

# REPORT

## The Keys to the Kingdom

Unlocking China's Consumer Power



THE BOSTON CONSULTING GROUP

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# Executive Summary

**A** dramatic shift in the geographic distribution of consumer spending power is under way in China. The middle classes are expanding out beyond the largest cities more rapidly and in greater numbers than any market has ever witnessed. In 2005, a consumer company doing business in 70 locations (cities and counties) in China could reach 70 percent of consumers in the middle and affluent classes. To achieve the same coverage today, a company must be in nearly 240 locations. By 2020, that number will exceed 400.

*China's dynamic environment has implications for companies at all levels and positions. Companies currently enjoying growth need to ensure that their economic model is sustainable. Laggards can capitalize on market dynamics and catch up to the leaders by winning in newly important locations. Knowing where, when, and how to move will require rigorous market analysis with accurate data. Getting it wrong could mean incurring huge costs—but companies that make the right decisions today could be tomorrow's winners. Is your company prepared for this challenge? Have you developed a strategy for taking advantage of China's growth and deploying your resources in a way that stretches your lead and guarantees economic efficiency in a land where scale is king?*

*The Boston Consulting Group has developed a field-tested methodology for helping companies answer these questions with precision. It is supported by a proprietary analytic model for forecasting population and income distribution annually through 2020 in urban and rural China. Companies that use it can discover where their targeted consumers will be over the next five to ten years across all of China—and how to serve them efficiently.*

**Consumer goods companies and retailers are stepping up their investments in China, where rapidly es-**

**calating consumer spending power will be a key driver of global strategies over the next few years.**

- ◇ China's persistent growth, despite the economic crisis, will bring close to 100 million households earning at least RMB 60,000 per year (about \$9,000) into the middle- and affluent-class (MAC) segments from 2010 to 2020—roughly the same number of MAC-equivalent households as in the United States today.
- ◇ The increase in MAC households will double consumer spending power in nearly a quarter of China's cities and counties over the next decade.

**BCG's latest analysis indicates that the rapid increase in disposable household income across China has magnified the complexity that companies encounter when deciding where to expand.**

- ◇ By 2020, there will be nearly 800 urban locations with real disposable income per capita greater than Shanghai's today—meaning that in 2020, a city with per capita income that equals Shanghai's today will be too poor to be counted among China's top 800 urban locations.
- ◇ Even rural China can be an attractive market for some companies and an engine for growth after most of urban China has been reached. But with the highest incomes in some rural areas as much as 30 times greater than the lowest, picking the right markets to enter is critical.
- ◇ The challenge of managing such complexity is one reason why not all companies have achieved their growth or profitability aspirations in China.

### **In China, scale is king.**

- ◇ The spread of consumer spending power across China means that a company must constantly expand its geographic footprint—but the requirements of scale make it extremely critical to cluster locations appropriately to ensure competitive scale economies.
- ◇ Not only must companies choose the right locations for long-term growth and scale economies, they must segment and cluster those locations appropriately given the company's specific business model.

### **Using off-the-shelf statistics or highly generalized data on city rankings as a shortcut for the complex analysis needed to accurately prioritize and cluster locations can result in expensive mistakes.**

- ◇ Simplistic tools in a dynamic market such as China are of little value. Aggregated population statistics and data on GDP per capita and disposable income correlate poorly with the size of specific income segments, a core determinant of the attractiveness of consumer markets.
- ◇ Misallocation of funds can be disastrous in a market as strategic as China, where competition is intense, regional variations are significant, and capable talent is scarce. It can lead to costly inefficiencies, short-term losses, and long-term disadvantage.

### **BCG has developed a flexible and field-tested methodology to help clients expand their geographic footprint on the basis of their specific business model and competitive dynamics.**

- ◇ BCG's methodology is supported by a proprietary analytic model for forecasting the size of different income segments through 2020 for all of urban and rural China, including some 650 cities and more than 1,600 counties.
- ◇ Cities and counties can be clustered according to the logic dictated by a company's specific business model.
- ◇ Companies can stress-test the results by using BCG's methodology to run a variety of scenarios on future economic growth and income distribution.

### **To win in China, marketing strategists must have a rigorous, fact-based process for making decisions about expansion opportunities, targeted consumer segments, and go-to-market models. BCG's approach involves five steps:**

- ◇ Define targeted consumer segments by thoroughly understanding current and future spending behavior across specific product categories.
- ◇ Determine which locations are likely to have the largest number of targeted consumers over the coming years.
- ◇ Group these locations into clusters to maximize scale economies.
- ◇ Prioritize clusters or individual locations according to targeted consumers and product categories.
- ◇ Make sure that expansion priorities are aligned with the company's business model and competitive landscape.

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# Capturing China's Market Potential

**D**espite the global economic crisis, China managed a healthy 8.7 percent growth rate in gross domestic product in 2009, thanks in part to a broad stimulus package. Most forecasts show growth sliding to 5 percent by 2020. Even so, China could represent 15 to 35 percent of the world's total growth in GDP over the coming four years—a significantly larger percentage than in the previous decade. This growth will raise disposable incomes to an extent never before seen in any other market anywhere—pulling tens of millions of households into the middle class and beyond. Such dynamic growth will continue to create opportunities for companies seeking a winning position in China's strategic market.

Given that prospect, it's no wonder that many consumer goods and retail companies—including Procter & Gamble, Inditex, and Tesco—are making major investments in China. Yet their success in this culturally complex and geographically massive market is by no means guaranteed. Many companies have bet high stakes in China only to realize disappointing returns, often because of the complexity of China's markets. More than one-quarter of China's provinces have populations larger than that of France, and more than 500 locations have populations of more than 250,000 people. Furthermore, China's rural population of 700 million people—the next frontier for companies already established in urban China—is spread across nearly 2,000 of China's administrative divisions.

## A Sustainable Economic Model

Although most companies will continue to find so-called white space for “easy” growth, lasting victory requires an

economically advantaged position. Not only must companies outdo their competitors in choosing the *right* markets for long-term growth, they must also segment those markets by consumer income, cluster them so that they can be served efficiently, and win them in order to ensure sustainable leadership positions.

Companies frequently underestimate the challenge of analyzing where targeted consumer segments are growing fastest and which product categories are most likely to benefit as incomes rise. Because government statistics can be insufficiently precise and nuanced, a lack of reliable data is often cited as an excuse for shortcutting this critical analysis. Considering how rapidly middle- and affluent-class (MAC) consumers are spreading beyond the principal locations, it is easy for companies using unsophisticated data to misallocate resources for media spending, trade spending, or sales personnel. One-dimensional solutions can be disastrous in a market as strategic as China, where competition is intense, regional variations are significant, and capable talent is scarce—and the result can be costly inefficiency, short-term losses, and long-term disadvantage.

