

McKinsey Consumer & Shopper Insights



2012 Annual Chinese Consumer Report
From Mass to Mainstream:
Keeping Pace With China's
Rapidly Changing Consumers



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Executive Summary



As living standards in China continue to advance, its vast consumer market is undergoing fundamental change. Most significant is the increasing manifestation of behavior and spending patterns typical of more affluent nations. A fast-growing segment of the population is becoming more self-indulgent in purchasing activity, more individualistic in wants and needs, and more loyal to favorite brands – even while maintaining some of the traits for which Chinese consumers are renowned, such as spending lots of time in stores comparing products. We anticipated this trend in our report “Meet the 2020 Chinese Consumer,” published last spring, which projected what would happen to buying habits and attitudes over this decade as the urban population became increasingly dominated by “new mainstream consumers” – those with incomes above RMB 106,000 (equivalent to \$16,000)¹.

A dichotomy is emerging, even more rapidly than we expected, between this segment and the broader mass of consumers who are still in the early stages of satisfying desires for goods and services that exceed basic needs. That is the principal finding of this report, which conveys the results of McKinsey’s annual survey of Chinese consumers.

Still by far a majority of the urban population are those exhibiting spending behaviors that have long been characteristic of Chinese consumers — that is, they are basic value seekers; they tend to take their purchasing cues from others; and although brand-conscious they lack sufficient sophistication about brands to become loyal to particular ones. But they will

¹ “New mainstream consumer” is the term we now use for those we called “mainstream consumers” in our “Meet the 2020 Chinese Consumer” report. “Mass consumer” is the term we now use for those we called “value consumers” in that report. All income cuts are in 2010 real terms for RMB and USD.

gradually be overtaken in number as more people reach mainstream levels of income — and the shift is starting to unfold with remarkable rapidity. Our survey data show consumers attaching much greater importance than before to emotional considerations such as whether products enhance their feelings of individuality and fulfill needs for self-expression. The data also show that in addition to having higher incomes, these types of consumers tend to be more prevalent in bigger cities and in the urban clusters along China's coast; they are also younger than the population as a whole.

Because the dichotomy between the two groups is materializing so rapidly, companies will have to adjust their marketing strategies with dispatch to serve both market segments, lest they fall behind in this must-win corporate battleground. Scale, speed and simplicity have been the key to success for many firms in China for the past 15 to 20 years, but capturing the rising generation of consumers over the next decade will require ensuring that products and marketing strategies are relevant to consumers' personal needs and wants. Instead of the big, trustworthy brands that many companies have used to good advantage up to now, more diverse portfolios of brands and niche products will be advisable — some with few frills but plenty of functional benefits, others that “speak directly” to consumers' emotions.

Other highlights of this year's survey include the following:

- Chinese consumers are a bit less optimistic about their futures in 2012 than they were last year. That dip in confidence should be kept in perspective, however. Compared with consumers elsewhere in the world, the Chinese remain extraordinarily positive regarding their prospects for enhancing their incomes. This bodes well for rebalancing the economy in a healthier direction, with greater dependence on consumption and less on business investment.
- At the same time, the propensity to save among Chinese is still very high, reflecting their concern about whether the nation's social safety net is adequate to protect their long-term financial security. But rising needs and changing lifestyles are translating into higher spending in a variety of categories. For example, as the Chinese get busier, they are buying more ready-to-eat food to save time. Notably, trading up — buying more expensive products and services — continues to be a powerful trend fueling the increase in Chinese consumer expenditures.
- Consumers prefer foreign brands in some categories, notably electronics, and prefer Chinese brands in others, such as personal care. But the good news for global companies is that the younger and more affluent consumers are, the more likely they are to favor foreign brands.

Introduction



Every year, as we prepare our annual report on Chinese consumers, we discover fresh reasons to marvel about the implications of China's fast-improving living standards. That is truer than ever in 2012. The Chinese economy's sizzling growth over the past two decades has infused consumers with bullishness about their futures — and that optimistic sentiment is dimming only slightly amid a slowdown in the pace of expansion. Our findings this year powerfully reinforce our hypothesis that the upshot will be fundamental change in Chinese consumer behavior; indeed, the survey data indicate that such a shift is well underway.

Hundreds of millions of consumers are still in the early stages of satisfying desires for goods and services that exceed basic needs, which means that the country's market offers the prospect of robust and rising demand for decades to come. Given how recently they have entered the consuming classes, the vast majority of them tend to use their newfound spending power in relatively unsophisticated ways — albeit with a high degree of pragmatism and value-consciousness.

