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EXECUTIVE SUMMARY

One of the most significant questions for global business leaders over the next decade is how to capture Chinese consumption growth opportunities against a backdrop of deep structural challenges in China’s economy. We provide a new perspective on how Chinese consumer spending will grow. We conclude that, while growth will become more difficult to capture in the increasingly complex environment in which consumer businesses are operating, that significant opportunities exist for them. We recommend strategies to capture these opportunities—a prioritization of the cities in which to invest, and the consumers with which businesses should be engaging.
INTRODUCTION

Consumption patterns in China are a paradox. The country has had the world’s highest real consumption growth rates over the past 15 years, yet consumption’s share of GDP—just 36% in 2013—is among the lowest. So while annual consumption rose by 50% between 1999 and 2011, average per capita consumption stood at just 16,700 yuan ($2,700) in 2014, compared with about $32,000 in the United States. The disparity demonstrates how little most Chinese citizens still consume despite a decade and a half of brisk growth.

Such extremes have proved tricky for many companies, especially foreign ones. While China’s market has held huge promise for those seeking growth, the pockets of increasing demand can be difficult to find. Understanding how to satisfy that demand, given that so many would-be consumers still have little to spend and unfamiliar consumption preferences, has proved yet more puzzling. As the economy slows, identifying the best growth markets can only get more challenging. Indeed, some companies are now beginning to question the potential of China’s consumer market altogether.

Much depends on the future course of the economy. Indeed, as we first described in The Conference Board China Center’s 2014 report The Long Soft Fall in Chinese Growth, we believe the economy is in the throes of what will be an enduring slowdown. The latest forecasts from The Conference Board predict GDP will grow by 4.4% a year on average between 2017 and 2020, and then by 3.6% on average over the following five
years. That China’s growth will slow as the economy develops is inevitable; this is the natural course followed by all maturing economies. But the expected duration of the slowdown reflects the government’s hesitance to pursue marketizing reforms that would help replace a tired growth model based on exports and investments with one based on consumption and innovation.

In the face of such an economic transition, companies are right to assess what slower growth will mean for their businesses, but they should not overreact. As the accompanying full report makes clear, aggregate consumption will continue to grow at a steady clip. The Demand Institute and the China Center for Economics and Business project that consumer spending will rise by 5.2% a year in the next decade to reach 40 trillion yuan ($6.4 trillion), with per capita consumption increasing by two-thirds. And even if GDP growth were as much as one percentage point lower, consumption could still grow by more than 4% a year. That is high relative to most of the world’s other economies.

Of course, as the volatility in China’s financial markets over the summer have made clear, there is a risk that political-economic disruptions could destabilize consumption growth. This risk is examined in the report. However, our view is that except under the direst political and economic scenarios, China’s consumption has strong growth potential.

The question is where to find that growth. Where will the new, vibrant consumer markets emerge against such an uncertain economic backdrop? Which cities offer the most potential to those wanting to capture consumption growth? In the best of times, companies struggle to make the right investment decisions without sufficiently detailed data. But in times of extreme economic uncertainty, the consequences of making the wrong call can be particularly severe.

Our City Strata and Connected Spenders frameworks, introduced here and in more detail in the accompanying full report, will help companies create value from consumption growth, despite the uncertainties.
Companies investing in China often rely on the official tier system of classifying cities to help formulate their growth strategies. Yet that system says more about a city’s relationship with the central government in Beijing and its importance as an administrative or logistical hub, or even as a military outpost, than its viability as a consumer market. Tier 1 cities such as Beijing and Shanghai, with which multinational corporation (MNCs) are familiar, are uniformly large and relatively rich. But Tier 2 cities have little discernible connection beyond their status as provincial capitals. And Tier 3 cities, of which there are more than 100, are not grouped geographically, nor do they have similar levels of wealth, logistical capability, Internet penetration, or many other important features of market development. For companies wishing to expand their presence in China, the tier system therefore offers little practical guidance.

As city prospects continue to evolve in line with China’s economic transition, a more rigorous segmentation of the market will be key to formulating robust market strategies. The City Strata framework fulfills this need. It analyzes approximately 200 variables in 286 prefecture-level cities, painting a portrait of urban China that is richer than one based on geographic, demographic, or administrative classifications, or one that uses metrics such as current income levels to give a straight-line projection of the viability of any given market. Instead, the variables chosen indicate an urban econo-
my’s capacity to adapt to China’s changing economic conditions, and so serve as a measure of the opportunity for consumer-facing businesses. Moreover, the segmentation is finer than most, as we have identified and ranked 11 different City Strata, allowing for a more targeted approach for assessing cities’ prospects. The 11 new City Strata are as follows, listed from strongest to most challenged: Super Cities, Affluent Cities, Satellite Cities, Regional International Cities, Integrated Industrial Cities, Inland Core Cities, Resource-Exhausted Cities, Tourism Cities, Modern Agricultural Cities, Frontier Cities, and Traditional Agricultural Cities.