## Employing Accurate Data and Rigorous Methodologies

To meet this challenge, The Boston Consulting Group has developed a flexible and field-tested methodology to help our clients create expansion and resource prioritization strategies tailored to their unique circumstances—including, for example, customized consumer targeting and go-to-market approaches. The methodology is supported by a proprietary analytic model for forecasting the size of different income segments through 2020 for all of urban and rural China by city and county.

We believe that simplistic tools in a dynamic market such as China's are of little value. Although some companies in China have tried to anticipate increasing levels of income across regions by looking at aggregated public statistics on population, GDP per capita, and disposable income, few have drilled down to less readily available data at the city level (especially for cities below the top 100). Nor do many companies adequately analyze income distribution. Yet such information is absolutely critical to prioritizing resource deployment and making important decisions on where to expand.

Our model includes both rural and urban populations, which are divided among some 650 official cities and more than 1,600 counties, totaling approximately 2,300 geographic units. Approximately 75 percent of the urban population resides in the 650 cities—some of which cover areas as large as Delaware. The remaining 25 percent resides in townships within the 1,600 counties, where income derives predominantly from nonagricultural labor and population density is high. Rural consumers, whose income derives mostly from agriculture, reside in low-density areas surrounding a subset of the 650 cities, as well as in the 1,600 counties.

We project populations and average incomes for all cities and counties, then break down those populations into six segments by annual household disposable income (in 2005 RMB): poor (less than RMB 25,000), aspirant (RMB 25,000 to RMB 40,000), emerging middle class (RMB 40,000 to RMB 60,000), middle class (RMB 60,000 to RMB 100,000), lower affluent (RMB 100,000 to RMB 200,000), and upper affluent (more than RMB 200,000). The result is a projected income distribution for all 2,300 geographic units. Although our numbers represent a base case, the model allows companies to assess the impact of changes such as fluctuations in overall GDP growth, a continuing export slowdown that disproportionately affects certain locations, or a faster-than-expected increase in income inequality.



# Preparing for the Surge of the Middle Class

**C**hina's GDP has been growing by about 10 percent per year for most of the past decade, and although that number is expected to drop to 5 percent by 2020, the impact of GDP growth on personal income will still be significant. Historical data from countries similar to China—as well as our own data on spending habits in China—indicate that overall consumption levels begin to increase significantly once annual disposable income reaches \$9,000 per household, or about RMB 60,000, which is the bottom of the middle-class segment as we have defined it. Because there are tens of millions of households just below this threshold in China today, our forecasts suggest that the growth of MAC households will far exceed GDP growth in the next decade. Our methodology is flexible, however, and can be applied to any set of targeted consumers, in addition to MAC consumers.

Our findings also indicate that the distribution of income for urban residents will shift significantly upward over the next ten years. Indeed, disposable income per capita is expected to double in nearly 600 locations in China from 2010 to 2020. By 2020, the size of China's urban middle class will likely have doubled and its affluent class (upper and lower) will have increased nearly four times over. More than 130 million urban households will be living at the middle-class level or above. (See Exhibit 1.)

Although differences in purchasing power make cross-country comparisons problematic, it is interesting to note that in 2005, China had more than 11 million MAC households, which put the country just above Australia and Poland in terms of the number of MAC-equivalent households. Today, that segment has grown to about 50 million households, which ranks China on a par with Japan. By

2020, when the segment is expected to exceed 130 million households, China will rank above the United States.<sup>1</sup>

## Expanding Companies' Geographic Footprint

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The dispersion of income across China's vast land mass means that the geographic footprint required for companies to reach most MAC consumers will be constantly expanding, and it will include increasing numbers of what many companies today consider to be low-tier cities. (See Exhibit 2.) In 2005, a company needed to be in approximately 70 locations (either cities or counties) if it wanted to reach 70 percent of China's MAC consumers.<sup>2</sup> Today, serving China's MAC population requires a presence in nearly 240 locations, and by 2020 that number will exceed 400. China's affluent population alone will increase by nearly four times between 2010 and 2020, and the required footprint to reach 70 percent of it will grow from about 90 locations to more than 250. (See the sidebar "Forecasting China's Growth.")

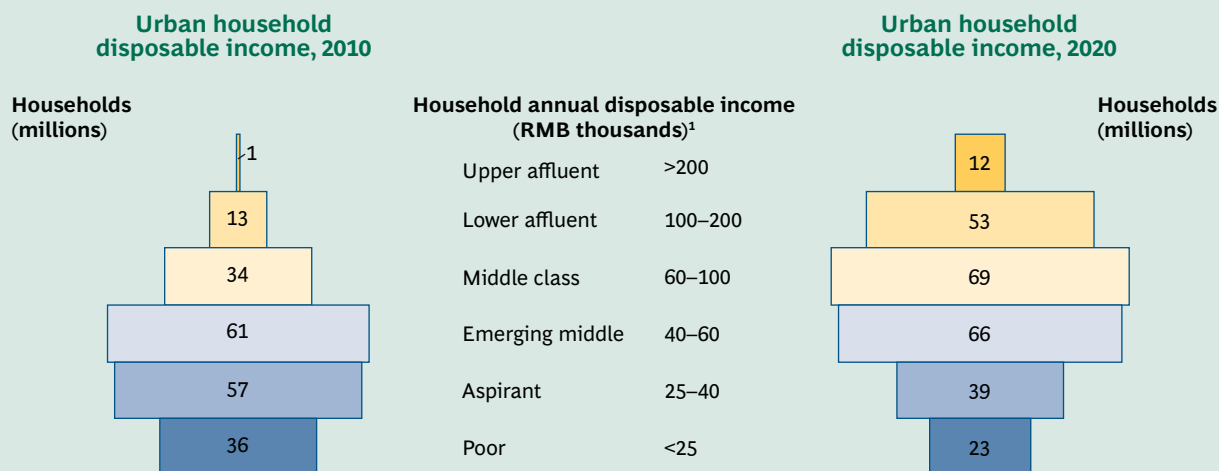
China's dynamic environment has implications for companies at all levels and positions. Those that have grown in the past few years need to ensure that they are building a sustainable economic model, not just blindly expanding in pursuit of white space. Companies that have been lagging behind can capitalize on the dynamics of this market and quickly catch up to the leaders by win-

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1. MAC-equivalent households in the United States are defined as households with real annual disposable income of more than \$25,000.