But a remarkable phenomenon is unfolding among a rapidly-expanding segment of the population — millions who live mainly in wealthier cities and coastal areas, and whose incomes range toward the upper end of the scale. With surprising speed, these consumers are adopting spending behaviors and patterns that resemble those found in the affluent countries of North America, Europe and East Asia. They are fast becoming more self-indulgent in their purchases, more individualistic in their wants and needs, and more loyal to favorite brands. Although retaining typical Chinese traits — they search hard for the best deals, for example, and spend a lot of time in stores to compare products — these consumers

are acting more like their developed-country counterparts in key respects, a trend we predicted to emerge over the coming decade in a report we published last spring. That report, "Meet the 2020 Chinese Consumer," projected how buying habits and attitudes would change along with a surge in the numbers of those with incomes above RMB 106,000 (equivalent to \$16,000) — "new mainstream consumers," we call them, because they are set to become a majority of urban dwellers by 2020. The divergence between this group (which is still a minority) and the broader masses of consumers is shaping up as one of the Chinese market's defining characteristics.

Understanding and responding to the evolution taking place among China's consumers will be decisive in boosting the performance of companies — both international and domestic — that compete there. While scale, speed and simplicity proved highly advantageous during the past 15 to 20 years, and helped some companies achieve spectacular growth and attractive returns, winning the next generation of consumers over the coming decade will require greater flexibility and skill at ensuring that products and marketing strategies are relevant to consumers' personal needs and wants. Scale will certainly continue to matter — and as before we strongly encourage players to pursue depth of presence in priority city-clusters rather than breadth across the entire country. But this approach can't be implemented in the same way in the future as it is today. Devoting resources to one big brand, as many companies have up to now, will prove much less effective as consumers become increasingly divergent in tastes and levels of sophistication.

Since 2005, McKinsey's intensive study of Chinese consumers has included annual surveys that have extracted a trove of information from in-depth interviews with thousands of people — this year's sample was 10,000 people, aged 18 to 65, in 44 cities. Each year we have published a report like this one sharing our analysis of the survey and highlighting findings of potentially major import for consumer companies in China. Our work on these surveys has enabled us to identify key trends that will dominate the next wave of growth in the nation's consumer-goods market; that knowledge was distilled in "Meet the 2020 Chinese Consumer." This year's survey clearly shows how several of the most important trends spelled out in the 2020 report are materializing even faster than we had expected.

1. Setting the Context – The Chinese Economy and the Role of Private Consumption



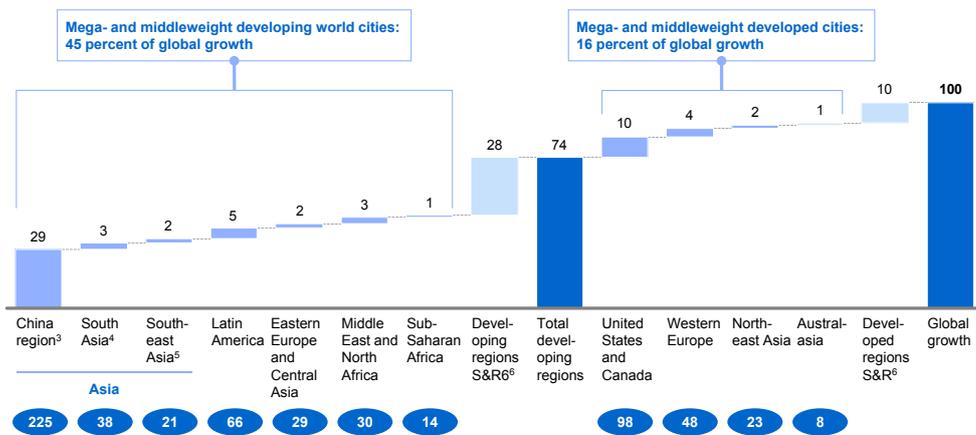
Much is riding on what China's consumers do in the years ahead. Although consumption has been rising briskly in China, it accounts for just a little over one-third of gross domestic product — in the United States, the fraction is more than twice as big — and increasing that share is essential for the sake of ensuring the sustainability of the nation's growth. The economy has become heavily dependent on investment spending by businesses, arousing fears that excessive capacity and unpayable debts are being created. That is why Premier Wen Jiabao has publicly described China's development as "unbalanced, unsustainable and uncoordinated," and why the government's current five-year plan is aimed at engineering a major shift toward consumption as a driver of growth.

