

Corporate Network

China: the business outlook

Part three:
Business issues

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Contents

- Latest 2008 update
- The business outlook
- The local Chinese market
 - Diversifying in the market
 - Brands
 - Statistics
- The war for the middle market: a case study
- Other issues at the top of the agenda in China
- Human resource issues in China
- Sound-bites for cocktail parties or Board presentations

Latest 2008 update (1)

- Business sales growth will remain good in 2008
- But companies think it may be a bit less than in 2007
- Sales growth is cluttered around about 18-20% in 2008
- For most companies in FMCG, industrial products, pharma and banking
- Chemicals and commodities will grow sales in single digits

Latest 2008 update (2)

- More companies are reporting good profit levels
- Most companies will increase capex by over 10%
- Headcount will rise
- Salaries for white collar workers are rising at 12-15%
- Staff turnover is about 14% per annum

Business outlook (1)

- Business is booming in China, but it wasn't always the case, far from it
- Global CEOs are more aware of the operational challenges now
- Managers on the ground have finally persuaded headquarters that the market is good but not an easy goldmine
- Some of the razzmatazz is wearing off with the daily grind of business
- Market performing at higher levels but operational issues now the challenge: regional strategy, partners/M&A, distribution, human resources
- Most western companies simply have to be in China and will increasingly adapt and upgrade their business models there

Business outlook (2)

- It is the world's key growth market
- The attitude of global headquarters has gone through several stages:
 - 1990s: wild optimism that 1.3 billion people would buy all their products next week
 - 1995-2000: learning the hard lesson that this was not so
 - 2000-2003: waiting for WTO – getting better, but profits tough
 - 2003-2005: steady pick up in top-line and some better profits
 - 2005-2008: strong surge in sales – profits getting better but competition getting fierce

Business outlook (3)

- Business much improved in 2005-06; sales growth in this period dramatic
- Every sector except telecoms profitable
- This is surprising given escalating wage growth and fierce competition
- Average sales growth across sectors ranges between 15-35% per annum
- Carrefour is looking to top-line sales growth of 25-30% in the five year 2007-2011
- Retail is booming and China is adding each year the retail market capacity of Argentina!
- Consumers are price sensitive and not always impressed by posh fittings in stores
- They calculate that this waste of money has to be added into the price they pay

Business outlook (4)

- But some of the big western market leaders have slipped into single-digit growth (8-10%)
- Hence the quest to get more growth from the inland provinces
- Profits are still harder to achieve than sales growth, but 60% of companies making some profit
- In infrastructure and construction sales have boomed but profits not
- All major sectors look to sales growth in 2008-09, with pharmaceuticals most bullish
- IT and software expect a burst in 2007-08 after being one of slower sectors in 2006

Business outlook (5)

- Corporate investment will rise across all sectors especially in consumer goods and retail as they expand into regions
- In one AmCham survey 68% of companies said revenues were up significantly in 2007 compared with only 26% in 2001
- 25% said revenues were up somewhat compared with 39% in 2001
- Those reporting flat or falling revenues in 2005 were only 7% compared with 35% in 2001

Business outlook (6)

- Companies need to adapt and rethink China strategy
- Catch their breath, take stock (quickly) and review strategy
- This means taking a long, hard look at the domestic market and rural areas
- The regions are clearly smaller per capita sales but this is where the growth will be
- Companies will look at their M&A strategies...
- ...and consider how they can save on raw material costs
- This rethinking can be difficult for those companies who have not met their very high expectations...
-when their HQs are starting to question their China strategy for the very first time

Business outlook (7)

- China managers are going to HQ with new ideas and investment plans just when doubts are being raised...
- ...and when China is facing more competition from Russia, CEE, Latin America and other parts of Asia for corporate resources
- This is a very tricky period for China managers
- But the good sales levels of 2005-07 have taken some of this pressure off and created more new faith in the China market
- But headquarters will be relentless in setting new and high targets
- This will need more investment and more risk