2. In most cases when we refer to locations, the designation includes cities and counties.

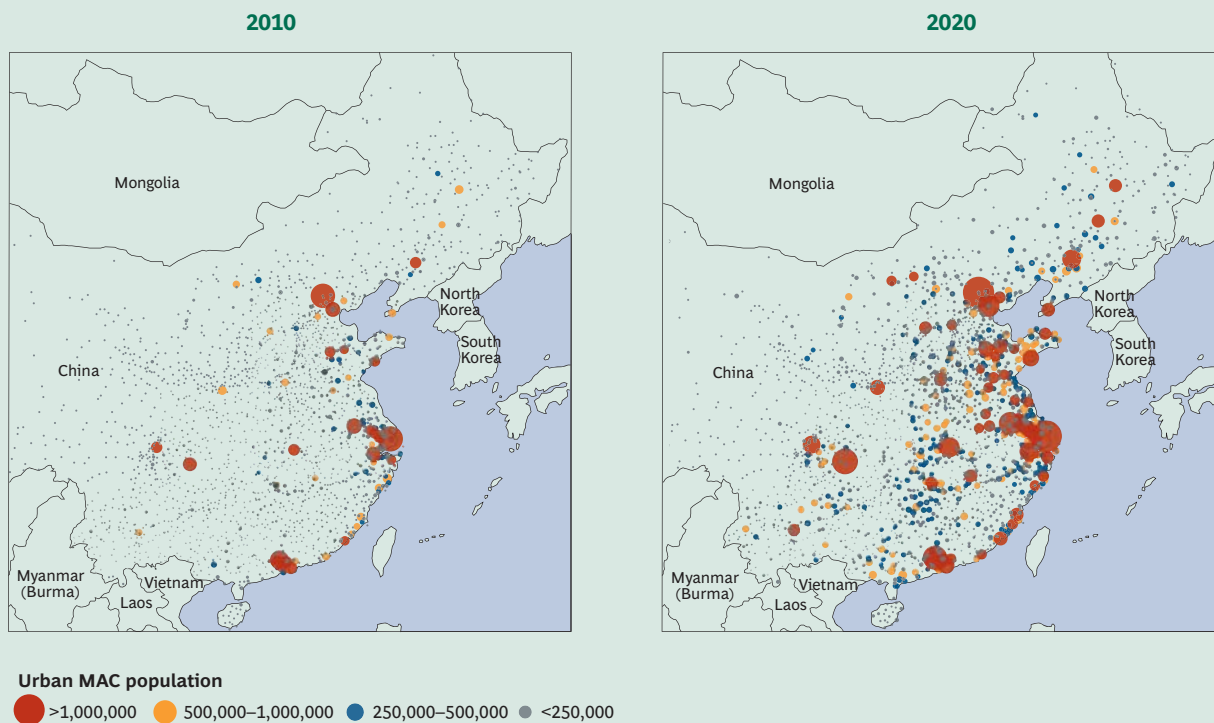
## Exhibit 1. China's Urban Income Distribution Will Look Very Different in 2020



Source: BCG analysis.

<sup>1</sup>Disposable-income numbers are stated in real 2005 renminbi (that is, adjusted for inflation).

## Exhibit 2. The Number of Locations with Significant MAC Populations Will Expand Dramatically in the Next Decade



Source: BCG analysis.

## Forecasting China's Growth

From 2010 to 2020, close to 100 million Chinese households will rise into the middle or affluent classes—that is, they will have real disposable incomes (in 2005 renminbi) of at least RMB 60,000 (about \$9,000). That is roughly the same number of MAC-equivalent households as in the United States today. And China's upper-affluent population will reach 12 million by 2020—promising a sizable market for luxury goods.

- ◇ Today, Shanghai has more than 8 million MAC consumers; by 2020 that segment will swell to 12 million, and average disposable income for the city overall will rise from the middle-class level to the lower level of the affluent class.
- ◇ Although there will be many more cities with more than 3 million people in 2020, six of them (including Shanghai) will have populations in which MAC consumers alone total more than 5 million, and seven will have MAC populations of between 3 and 5 million.
- ◇ By 2020, half of the urban population will live in cities of greater than 1 million, and there will be nearly 800 locations with real disposable incomes per capita that are greater than Shanghai's today. This income growth is occurring throughout the country, which means that many smaller and lesser-known locations may become attractive markets for consumer goods companies and retailers.

- ◇ In the coming decade, consumer companies will find nearly 60 cities with MAC populations of a million or more, and about 400 locations with 250,000 or more. Contrast that with the United States, where there are only about 50 cities with total populations of more than 1 million.<sup>1</sup>
- ◇ In four years, nearly 13 million additional Chinese households will have disposable incomes of more than \$25,000 (although purchasing power will vary among them). That is more than three times the increase from 2000 to 2010 in the number of households with equivalent incomes. The expected growth in the number of households in China with incomes greater than \$25,000 will be twice the growth expected for the United States, 7 times more than the growth projected for Germany, and 16 times more than that projected for Japan.
- ◇ The disposable income in rural areas is expected to grow by 50 percent between 2010 and 2020, although it will lag far behind urban income. Still, rural income in 2020 will be roughly equivalent to China's total disposable urban income in 2003.

1. We define U.S. cities as "metropolitan statistical areas," incorporating both the downtown area and the surrounding suburbs. This is equivalent to our designation for locations in China.

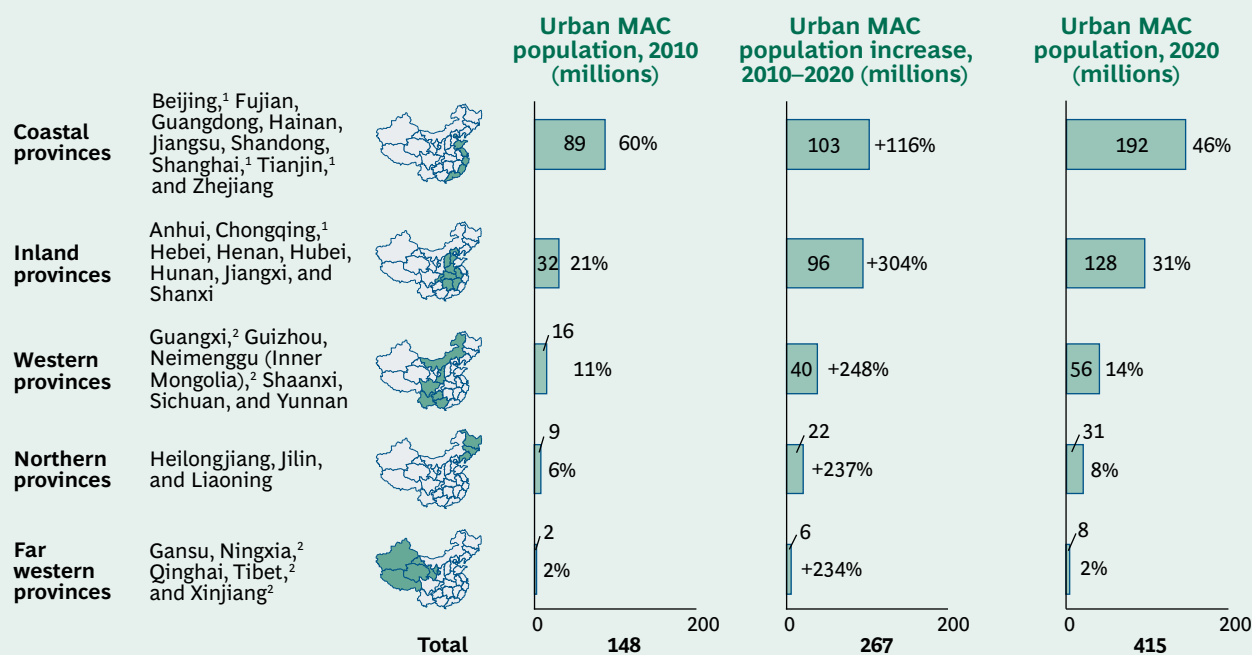
ning in newly important locations. Market leaders will need to reevaluate their plans for resource deployment and expansion to ensure that they can maintain their position in areas where they are strong and establish new leadership positions in markets with rising MAC populations. For these leaders, there is a premium for avoiding mistakes and not giving laggards the opportunity to gain ground.