China's growth is decelerating from the double-digit pace of recent years — McKinsey's updated macroeconomic model projects annual rates averaging about 8% for the remainder of this decade, slowing even further in later years. Even in a slower-growing China, however, consumer spending power will soar. The share of urban households with disposable annual incomes high enough to afford family cars and small luxury items will rise nearly six-fold during this decade, reaching about 57% of the total by 2020, according to our model. Although that will still leave Chinese per-capita disposable income at less than a quarter of the \$35,000 level currently prevailing in the United States, China will be the world's largest growth market by far for many years to come; the top 225 Chinese cities, by our estimates, will contribute 29% of global GDP growth over 2007-2025 (see Exhibit 1).

Exhibit 1

The top¹ 225 Chinese cities are on track to contribute 29% of global growth

GDP growth, 2007-2025² by geography
 100% = USD54.9 trillion



1 Top 225 cities ranked by their contribution to global GDP growth over the next 15 years
 2 Predicted real exchange rate
 3 Includes cities in China (including Hong Kong and Macau) and Taiwan
 4 Includes cities in Afghanistan, Bangladesh, India, Pakistan, and Sri Lanka
 5 Includes cities in Cambodia, Indonesia, Laos, Malaysia, Myanmar, Papua New Guinea, Philippines, Singapore, Thailand, and Vietnam
 6 S&R = small cities and rural areas

SOURCE: McKinsey Global Institute

With so many companies pursuing the Chinese consumer and with many of them having already expanded into the most important geographic clusters, competition is set to intensify as never before. The data and insights that follow are aimed at providing essential guidance to players in this must-win battleground for consumer-facing companies.

2. General Trends Among Chinese Consumers in 2012



Staying upbeat

The future looks a tad less rosy to Chinese consumers now than it did in 2011, as the percentage voicing confidence about their incomes declined in this year's survey compared with last year's. Still, the Chinese remain among the world's leading optimists regarding their economic prospects. That bodes well for economic rebalancing.

Asked whether they expect their household income to significantly increase over the next five years, 56% of Chinese respondents agreed, which is down from 60% a year earlier. That decline is understandable, given signs that the Chinese economy is slowing from the supercharged pace of recent years, and worries that economic troubles overseas — notably the crisis in the eurozone — may deal a fresh blow to the nation's export industries. After a decade of expansion averaging close to 11% per year, China's gross domestic product grew at a less-speedy pace of 8.1% in this year's first quarter and 7.6% in the second quarter, putting the country on track for its lowest annual growth since 1999. Even so, Chinese consumer sentiment is much more upbeat than it is in Western countries. Only 32% of U.S. consumers responded optimistically in 2011 to questions about their household's income over the next half-decade.

Spending more (while still saving plenty) amid changing lifestyles

As buoyant as the mood of Chinese consumers may be, they continue to stash away much of their money, reflecting their well-deserved reputation for thrift and the nation's lack of a strong social safety net. The average respondent to our 2012 survey reported saving 22% of monthly

household income, which is eight percentage points higher than the savings rate reported by American and British consumers in 2011.

At the same time, rising needs and changing lifestyles are translating into higher spending in a wide variety of categories. Nearly half of the survey respondents said they spent more on electronic appliances such as televisions, 42% said they spent more on jewelry, watches and personal digital gadgets, and more than a third reported spending more on mobile phones. As the Chinese get busier, they buy more pre-cooked food to save time — with 26% saying they did so more often over the past year than before. They are also taking more time to enjoy themselves: Thirty-four percent of the respondents said they had spent more on dining out, and higher spending on leisure and entertainment, as well as travel, was reported by about a quarter of them.

At the same time, the Chinese are becoming increasingly health and eco-conscious. This year, 48% reported eating less fried food or western fast food, a further increase from last year's survey though it is about ten percentage points below the numbers in the United States and Great Britain who said they were cutting back on the consumption of such food. And 44% of Chinese respondents said they were willing to pay more for products that are good for the environment, which is also above last year's figure and even higher than the 37% of Americans and 33% of Britons who expressed such environmentally-oriented sentiments in 2011 surveys.

