



Enter China's Consumers

A Rapidly Growing Middle Class is Expected to do Some Serious Shopping

By Levi Folk, September 2009



Two thousand and nine may just be the year that marks the rise of the Chinese consumer and the Chinese brands that they will covet. After three decades of conspicuous consumption in the United States whereby savings were obliterated, American households have hit the debt wall. In marked contrast, hundreds of millions of Chinese have saved every morsel of their meager incomes to guard against calamity in a country that offers little in the way of a social safety net.

That trend is about to change and investors should be ready to take advantage of it.

With personal savings rates in China bumping up on 50% of income, authorities recognize that they must forge policies to encourage spending. The gravity of the situation hit home at the end of last year when the U.S. credit binge went into reverse and as a result China's economy went into a tailspin. In January, Chinese authorities announced plans to deliver universal health care to Chinese households by 2011.

The brute force of 1.3 billion people spending even a little more money thanks to rising incomes is propelling China's consumer market forward. Savings may be falling as a percentage of total output, but incomes are rising, making the consumer market in China an unstoppable force that will see urban consumer spending grow five-fold between 2006 and 2025 to US\$2.3-trillion, according to a report by Mc-Kinsey Global Institute (MGI).

Look no further than the mobile phone industry to capture the imagination of the potential for China's domestic demand. Each month, it lifts its net and snags an additional 10 million subscribers or so to add to the 650 million people already with mobile phones in China. The biggest player, China Mobile (CHL), with 498 million subscribers, is about to get some serious competition from the numbers two and three companies, China Telecom and China Unicom (CHU), which is bringing Apple's iPhone to the mainland next month.

A middle class is rapidly taking shape in China -- accounting for roughly one-third of the population today from virtually nothing in 1990, and set to rise to 70% by 2020, MGI says. At US\$3,000 in annual income, the threshold for entering the middle class may sound despairingly low by our standards, but it is the point in the developing world where households start buying non-discretionary items beyond food and housing, bearing in mind that the cost of goods is far lower in emerging markets such as China.

Discretionary spending at the margin starts on small-ticket items such as apparel, televisions and home appliances, and builds from there to more extravagant items such as automobiles. Sportswear, for example, is rapidly becoming a must-have.

"The Beijing Olympics 2008 gave a boost to the overall sentiment toward the sportswear market," says Agnes Deng, portfolio manager at Baring Asset Management in Hong Kong and lead manager of Excel China Fund.

Two sportswear companies highlighted by Ms. Deng are Anta and Li Ning, unknown outside of China but growing brands locally. Anta, which recently acquired FILA brand for distribution in the Chinese market is the top brand in the lower-tier cities where the growth is stronger, says Ms. Deng.

Li Ning is gaining improved brand awareness.

At the high end of middle-class incomes, car purchases will surely be a major focus of status-hungry consumers. **China has the second largest highway network in the world and leapfrogged the United States to the position of number one car market this year.** Given that the auto market is in its infancy, the prospects for car companies over the next decade have auto executives in rapture.

While General Motors Co. has found China's automobile market to be a godsend in a horrible year for the global car industry, the biggest beneficiary of foreign auto companies' forays into China are probably domestic manufacturers, with whom foreign companies are required to partner.

This year, domestic auto company share prices have been on a tear. Dongfeng motors, for example, has seen its share price appreciate 65% year-to-date on strong sales and earnings growth.

Domestic companies in any field have two natural advantages over foreign competitors: cultural knowledge and established distribution networks; many also benefit from government regulation. Foreign multinationals may have initial success in the four tier-one cities (Shenzhen, Shanghai, Beijing, and Guangzhou) in China where they are "out-marketing" the competition, says Jonathan Chajet, managing director for Interbrand China, but they are finding that a great deal of spending comes from the 37 tier-two cities and the 136 tier-3 cities with populations greater than one million inhabitants. These tier-3 cities represent more than half of all disposable income in China.

Foreign entries into China's life-insurance market are having a rough go of it, losing ground to domestic heavyweights such as China Life (LFC) and Ping An (PNGAY) since 2005 in a highly regulated market. They have seen market share slip from 8.5% to less than 5% this year.

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China Life, the fourth most valuable brand in China, according to Interbrand's Best Chinese Brand ranking for 2007, has spread its roots across the country since 1945, employing more than 650,000 exclusive agents in about 18,000 field offices and 87,000 outlets.

It's not just about distribution but tangible cultural differences, a hurdle that even the mighty Internet juggernaut, Google Inc., has been unable to overcome. Local technology upstart, Baidu (BIDU), has kept Google at bay in China by exploiting the different tastes and mindsets of Chinese consumers while playing on nationalistic tendencies, portraying Google in media campaigns as the evil foreigner.

"The nature of Internet search is highly contextual, and you have to understand what people are going to want," says Mr. Chajet at Interbrand China. "Westerners love a nice clean page with a lot of white space, but the Chinese doesn't like that; they like things that are crowded, a little bit chaotic."

Baidu has done a great job of anticipating these different demands.

It is astounding to think that China has the largest auto market in the world when only 0.5% of the population owns a car, in contrast to the United States, where 80% of the population owns a vehicle. **It is the same story for so many goods and services in China. The growth potential is astounding.**