For most companies and product categories (except, perhaps, companies targeting only very affluent consumers), reaching a significant portion of China's new MAC consumers will require a broader footprint than it did a few years ago. Therefore, making the wrong decision today about regional expansion will impose a high penalty on a company's ability to reach the most valued consumers in the future.

## Tracking the Distribution of Urban Income

Incomes will grow everywhere, but in terms of raw numbers of MAC consumers, the most significant increases will occur on China's east coast and in the adjacent inland provinces. MAC consumers will continue to be found predominantly in urban areas; by 2020, more than 93 percent will be urban. Historically, economic growth in China has been concentrated in the coastal provinces, where 60 percent of all urban MAC consumers live today. (See Exhibit 3.) And MAC populations will remain denser in the coastal provinces, where the average city has at least four times as many MAC consumers as in other parts of China. By 2020, nearly 200 million urban MAC consumers will live in the coastal provinces. For many consumer goods companies and retailers, therefore, these provinces

### Exhibit 3. Urban MAC Populations Are Growing Throughout China



Source: BCG analysis.

Note: Percentages indicate the percent of the total urban MAC population for 2010 and 2020, respectively, and the percent change from 2010 to 2020.

<sup>1</sup>Province-level municipality.

<sup>2</sup>Autonomous region.

may remain a primary focus because of their large and accessible MAC populations.

By 2020, however, income growth will have dramatically increased the MAC populations in the inland provinces, which are expected to gain nearly as many new MAC consumers as the coastal provinces. The northern and western provinces will also post significant gains in their MAC populations, so that by 2020 there will be about the same number of urban MAC consumers found there as in the coastal provinces in 2010.

Consider, for example, the city of Huainan, in Anhui province, where about 260,000 MAC consumers live today. Its distribution of income may not be attractive for most companies now. But in a few years, as disposable income doubles and the MAC population increases to nearly 1.5 million, Huainan could become a high-priority market. For companies that have already achieved broad distribution in the coastal provinces, the emergence of large numbers of locations like Huainan in the inland, northern, and western provinces could represent a logical next step

for expansion. For companies that have been less successful than their competitors, these new markets could offer an opportunity to catch up in areas where the market leaders are less entrenched.

Although average incomes will also increase in the far western provinces (whose MAC populations, as in the northern and western provinces, are expected to grow at a respectable 13 percent annually from 2010 to 2020), they will still be far below incomes in the other regions. What's more, the far western provinces are starting from a very low base—only about 1.6 percent of MAC consumers live there today, with an expected increase to just 2 percent by 2020. Given the vast size of these provinces and their relatively low levels of income, they are unlikely to be a priority except for the most deeply penetrated consumer-goods companies and retailers.



# Understanding the Rural Opportunity

**M**ost consumer-goods companies and retailers give priority to urban expansion before considering rural opportunities. To be sure, average rural disposable incomes are only about one-third of urban incomes, and the gap could very well widen slightly in the next decade—despite the Chinese government’s recent efforts to stimulate the rural economy. Furthermore, given China’s rapid urbanization, the rural population will decline from about 50 percent of the total population in 2010 to about 40 percent in 2020. Taken together, these trends suggest that rural households’ share of China’s total disposable income (currently about 25 percent) will fall to about 15 percent by 2020. And although rural incomes are rising, the rural population will remain predominantly poor, even ten years hence.

But such statistics underplay the magnitude of the rural opportunity. In product categories in which consumption is less income sensitive, such as some personal-care items and food and beverage products, rural markets can be as important as urban markets of a similar size. Many companies in China find significant profit pools in rural areas, just as they do in lower-tier cities, because fewer competitors are focusing resources there and the limited presence of national retail chains allows suppliers to earn high margins.

Rural consumers are often treated as a homogeneous group that is distinct from urban consumers. But such generalizations ignore the diversity of China’s rural areas, as well as the similarities between rural consumers and some urban consumers in lower-tier cities. (See the sidebar “China’s Rural Consumers Look to the Future.”) About 70 percent of the rural population and nearly 80

percent of rural income are found in the coastal provinces and the inland and northern provinces, where most companies have already focused their urban-expansion plans. Large rural markets can be found only an hour’s drive outside many city centers.

Some segments of rural consumers are much more sophisticated than stereotypes would suggest. For example, there are more than 100 television sets per 100 rural households, almost half of rural households have a washing machine, and about two-thirds have a mobile phone. Consumer brands such as Nokia, Want Want, Coca-Cola, Wrigley, and Haier are already household names. In fact, the level of sophistication and brand awareness frequently correlates with proximity to an urban center, because rural consumers often travel to a nearby city to shop in modern stores. But even consumers in remote areas can be a long-term source of growth, because their incomes are rising and they are willing to spend, especially on their children. However, their distance from urban markets challenges supply chains, and their lack of familiarity with brands can make it difficult for branded products to command a price premium over very inexpensive local products.

To succeed in rural areas, companies must start by segmenting the market. For example, rural areas that have a relatively large population of sophisticated consumers with relatively higher incomes might be served with product portfolios and go-to-market approaches that are similar to those offered in lower-tier cities. But remote or poorer rural segments would require a different go-to-market approach to make serving those segments economically viable. For example, given the lack of modern retail establishments in most rural areas, Procter & Gamble has partnered with China’s Ministry of Commerce to



## China's Rural Consumers Look to the Future

Although China's rural consumers are poorer on average than their urban counterparts, they can still represent an attractive market for some consumer-goods companies. Incomes of only a few hundred dollars a month may seem low, but rural consumers are already buying home electronics and appliances, and they are investing heavily in anything that will better their children's future, from education to nutritional supplements. China's rural consumers are far from a homogeneous group, and their spending habits and level of sophistication can vary considerably from place to place. Below are two typical rural consumers, similar in income but very different in attitudes and sophistication.



