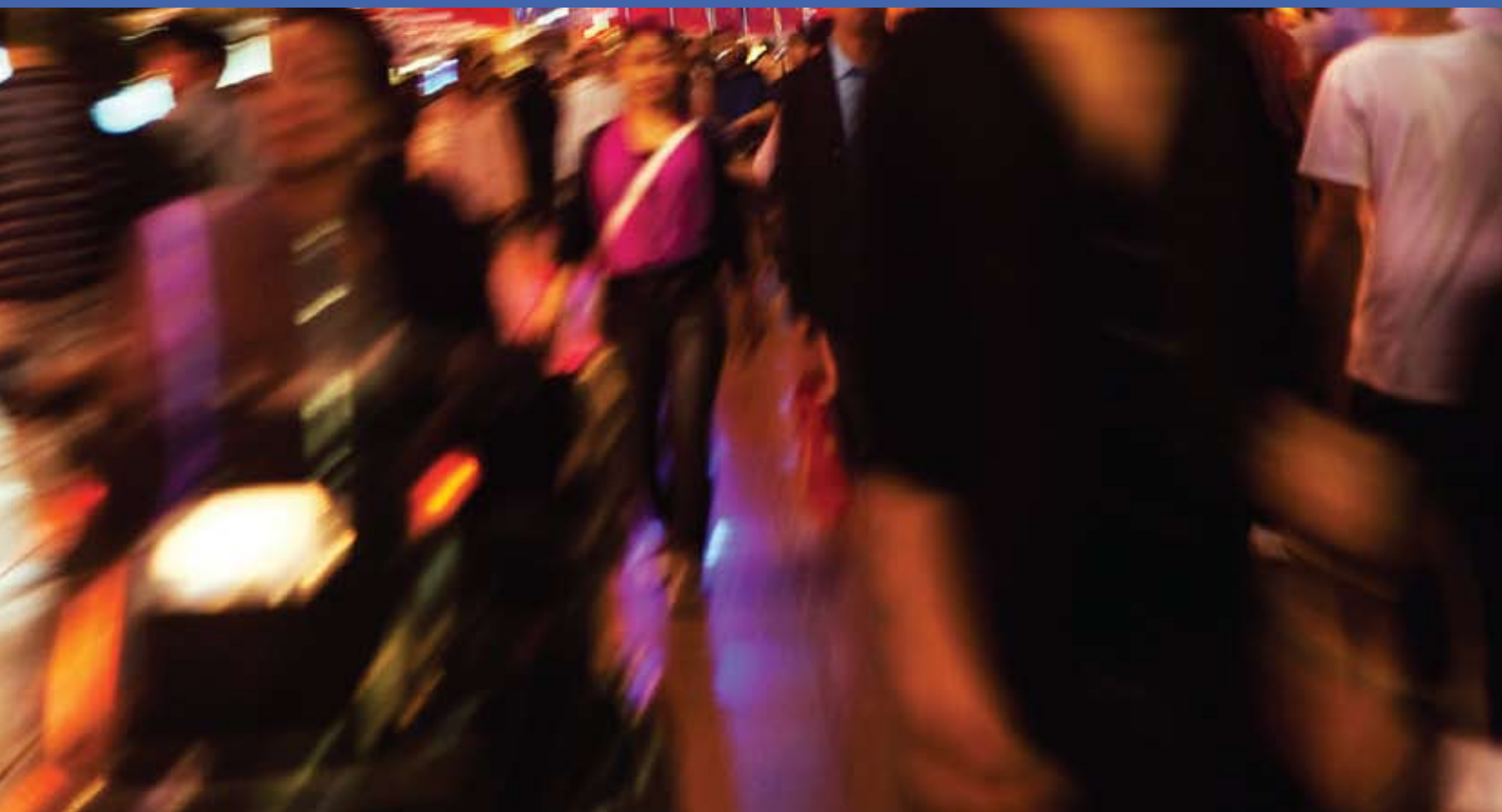
The “Trends in China’s Consumer Market” survey was conducted by The American Chamber of Commerce in Shanghai (AmCham Shanghai) in cooperation with Booz & Company, a global management-consulting firm that works with many of the world’s top businesses, governments and other institutions. A total of 135 companies with extensive sales operations in China were surveyed in April and May 2011. The companies were presented with six trends impacting the Chinese consumer and in a series of 22 questions were asked to rank them by the following: a) their overall importance; b) how these six trends will separately impact consumers in the coming years; and c) how businesses are responding to these trends. Findings were then further explored and validated in focus groups and one-on-one interviews.

Of the companies surveyed, 70 percent were Western multinationals, 15 percent were private Chinese companies, 10 percent

were Chinese state-owned enterprises, four percent were based in Hong Kong or Taiwan, and two percent were other Asian companies. Broken down by industry, 38 percent were consumer goods companies, 33 percent were industrial outfits catering to the consumer market such as auto companies, nine percent were materials companies, eight percent were healthcare-related and 12 percent were in other categories. The survey was conducted through online questionnaires and follow-up interviews.

For complete survey results please go to www.amcham-shanghai.org/publications

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