The local Chinese market (1)

- Most companies use China as an export base and this will remain so for the next 2-3 years
- But more companies are now looking at the local market
- Few Westerners have cracked the domestic market
- One survey shows that in 2007 86% of companies were looking at the internal market compared with only 55% in 1999
- The local market used to be quite small—people were poor
- Private consumption per head in 2005 was only \$650 and clustered in the coastal cities
- But by 2008 this figure had doubled to \$1,000
- This means that the economy has started to focus more on domestic consumption and not just exports

The local Chinese market (2)

- This is substantiated by the fact in 2007 the amount of imports from abroad used in domestic consumption equalled those imports used in assembly (and re-export).....
- The point is that 5 years ago imports used in domestic consumption were only half those used in assembly
- Other indicators point to the surge in the domestic economy and consumption
- Personal disposable income has been rising at about 8% per annum and will continue to do in the next 3-5 years
- A key driver to business is that real wage growth is one of the highest in the world, rising at 10% per annum and will maintain this level for another 5 years
- This means that there is a huge and growing pool of money waiting to be spent

The local Chinese market (3)

- The issue though is that most Chinese workers save these wages (to pay for emergency health needs or extra tuition for their children)
- But western companies are making their pitch
 - Western advertising will whittle away at peoples' reluctance to spend, peer pressure will contribute to this as well as youth aspirations
 - Youngsters in the cities and towns will want to spend more, save less, and the government is promoting consumption at home
 - The nouveaux riches will be another source of high spending

The local Chinese market (4)

- There are 30m households regarded as “affluent” with annual incomes greater than \$9,500; by 2015 there will be 90m such households
- Today 40m can afford to buy luxury goods (3% of the population); sales of chocolates will have tripled between 1998 and 2008.
- Private consumption topped one trillion dollars in 2006 and will reach 1.7 trillion in 2009
- Based on current trends, China will displace the US as the largest consumer market in the world in 2014

The local Chinese market (5)– diversifying in the market

- Over the next 10 years most sales growth will come from tier 2 and tier 3 cities
- Most companies have not yet fully worked out how to service lower tier income groups
- This is a challenge in all big emerging markets
- Western companies have to innovate downwards
- A key issue for China managers will be to convince and calm HQ's concerns about the validity of moving to the inland markets, away from the comfort zone of the big cities
- One big question in that research is at what rate will rural incomes rise
- If they do rise, how can companies get a piece of that cake?

The local Chinese market (6)– diversifying in the market

- Some are developing new distribution methods: vans with music patrolling the villages; women wandering the countryside with rucksacks of product etc
- These are methods being tested in India and Latin America
- Distribution is NOT national but regional and therefore companies must build several key supply chain partnerships
- Cross country transport can sometimes be bettered by sea transport north-south both ways
- Logistics therefore also fragmented

The local Chinese market (7)– diversifying in the market

- Outside big cities consumers are a diverse bunch: Yunnan province in south-west China has some 25 ethnic groups
- Even small cities have 3-5 consumer segments
- The key to success is getting into the many regions
- In order to achieve this “rural strategy” and to expand existing business...
- ...companies are looking to get a grip on capacity by consolidating existing facilities
- More companies will look at acquisitions in order to break into the local domestic market

The local Chinese market (8)– diversifying in the market

- But getting qualified staff out there is a challenge
- Either Chinese staff know the region but not the business
- Or expatriates know the business but don't know the region and don't want to go there
- Usually companies look to single western staff without families
- Given the hardship and isolation companies often choose young male executives aged 28-35 who are up for this challenge in their career
- As companies go more local, they will realise that local municipal governments are becoming more independent vis-à-vis the centre
- Growing need to work more closely with local authorities