Chen Yi, a 35-year-old mother of three, is a typical resident of Lianhua village, located in a southern county in Guangdong province. Although the county ranks in the top 10 percent of rural incomes, it is relatively remote, with the nearest city about two hours away. This remoteness limits

Chen Yi's exposure to large retail stores and even to major news reports—for example, she had never heard of the melamine milk scandal. Her unfamiliarity with brands means that in most product categories, Chen Yi does not have a favorite. Roughly half of her \$250 monthly income

is devoted to improving her children's lives, in the form of tuition payments and pocket money.



Chen Heyin is a 23-year-old mother of two in rural Jiangxi province. When she was younger, she worked in a garment factory in neighboring Fujian province and was exposed to a wide variety of consumer brands and products. Compared with Chen Yi, she is much more informed

about brands, such as Minute Maid, Wahaha, Uni-President, Danone, Mengniu, and Yili. She also has a fairly sophisticated understanding of nutrition, which is why she purchases premium milk as well as calcium tablets and fortified biscuits for her children.

Chen Heyin's home is a new three-story house that was just completed last year. Although her only major purchases to date have been a cathode-ray-tube TV, a DVD player, and a refrigerator that is used only during the summer, she plans to buy a washing machine soon, and she is saving money to upgrade the furniture in her home.

explore ways to help rural mom-and-pop stores upgrade their offerings.

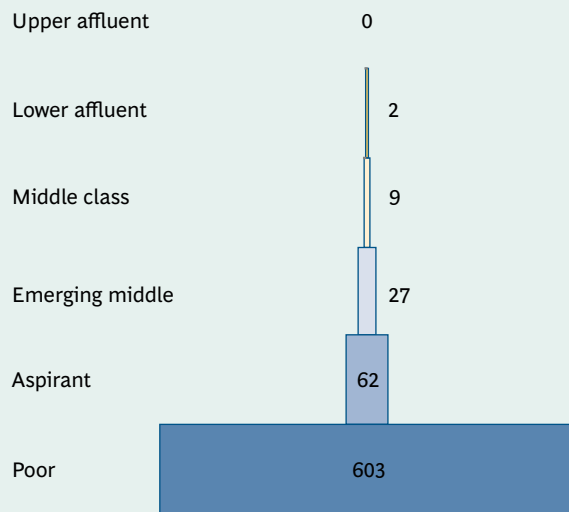
Although most rural consumers fall into the poor segment, average rural incomes across China can vary considerably—with the highest as much as 30 times greater than the lowest. (See Exhibit 4.) Therefore, what is affordable in one rural area may not be affordable in another.

Some segments of rural consumers will require products that are very different from the products that urban consumers seek, and companies wishing to do business in rural China will need to understand these differences. Procter & Gamble has devoted about 30 percent of its product-development budget in China to products designed for rural consumers.



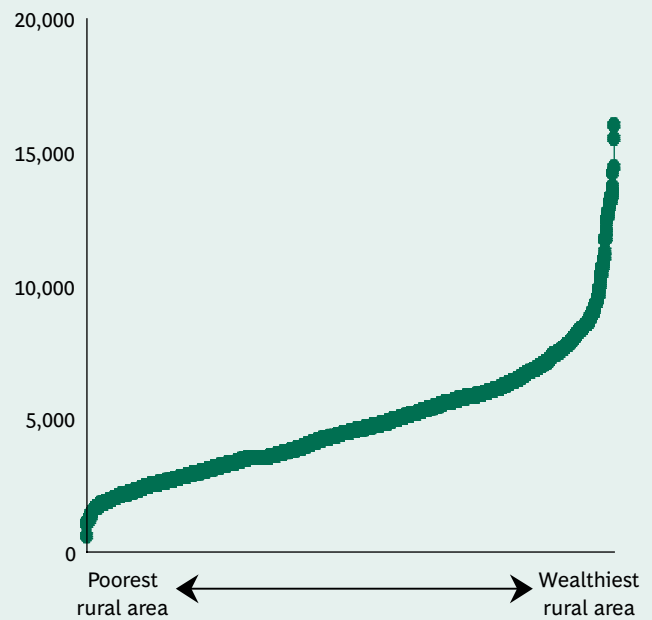
#### Exhibit 4. Rural China Is Still Predominantly Poor, but Average Incomes Vary Significantly

Rural income distribution by segment, 2010 (millions of people)



Distribution of rural income across all administrative divisions, 2010

Annual disposable income per capita (RMB)



Source: BCG analysis.



# Overcoming the Challenges of Expansion

**A**s more locations begin to have a critical mass of MAC consumers, many consumer goods companies and retailers will rightly seek to extend their footprints or deploy their resources more effectively across the markets they already serve. But moving into new locations in China can pose more challenges than it does in developed markets, because companies often have to create new infrastructures, which can mean uncompetitive economics until sufficient scale is achieved. Retailers, for example, often need to set up warehouses or distribution centers in each new location, because national logistics networks are costly. Consumer goods companies often have to form new relationships with each city's set of distributors. They must also work with national key-account retailers at the local level, as well as with many local key accounts.

Given such challenges, it is crucial to determine which regions a company should move into and in what order. There is no rule of thumb that will work for every company, especially since consumer spending in different product categories increases at varying rates as incomes rise. Therefore, companies must ensure that their process for making these decisions is rigorous, fact based, and relevant for their targeted consumer segments and go-to-market model. And they will need to revise their plans at least annually to incorporate unanticipated changes in this dynamic market.