Our framework yields important insights. Conventional wisdom is that the fast-paced growth expected for many of the cities in Tiers 3 and 4—the result of national economic growth and convergence—makes all 230 cities within these tiers ripe for investment. But our segmentation shows this not to be the case, given what current conditions say about the longer-term health of their economies. Indeed, the best oppor-
tunities for the majority of MNCs and domestic brands will be limited to between 40 and 79 of the country’s 286 prefecture-level cities, all within the top five strata of our hierarchy.

The top three strata, consisting of 40 cities, will provide the primary opportunity for most consumer companies. The fourth stratum, which includes another nine cities, provides a secondary opportunity to consider. Beyond that, we think only companies that are already deeply penetrated throughout China would consider the 30 cities in the fifth stratum. Neither MNCs nor most domestic brands are likely to consider investing in cities in the remaining six strata, except in specific situations.
Just as there are vast variations in consumption patterns between different cities across China, so there are between consumers in any given city—differences in their means, preferences and behaviors. Simply put, some consumers will drive spending growth more than others. Identifying, understanding and meeting their needs should be fundamental to the growth strategy of consumer-facing businesses.

The middle class is often seen as the big opportunity for consumer goods companies. But there is no agreement on the definition of a middle-class consumer. The World Bank defines the middle class as those people who can afford daily expenditure of $10 to $50—an enormous range in purchasing power. Moreover, income does not necessarily denote purchasing power. Neither does it reflect a consumer’s willingness to spend or his or her access to consumer goods. In China and other emerging markets, the challenge of distribution and logistics is significant, which is one reason why access to the Internet can be so important. Additional insight is needed.

The Connected Spenders framework therefore identifies those who are willing to spend spare cash once basic essentials have been bought and who have access to the Internet. Our research shows that Connected Spenders will account for 80% of the aggregate growth in consumption in the next decade. For consumer-facing businesses seeking to grow in China, these are the consumers whose needs will have to be
addressed. Here are some key facts about this newly defined cohort:

**The numbers.** In 2014 there were 368 million people—27% of the total population—living in Connected Spender households across all City Strata. These households accounted for 44% of total consumer spending. Connected Spenders will grow by 60% to about 590 million people by 2025, accounting for 41% of the population. Their collective spending power will rise from 44% of the total today to 60% in 2025.

**Their income.** Connected Spenders are more educated, urban and younger than consumers overall, so it may not be surprising that they have higher average incomes—though they are far from rich. Their average annual household income was 120,600 yuan ($19,000) in 2014, compared with just over $72,000 for all households in the United States. Only 12% reported monthly household income of more than 20,000 yuan ($3,100), or $85 a day.

**Their geographic location.** More than half live in the top five City Strata, although this group of 79 cities contains just 38% of the total City Strata population. More than half will still live there in 2025, as those top strata will see faster growth of their Connected Spender populations than the less robust strata.

**Their spending habits.** Some 43% of their spending is dedicated to nonessential categories, compared with 36% for other consumers. Connected Spenders are the most likely to trade up to higher-quality goods and services, whatever their income. In lower, poorer strata, basic categories such as facial tissues, toothbrushes and chewing gum will see growth as incomes rise above the levels of basic consumption. In the higher strata, more advanced trade-up categories will see the fastest expansion. These include products such as baby formula, soy milk and carbonated soft drinks.

That Connected Spenders are concentrated in the top five strata of the City Strata framework reinforces the recommendation that emerges from the City Strata analysis that companies should consider new investments here first. However, Connected Spenders can be found in every strata, and their consumption patterns vary systematically across them. Thus, the Connected Spenders framework is an important lens through which to assess growth opportunities. Regardless of whether companies ultimately choose to focus their investments in the top strata or build broader market penetration—and regardless of whether they choose an online or offline strategy, or both—understanding the different spending habits of Connected Spenders across China will help ensure that companies create more value from those investments.
CONNECTED SPENDERS WILL DRIVE GROWTH OF CHINESE CONSUMPTION.

WHO ARE CHINA’S CONNECTED SPENDERS?