The local Chinese market (9) – brands

- There is a proliferation of brands
- On average in a Chinese hypermarket there are 40 brands of shampoo (US = 20) and 30 toothpaste brands (US = 9)
- Advertising spend is rising 45-55% each year as companies fight each other on brands
- So far, no “power brands” have emerged
- But this will change in next 2-5 years as domestic and western brands take more share
- As in other emerging markets, there will be a need for increasing product differentiation
- Consumers are fascinated by brands but not loyal to them
- There is nationalistic pride in local products and Chinese advertisers play on this

The local Chinese market (10) – brands

- Many first-time buyers are entering the market and eager for new brands
- More consumer loyalty to consumer electronics than FMCG products
- Companies may have to spend even more on brands to create that brand loyalty (as in Russia today)
- A Chinese consumer will enter a hypermarket with the intention of buying three branded products and they will be in her/his mind
- On leaving the store they will have bought three brands but three different ones from what they intended on entering the store
- Point of sale advertising is then even more critical

The local Chinese market (11) – brands

- While they like brands they are also very value orientated and price sensitive
- Consumers value functional attributes of products and will try several products to find the right one for them
- A 10% price premium makes 30% of consumers turn away from a premium brand
- (Normally this level of shift would require a 40% price premium in the West)
- A minority of consumers will pay up to 20-30% premium
- Channels will proliferate but margins may be thin as companies look to market share
- This is sort of the First World War in price/brands wars
- It is critical to capture market share now and then to defend it

The local Chinese market (12) – statistics

US\$ bn	2007 e	2008 f	2009 f	2010 f	2011 f	2012 f
Food, beverages & tobacco	327.9	393.4	447.9	507.5	573.3	649.1
Clothing & footwear	77.2	91.6	103.5	117.2	132.2	149.5
Housing and household fuels	150.8	187.2	223.6	268.1	320.6	384.5
Household goods & services	75.0	90.2	103.8	119.6	137.5	158.4
Health	61.6	78.5	96.3	118.7	145.9	179.8
Transport & communications	231.8	293.5	356.6	434.8	529.1	645.7
Leisure & education	137.0	171.5	205.9	248.0	298.0	359.0
Total	1,198.6	1,480.3	1,750.4	2,074.1	2,453.9	2,914.0
% of total						
Food, beverages & tobacco	27.4	26.6	25.6	24.5	23.4	22.3

The local Chinese market (13) – statistics

	2007 e	2008 f	2009 f	2010 f	2011 f	2012 f
Passenger car registrations ('000)	4,855	5,980	7,080	8,341	9,676	11,160
Passenger cars (stock per 1,000 pop)	14	18	22	27	32	38
Commercial vehicle registrations ('000)	5,101	6,023	6,996	8,005	9,074	10,340

The local Chinese market (14) – statistics

	2007 e	2008 f	2009 f	2010 f	2011 f
Retail trade					
Retail sales (US\$m)	904,312	1,139,029	1,382,201	1,678,790	2,040,072
Retail sales growth (% pa)	4.9	13.2	12.8	12.5	12.6
Clothing, cosmetics & household goods					
Clothing, sales value (US\$ m)	93,459	110,076	124,859	142,005	161,375
Cosmetics and toiletries, sales value (US\$ m)	11,755	14,255	16,616	19,404	22,645
Perfumes and fragrances, sales value (US\$ m)	316	386	452	531	623
Household cleaning products, sales value (US\$ m)	5,771	6,625	7,372	8,216	9,146
Electronic and domestic appliances					
Personal computers, sales volume ('000)	12,679	14,368	16,281	18,449	20,906
Washing machines, sales volume ('000)	16,687	18,740	20,904	23,140	25,479

The local Chinese market (15) – statistics

Pharmaceuticals sales (US\$ m)

	2007 e	2008 f	2009 f	2010 f	2011 f	2012 f
Pharmaceuticals sales (US\$ m)	22,600	24,500	26,600	28,900	31,000	33,253

The war for the middle market: a case study (1)