BCG has developed an approach to geographic expansion that all companies can use as a guideline in developing their own customized strategies. It involves five steps:

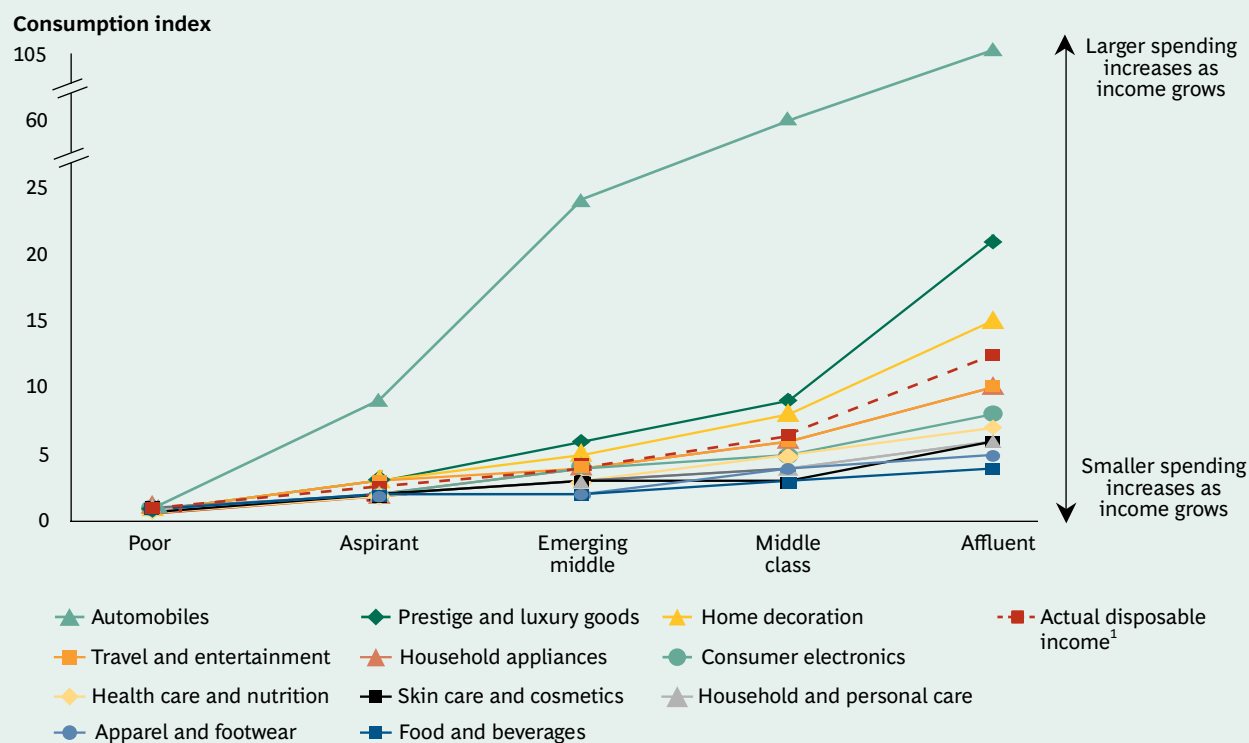
- ◆ Define targeted consumer segments by thoroughly understanding current and future spending behavior across specific product categories

- ◆ Determine which locations are likely to have the largest number of targeted consumers over the coming years
- ◆ Group these locations into clusters to maximize scale economies
- ◆ Prioritize clusters or individual locations according to targeted consumers and product categories
- ◆ Make sure that expansion priorities are aligned with the company's business model and competitive landscape

## Understanding Consumers' Spending Behavior by Product Category

As consumers' incomes grow, their overall spending increases—but at different rates depending on the product category. (See Exhibit 5.) Therefore, companies need to support market analysis with category-specific research. Spending on basic necessities, for instance, such as apparel and food, increases more slowly relative to rising income than does spending on categories such as skin care and cosmetics, home decoration products, luxury goods, and automobiles. When spending in a category outpaces income growth, that spending is more likely to be on trading-up products. This is a general tendency, however, and it is important to look at specific subcategories to find the exceptions. For example, as families become wealthier, they are willing to spend much more on infant formula, although their spending on the food category as a whole increases only modestly. Once these spending patterns are understood, the targeted income segments can be identified to drive the next steps.

## Exhibit 5. Spending Increases Vary by Product Category as Incomes Rise



**Sources:** BCG China Consumer Behavior Quantitative Research (2,594 consumers in 12 cities, 2007); BCG analysis.

**Note:** Annual household disposable income brackets are as follows: poor (<RMB 25,000), aspirants (RMB 25,000–40,000), emerging middle (RMB 40,000–60,000), middle class (RMB 60,000–100,000), and affluent (>RMB 100,000).

<sup>1</sup>Actual disposable income is indexed to the lowest level of income in order to show whether increases in product spending by category are greater or less than increases in income.

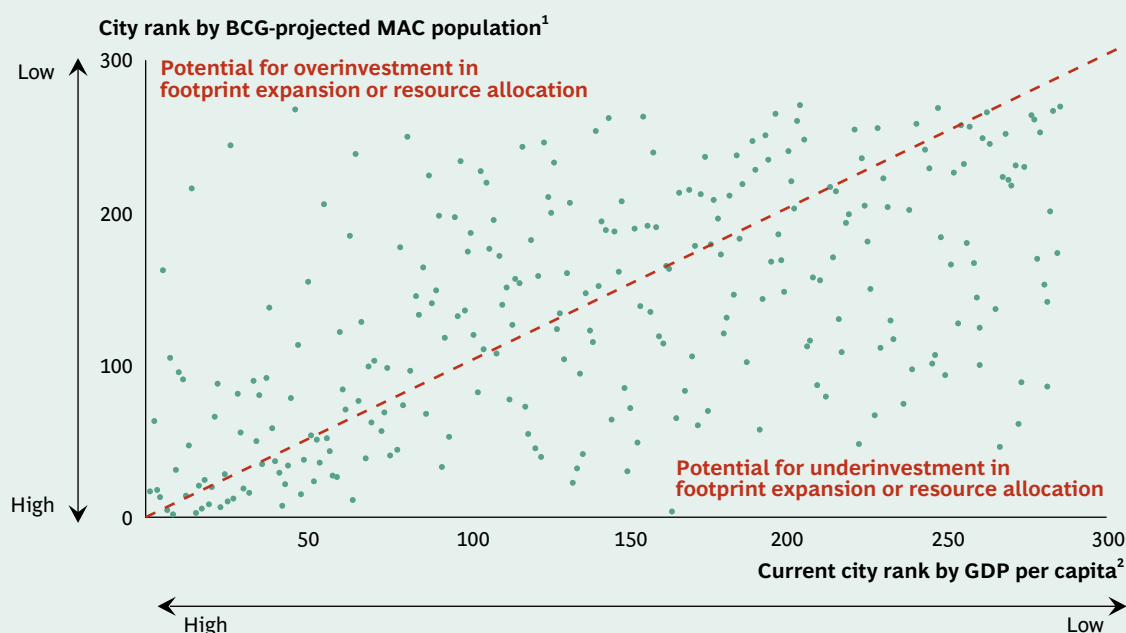
The dispersion in category spending becomes noticeable at the emerging-middle-class level, but it increases rapidly at the middle-class level, especially for luxury goods. Because families spend their increasing income at different rates, depending on the product category, companies need to take a much closer look at rising incomes in specific geographic locations and clusters. For companies with product categories in which consumption accelerates quickly as incomes grow, such as automobiles or luxury goods, it may be important to establish an early footprint in locations that are expected to see large income increases, in order to set up a distribution network and establish the brand. For categories in which consumption will increase more slowly relative to income growth, such as food or household care products, it may be less critical to enter early and more important to efficiently serve a large and growing base of consumers by focusing on certain geographic areas. Because the degree to which con-

sumption increases with income depends on the product category, companies should define income segments in terms of their own specific categories.