**CONNECTED SPENDERS**
- Average annual consumption, 2014: $4400 per year
- Big spenders
- Younger age distribution, % of households, 2014:
  - 19-34: 43%
  - 35-69: 42%
  - 50-64: 15%
- More affluent income distribution, % of households, 2014:
  - Low: 14%
  - Middle: 72%
  - High*: 14%
- Better educated % with college education or above, 2014: 53%
- More urbanized % living in urban area, 2014: 91%

**OTHER HOUSEHOLDS**
- Average annual consumption, 2014: $2000 per year
- Younger age distribution, % of households, 2014:
  - 19-34: 29%
  - 35-69: 41%
  - 50-64: 30%
- More affluent income distribution, % of households, 2014:
  - Low: 67%
  - Middle: 31%
  - High: 2%
- Better educated % with college education or above, 2014: 15%
- More urbanized % living in urban area, 2014: 31%

WHERE ARE CHINA’S CONNECTED SPENDERS?

- Connected spenders per 100 people, 2014:
  - Super: 68
  - Affluent: 27
  - Satellite: 33
  - Regional international: 35
  - Integrated industrial: 35
  - Inland core: 24
  - Resource-exhausted: 24
  - Tourism: 24
  - Modern agricultural: 19
  - Frontier: 22
  - Traditional agricultural: 17
  - Other: 19

- Share of new connected spenders, 2014 >> 2025:
  - Super: 14
  - Affluent: 21
  - Satellite: 5
  - Regional international: 14
  - Integrated industrial: 12
  - Inland core: 12
  - Resource-exhausted: 8
  - Tourism: 4
  - Modern agricultural: 4
  - Frontier: 8
  - Traditional agricultural: 4
  - Other: 4

MORE THAN HALF OF NEW CONNECTED SPENDERS WILL COME FROM THE TOP 5 CITY STRATA.
POTENTIAL VARIANTS IN THE NEXT DECADE OF CONSUMPTION GROWTH

The projections in this report are built on our assumptions about how the Chinese economy and government policy will evolve over the decade. Their accuracy will depend in particular on developments in four areas, which business leaders should monitor:

**GDP growth.** Our projection of 3.6% a year from 2020 to 2025 is relatively conservative. If it proves to be optimistic, the pace of consumption growth forecast in this report will be lower, too.

**Internet penetration.** We project it will rise to 75% by 2025 from 48% in 2014. This is another important component of our consumption projections. The government’s Internet Plus initiative and stated targets for Internet access imply it is committed to building the necessary infrastructure. However, much can change in the coming decade.

**The household financial-services sector.** The development of this sector, key to higher consumer spending, depends on a regulatory framework and infrastructure to support credit cards, consumer loans and other financial services. There is evidence that these are finally starting to evolve. But there is a long way to go, and the enduring support of government regulators is far from certain.

**The business environment.** Our projections take into account signs that the government is pulling back from marketization of the economy and is instead seeking to engineer solutions to the country’s economic problems. This raises questions about its commitment to driving consumption-led growth. Moreover, there is a prevailing ideological pillar that would resist seeing the proceeds of increasing consumption flow disproportionately to foreign brands. Policy developments will inevitably affect consumption, for better or worse.
APPLICATIONS AND IMPLICATIONS FOR BUSINESS STRATEGY

This report helps guide executives amid so much uncertainty. The City Strata framework serves as a road map whose central purpose is to guide geographic decisions: where to go first, where to go next. Strategies will vary. Those looking to emulate Nestlé and Yum! Brands, for instance, will seek to travel far and wide. They might start in a few big cities but quickly build from there. Those taking Disney or Apple as their example will make selective investments in retail and service infrastructure in a small number of cities.

The majority of companies will start and finish their journeys within the top five strata, at least for the next 10 years. Companies in particular industries or with well-established distribution systems might find it beneficial to venture into cities even lower down the hierarchy, but they should proceed with extreme caution. Whichever locations they choose, understanding the needs and desires of Connected Spenders—which will not be the same as those of middle-income consumers in Western economies and, importantly, which will differ between strata—will dictate how best to serve them.

During the years of booming economic growth, many consumer businesses in China enjoyed unprecedented growth. But the situation has changed, permanently. A far higher degree of strategic precision is needed. The City Strata and Connected Spender frameworks presented in this report will enhance that precision. They will guide geographic-market selection and customer focus, which in turn will enable improvement across a range of business activities, including new-product development, marketing and communications, and distribution—all of which are critical to differentiating a company’s brand in a more competitive environment, and some of which were arguably not sufficiently targeted during the boom years.