- One European engineering company was selling refrigeration units in China
- And were seeing top-line sales growth of about 75% per annum
- They were very satisfied with this
- But when they made independent commercial research (and getting good market figures is still hard in China)...
- They discovered the market was growing 300% per annum
- They were losing market share every week!
- They responded by asking their engineers to make a modified, cheaper version of their main product

The war for the middle market: a case study (2)

- When the engineers replied that tinkering would not succeed with this product...
- They went to consumers and asked them what they wanted
- They replied they wanted a cheap functional machine with dust covers because there is a lot of dust floating around
- So a new, an entirely new machine, with dust covers was put on the market and with revamped marketing sales soon shot up 300%

The war for the middle market: a case study (3)

- Several important points arise from this which apply to China and all emerging markets
- Western companies are great at selling top-quality products at top-quality prices
- But this means that they only reach the top 5-10% of the market segment
- Companies now have to adapt, innovate their products so that they can get lower down...
- ...and increase their market segment to 30-60% of potential consumers
- The lowest consumer segments may be off the scale for western companies for the time being
- Unless they acquire a low-cost producer but even then margins may be too low

The war for the middle market: a case study (4)

- But it is essential to promote not only to the rising middle class, but also to the lower middle class and the upper working class
- These are the consumers who will define business in the next 2-5 years
- Companies will need to adapt their manufacturing, the functionality of products and their marketing and distribution methods to achieve this
- One huge challenge for western companies in China (and India) is that local companies are very adept at servicing the lower income consumer segment
- They produce a killer formula which is to provide moderate quality products at moderate or lower than moderate price and provide micro-credits, after sales services, spare parts
- Local consumers love this equation

The war for the middle market: a case study (5)

- Domestic companies are very strong in this market segment, but margins are tight
- So as local players mature they adapt their business to go upwards in consumer segments offering better quality
- They have to do this because their customers are getting a bit richer and want marginally better quality
- Local car-makers Geely and Chery have done this successfully
- And Haier, white goods, is a striking example of the local company which starts at the low-end, moves up into the mid range and then goes international to buy brands and expertise
- Hauwei, the Chinese telecom equipment company, is another classic example which followed this path and ranks now as the global No. 2 behind Cisco

The war for the middle market: a case study (6)

- Domestic companies want to move abroad to go up market
- But also they can move into other emerging markets and sell into those lower-end markets as well
- The skills they learn at the tough low-end of their own markets turns them into very resilient business competitors
- Where they may fall down is in their management and strategic planning...
- Which is why they look to foreign acquisitions to buy in that missing managerial expertise
- This can also prove a pleasant trend for them i.e. getting out of the extreme low-end market and raise margins
- This is sometimes facilitated by consolidation of many loss-making low-end companies

The war for the middle market: a case study (7)

- Western companies have often underestimated the ability of local companies to rise in the market
- Western companies are going in the opposite direction
- They find the high-end of the market getting more saturated
- Only very few consumers are willing to pay 50% brand price premiums and more of this top market consumer segment starts to move down
- So western companies have to innovate to go downwards in the market with them
- All these companies (western and Chinese) meet with one mighty crash in the middle ground
- This will continue to occur in the next 2-5 years and it will be bloody

The war for the middle market: a case study (8)

- The extent of the middle market is shown in that 8 out of 10 Chinese washing machine sold are such “good enough” brands
- Estimates suggest that 62% of the TV market is this mid-range one, with 25% accounting for the low-end market and 13% premium brands
- Those who want to get into the local market face fierce domestic competition...
- ...from companies which often have the inside track with government officials and pay a lot less in taxes
- Challenges for the price equation:
 - how to source cheaper inputs
 - how to distribute
 - how to market products to poor peasants?
 - more local market research

Other issues at the top of the agenda in China (1)

- Over-investment in several sectors leads to more competition
- Rising costs for raw materials, utilities and salaries
- Corporation tax will rise in 2008—but manageable
- Western companies operating in China are: reassessing their corporate structures—centralising some functions and outsourcing others
- Coming to grips with government policy on the WTO while the government is still openly or covertly supporting state owned enterprises (SOEs)
- Looking at Chinese domestic players and assessing them as current/potential competitors or as take-over targets
- Competing with Chinese companies can be very difficult as they have low cost structures and often have inside contacts