### Determining Which Locations Will Have the Largest Number of Targeted Consumers

Once the targeted consumer segments have been defined, their current and future sizes in each location should be determined. (Companies targeting lower-income consumers should include rural areas in this process as well.) Shortcutting this step by relying on readily available data can produce misleading results. For example, government statistics on GDP per capita and total population may not correlate well with targeted income segments, as the scatter plot in Exhibit 6 illustrates. The horizontal axis dis-

## Exhibit 6. There Is Little Correlation Between Published City Rankings and Projected MAC Populations



Sources: CEIC Data Company; BCG analysis.

<sup>1</sup>Based on BCG's projections for 2020.

<sup>2</sup>Based on 2007 data (the most recent available) from CEIC.

plays a simple ranking of cities (0 for the largest city, 1 for next largest, and so on) based on a commonly used and publicly available statistical ranking of GDP per capita. The vertical axis displays a ranking of the same cities based on BCG's projected MAC populations in 2020. Although there is general agreement in the ranking of the top 20 cities (which cluster together at the bottom left of the exhibit), there is significant potential for incorrect prioritization—and therefore misallocation of resources—beyond the top cities, as the differences between BCG's rankings and the published rankings indicate.

These differences are the result of effects that GDP per capita does not take into account, such as varying forecasts of growth and varying relationships between income and GDP growth. The cities that fall above the 45-degree line are those in which a company might be overinvesting resources or assigning too high a priority to expansion. The cities that fall below the 45-degree line are those in which a company might be underinvesting resources and perhaps allowing a competitor to gain an early foothold.

Companies can also determine the extent to which consumers with targeted income levels are found in rural areas. As noted earlier, it is a mistake to assume that all rural areas are poorer than urban ones. In 2020, the average income of the top 200 rural areas will exceed the average income of the bottom 300 urban areas. And even rural areas that are not as wealthy as some urban areas can be a source of growth. For nonpremium basic necessities, for example, consumers in the aspirant or even poor segments can be an important target, and of course those are the dominant segments in the poorer rural areas. For such products, rural markets should be considered an important component of a company's China strategy.

### Establishing Clusters According to Scale Economies

For most consumer-goods companies, a smart expansion strategy involves more than just prioritizing individual locations according to market size. It is also important to aggregate these locations into sensible clusters. To do this,

the cost of expansion—in economies of scale gained or lost—must also be considered.

Scale economies are critical for profitability in the Chinese market. In fact, empirical evidence suggests that until companies achieve revenues in excess of about \$250 million to \$300 million and capture relative share leadership in attractive product categories, profitability can be elusive.<sup>3</sup> Given the economic challenges of expanding across disparate regions, it is often advantageous to build scale in one area before attempting to move on to another.

A company may choose to focus on a particular province, for instance, before expanding into a new one. When prioritizing provinces, it is important to consider not just the total size of the targeted income segment but also its density, because provinces vary significantly in their concentrations of MAC consumers in various locations. All things equal, provinces with targeted segments concentrated in a few locations are more economical to serve.

A company might also take a finer-grained approach to clusters. More than 200 of China's 650 official cities have

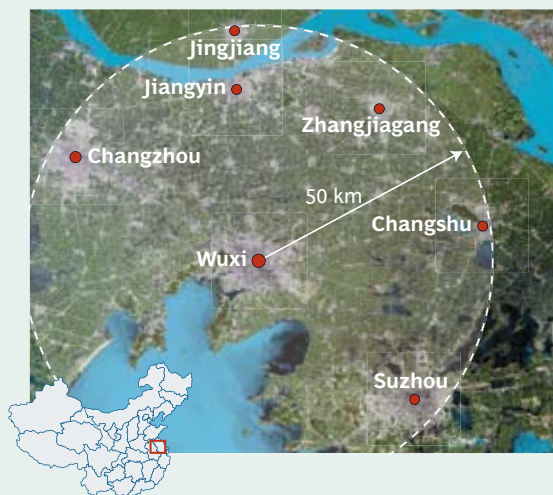
at least one (often smaller) city located within 50 kilometers. That introduces the possibility of expanding to lower-tier cities without significant incremental cost. Small cities often look appealing because of high average incomes, but a city with a MAC population of 150,000 cannot compare with cities that have more than 1 million MAC consumers, even if the latter have lower average disposable incomes.

Taking this approach to clusters, a company could identify a large “anchor” city surrounded by lower-tier cities that it could serve cost-effectively with the existing infrastructure. (See Exhibit 7.) In addition, the nearby rural areas can be clustered with the anchor city as long as the rural consumers are within the company's targeted set of consumers. The geographic size of these clusters can vary with product category economics and market dynamics. For example, high transportation costs relative to product margins rule out long supply chains in the beer category,

3. The revenue threshold has increased over time because of overall market growth and the complexities of geographic expansion. For a detailed study of the importance of scale economies for consumer companies in China, see *The Quest for Defendable Scale in China*, BCG Focus, December 2007.

## Exhibit 7. Wuxi Could Be the Center of a City Cluster

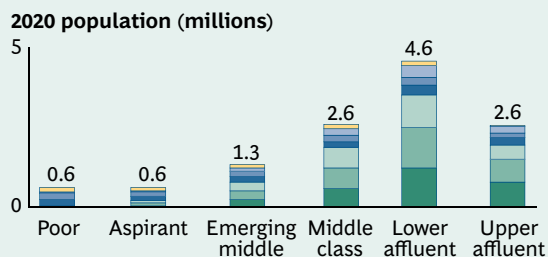
**Wuxi, a tier 1 city, has six cities within 50 kilometers**



Source: BCG analysis.

<sup>1</sup>Ranked on the basis of cities or clusters as appropriate.

**Income in the cluster of cities near Wuxi is significantly more attractive than Wuxi's alone**



	Wuxi itself	Cluster
Total population (rank) <sup>1</sup>	2.9 million (#33)	12.3 million (#3)
MAC population (rank) <sup>1</sup>	2.6 million (#19)	9.7 million (#4)

■ Jingjiang    ■ Changshu    ■ Changzhou    ■ Wuxi  
■ Zhangjiagang    ■ Jiangyin    ■ Suzhou

indicating that meaningful clusters must form a tight radius around breweries. Such clusters are more readily established, and therefore more useful, in the coastal and inland provinces. In these provinces, 50 to 70 percent of the official cities have at least one other official city within a 50-kilometer radius, compared with only 15 to 20 percent of cities in the northern, western, and far western provinces. As a result, clustering makes the most sense in the coastal region and, to a lesser extent, in the other regions, given their population densities.

Of course, every company must define scale according to its own needs, which will depend, in part, on its sales and distribution systems and its advertising and promotion models. As with regional prioritization or tiering, there is no single clustering approach that is relevant for every company. Companies that spend heavily on TV advertising should explore the possibility of mixing CCTV, satellite, provincial, and city-TV advertising. With such a mix, they can cluster cities to maximize the impact of their advertising spending.

Some companies may want to leverage local key-account retailers, whose geographic span may be a single province or part of a province. For other companies, driving sales through individual distributors might result in better distribution and trade-spending efficiencies, so a cluster approach would produce greater scale economies. When scale is not created at the local level (as, for example, with luxury goods), clustering may be unnecessary, and decisions about store openings should be made on a location-by-location basis.

Product development can also be a significant cost. If regional consumer tastes or preferences vary enough to require developing different products, then pushing for regional scale will enhance returns for the product development investment. Therefore, when considering where to expand, companies should understand the source of their individual scale economies and look not just at individual locations but also at those that might be grouped into clusters.

### **Prioritizing Locations on the Basis of Targeted Consumers and Product Categories**

The prioritization of locations, be they individual cities, clusters of cities, or entire provinces, forms the core of an

expansion strategy—but prioritization must be customized for individual companies. The prioritization for a luxury goods brand targeted at sophisticated upper-affluent consumers will be very different than for FMCG (fast-moving consumer goods) companies whose products are purchased by many or all income segments. Companies that use generic schemes for prioritization run the risk of misallocating funds on both the tactical and strategic levels.

Particularly misleading are schemes that follow the Chinese government's hierarchy of city tiers, in which county-level cities are in a lower tier than are prefecture-level cities. Such a scheme would place the eight prefecture-level cities of Yunnan province in a higher tier than all of Jiangsu's 27 county-level cities, even though the average disposable income in those 27 cities is higher today than that of even the wealthiest of Yunnan's prefecture-level cities. Such a system would also give too low a priority to the 1,600 counties, many of which have larger and wealthier urban populations than some official cities.

Instead of relying on off-the-shelf tiering schemes, companies should combine an understanding of consumer spending behavior (by product category) with BCG's population forecasts in order to prioritize their expansion locations in the most meaningful way for their business. A good approach is to choose a time horizon—2015 or 2020, for example—and estimate the potential market size for a particular product category in that year by combining spending and population data for each income segment and then ranking cities, clusters, or provinces accordingly. This will yield a far more valuable prioritization.

### **Aligning Expansion Priorities with the Business Model and Competitive Landscape**

Accounting for challenges beyond market size and the nature of scale economies is the last step. One source of complexity lies in the nature of the local competition. In many product categories, there can be strong local competitors that are active in just a few locations or a single province. A new entrant in the department store market, for example, will find that the most popular department store differs from city to city. Therefore, it should evaluate its competitors and consider whether to expand into places where the local competition is weaker.

Another source of complexity is the variation in tastes and customs across China—which could require a company to alter its product offering, emphasize different benefits, or manage a larger number of customized assortments. Food categories provide the starkest examples of varied regional tastes, with salty flavors preferred in the north, sweet and light flavors in the south, and spicy flavors further west. Usage patterns can also vary: in the north, most consumers install their washing machine in the bathroom, whereas in the south, the preferred location is on the apartment balcony. These complexities add a final, sometimes qualitative, lens to prioritizing, because success may be more likely in a location or cluster where an existing product portfolio is particularly suited to consumer tastes, or where the primary competitor is weaker.

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Being in the right place at the right time is a challenge in China's shifting landscape. It requires syndicating intelligence—on how consumers shop, how fast incomes are growing, and how income will translate into spending by product category—and synthesizing that understanding into a rollout plan for competitive advantage. The final strategy will be different for every company because it must depend on a company's specific targeted consumers, product categories, sales and distribution system, marketing models, competitors, and economics. The decision process is neither easy nor quick, but that is not an excuse for shortcuts. The stakes are high—and success will depend on the rigor of the process and the clarity of the thinking that goes into it.

If your company is considering entering or expanding into new regions in China, the questions below will guide you in making the right choices in this very important decision.

- ◇ Do we know who our targeted Chinese consumers are and where they are likely to reside in the future?
- ◇ Do we know how far we will have to expand to profit from the growth of China's middle-class and affluent households?
- ◇ Do we know how rising incomes will affect growth in our specific product categories?

- ◇ Do we understand the source of our company's scale benefits and whether we should prioritize expansion plans by individual locations, clusters, or provinces?
- ◇ Have we anticipated China's high degree of complexity in managing a widening geographic footprint?
- ◇ Are there segments of rural China that represent an attractive additional market for our products?

To capture a strategic advantage in China's rapidly growing markets, companies need to act quickly but also thoughtfully and carefully. They must establish critical sales and distribution networks in areas where infrastructure is limited and distributors are narrowly focused. They must understand local cultural preferences and attack the weaknesses of local competitors. They must generate scale advantages in media buying and create early brand awareness. And they must leverage resources and expertise to maximize performance in the regions and city clusters they have chosen. The challenge is a serious one, but so is the reward: the golden key to China's outsize kingdom of consumer spending power.





# For Further Reading

The Boston Consulting Group publishes many reports and articles on China that may be of interest to senior executives. Recent examples are listed here.

## **China's Luxury Market in a Post-Land-Rush Era**

A White Paper by The Boston Consulting Group, September 2009

## **Lucky 8: Understanding and Capturing China's New Growth**

A White Paper by The Boston Consulting Group, July 2009

## **Sourcing Consumer Products in Asia: Managing Risk—and Turning Crisis to Advantage**

A Focus by The Boston Consulting Group, March 2009

## **The Next Billions: Unleashing Business Potential in Untapped Markets**

A report by the World Economic Forum in collaboration with The Boston Consulting Group, January 2009

## **China's Digital Generations: The 570-Million-Hour Opportunity**

A report by The Boston Consulting Group, July 2008

## **Foreign or Local Brands in China? Rationalism Trumps Nationalism**

A Focus by The Boston Consulting Group, June 2008

## **Creating People Advantage: How to Address HR Challenges Worldwide Through 2015**

A report by The Boston Consulting Group in collaboration with the World Federation of Personnel Management Federations, April 2008

## **Winning the Hearts and Minds of China's Consumers**

A Focus by The Boston Consulting Group, September 2007

## **Aligning Talent for Global Advantage: How Top Companies Develop the Right Talent in the Right Places**

A Focus by The Boston Consulting Group, September 2007 (revised November 2007)

## **The Quest for Defendable Scale in China**

A Focus by The Boston Consulting Group, December 2007





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