Other issues at the top of the agenda in China (2)

- Even Chinese companies look abroad because the home market is so competitive
- Motor bikes sell in China for just a fraction more than their scrap value
- Western companies can respond by:
 - going up the value and IT chain
 - getting costs down further by sourcing from inland China
 - buying out the competition
- In the face of these challenges companies are also:
 - developing their procurement strategies
 - weighing the sustainability of premium price strategy
 - planning how to organise their trading rights and distribution control

Other issues at the top of the agenda in China (3)

- Another issue facing western MNCs is how to consolidate production facilities between different regions of China
- Manufacturing location is also important...
- ...as one can argue that China is not a single market but a series of regional ones...
- ...with significantly different purchasing powers and local political risks
- More large western MNCs will have to operate trans-nationally
- They will be rolling out their retailing, wholesaling and distribution facilities throughout 2008-10

Human resource issues in China (1)

- Despite the hundreds of thousands of MBAs that China churns out each year...
- ...an increasing number of western investors are reporting problems in recruiting the right staff at the right price
- The trends are comparable in part with Russia, but it is becoming clear that Russian HR are probably stronger in skill sets than their Chinese counterparts
- But comparable problems include the following:
- Chinese domestic companies are driving up wage levels for the best staff
- In 2008 local Chinese companies will need 7,000 managers with global experience; in 2015 they will need 70,000!

Human resource issues in China (2)

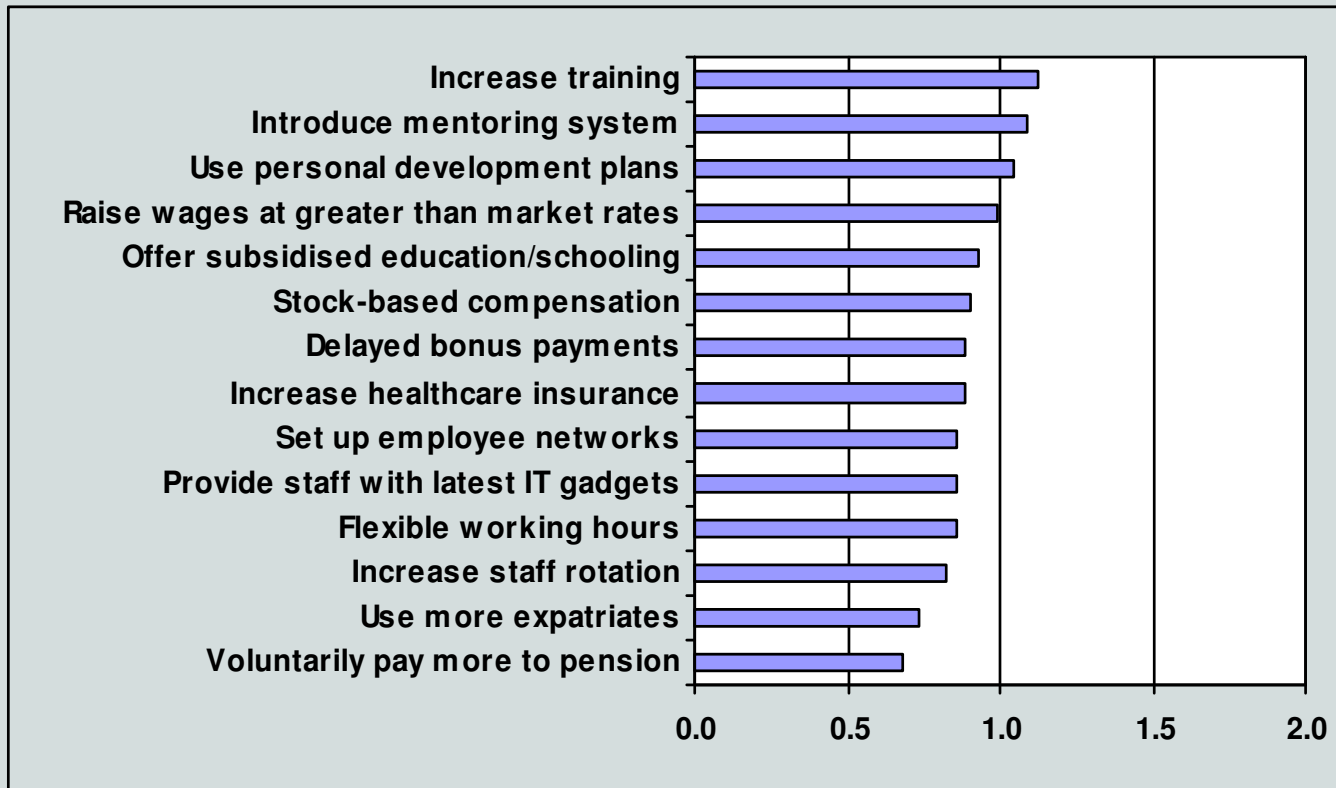
- Local attrition rates at 12-18% are higher than global ones of 3-7%
- Some companies report 25% turnover at managerial level which is extreme
- Average salary rises were 13-15%
- These are rising steadily and high wages have to be paid for very best
- But average wages are still remarkably low at 6% of Hong Kong ones and 9% of those in Taiwan
- Carrefour offer big pay bonuses to staff who stay for 5 years (bonus of 2-5 months of annual salary)
- 50 of their 73 hypermarkets (2006 figures) were run by Chinese managers

Human resource issues in China (3)

- Generally competition for managers with 3-5 years experience is most intense
- Keeping managers in second-third tier cities is difficult
- Chinese staff are not good at taking initiative nor, curiously, in logistics
- Like in Russia, money talks, and while local staff say they want training and career development (and they do), the big driver is cash
- Chinese staff yearn for western managers who know something (!)
- Since in the past Chinese managers were often poorly trained in technological and managerial skills

Human resource issues in China (4)

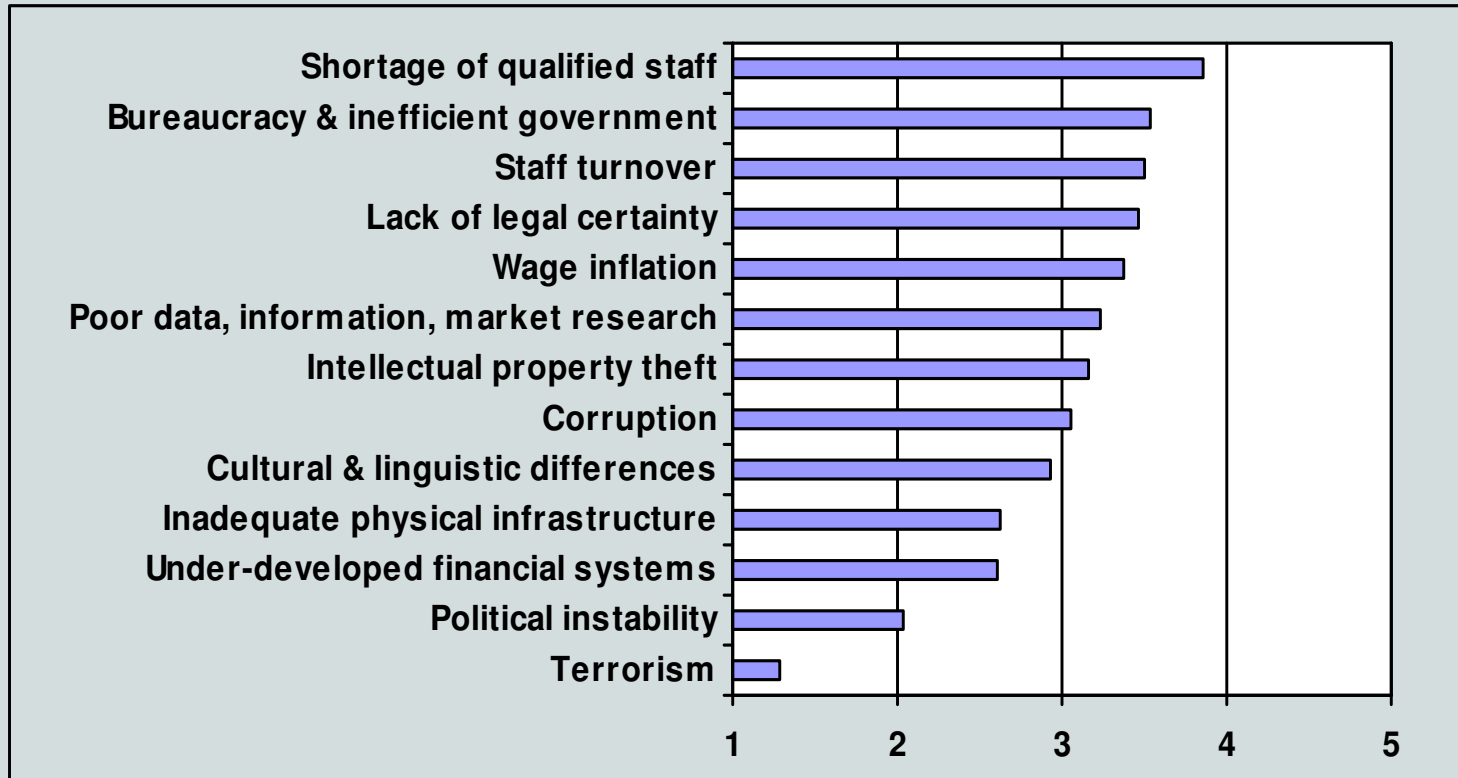
How successful have the following HR initiatives been in your organisation in China?



(0 = not successful, 2 = very successful)

Human resource issues in China (5)

Have you found any of the following to be a serious issue in China?



(1 = not an issue, 5 = serious issue)

Sound-bites for cocktail parties and Board presentations (1)

- China is the key growth economy in the world (25% of world growth in 2007)
- Over the last five years China has accounted for 20% of global growth
- China is the world's fourth largest economy and will become the third largest in 2008 surpassing Germany
- It is the magnet for foreign direct investment (\$96bn in 2007)
- Along with Russia regarded as number 1-2 strategic market for global players
- Second largest market in world for Coca-Cola
- Now a bigger market than the US for mobile phones
- In 2007 Philips saw 30% of its global revenue come from China

Sound-bites for cocktail parties and Board presentations (2)

- In 2001, GDP per capita rose above \$1,000 on an exchange rate basis for the first time (in 2008 at exchange rate is \$3,000 and \$9,600 in PPP terms).
- China has the second largest currency reserves in the world at \$1.7 trillion
- Reserves rising from one trillion dollars in 2006 to two trillion in 2009!
- China accounts for 25% of the US trade deficit, but only runs a modest surplus with Europe
- Some 60% of its exports are generated by companies with FDI
- It is the world's largest exporter in 2008 with 1.5 trillion dollars in exports (in 2005 fourth largest exporter)
- Imports have been rising at 40% per annum

Sound-bites for cocktail parties and Board presentations (3)

- Last year, it consumed 25% of the world's steel and zinc, 40% of cement and one third of the growth in global oil consumption
- China overtook Japan in 2005 as the world's second largest importer of oil after the US
- Wal-Mart imported \$25 billion of cheap products from China in 2007, helping keep down US inflation
- One for the future: in 2009 the Chinese language Internet will be larger than its English-language counterpart
- In 2007 there were 75,000 reported demonstrations against the government
- The move of peasants to the cities in the last ten years is the greatest migration in human history

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