Higher spending: a variety of types and reasons

Inflation, a growing problem in China in recent years, was an important explanatory factor for higher spending in a number of categories. Food was the category where inflation hurt the most; 80% of the respondents who said they spent more on food cited higher prices as the main reason. For alcohol and cigarettes, inflation was cited by 59% as the principal reason for higher spending, and for clothing, the share blaming inflation was 56%. But in other categories — home appliances, jewelry, and electronic products among them--one-third or less of those reporting higher spending cited inflation as the main factor. Put another way, at least two-thirds of the consumers who reported higher outlays in those categories were spending more in "real" terms.

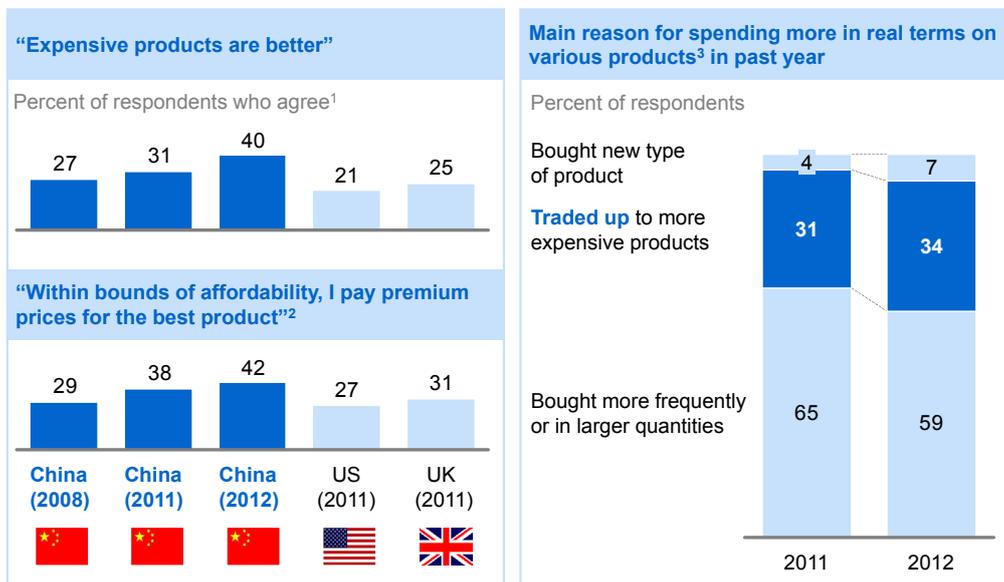
One major reason for higher real spending was that consumers bought products more frequently or in larger quantities. This explanation was given by 59% of the respondents who reported spending more for causes other than inflation, while 7% of this group said they were buying products in entirely new categories.

Most notably, trading up — buying more expensive products and services--continues to be a powerful trend fueling the increase in Chinese consumer expenditures. Among those who reported higher spending in real terms, 34% cited trading up as the main reason. A related development was an appreciable rise in the number of consumers expressing willingness to pay premium prices for good quality. Those saying that they "always pay premium prices for the best product, within the bounds of affordability," rose to 42% of all respondents.

That is four percentage points above last year, and considerably higher than the share of Americans (27%) and British consumers (31%) who gave similar responses in recent surveys (see Exhibit 2).

Exhibit 2

Chinese consumers continue to trade up



¹ Adjusted scores of strongly agree or agree

² Weighted average of Food and Consumer electronic categories

³ Covers 12 categories: food, beverages, alcohol, dining out, personal care, apparel, home care, health care, public transportation, telecommunications, leisure & entertainment, and housing & utilities. Excludes responses of those attributing higher spending to inflation

SOURCE: McKinsey Annual Chinese Consumer Survey (2008-2012); Online Benchmark Survey (2011)

Leisure and entertainment was where a lot of trading-up occurred--and considerably more than in 2011. Nearly one-third of those who reported higher real spending on leisure and entertainment said they had traded up, a significantly higher figure than the 19% who reported doing so last year.

Reasons behind increased spending vary depending on product categories, but also by city tiers — that is, the different groupings of Chinese cities, which we rank using a formula based largely on GDP and population. Take food for example: in “tier 1” cities, the metropolises with the biggest population and economic output (Beijing, Shanghai, Guangzhou and Shenzhen), 8% of respondents said they were spending more because they were trying out new products, a sharp increase from the 2% who said so in 2011. But in tier 2 cities, there was a big jump in trading up, with 39% citing that reason for spending more, compared with 29% in last year’s survey. By contrast, the dominant factor in tier 3 and 4 cities was spending with increased frequency and on greater quantities. That reason was cited by 67% of the higher-spending tier 3 consumers (up from 65% in 2011) and 58% of those in tier 4 (up from 56%).

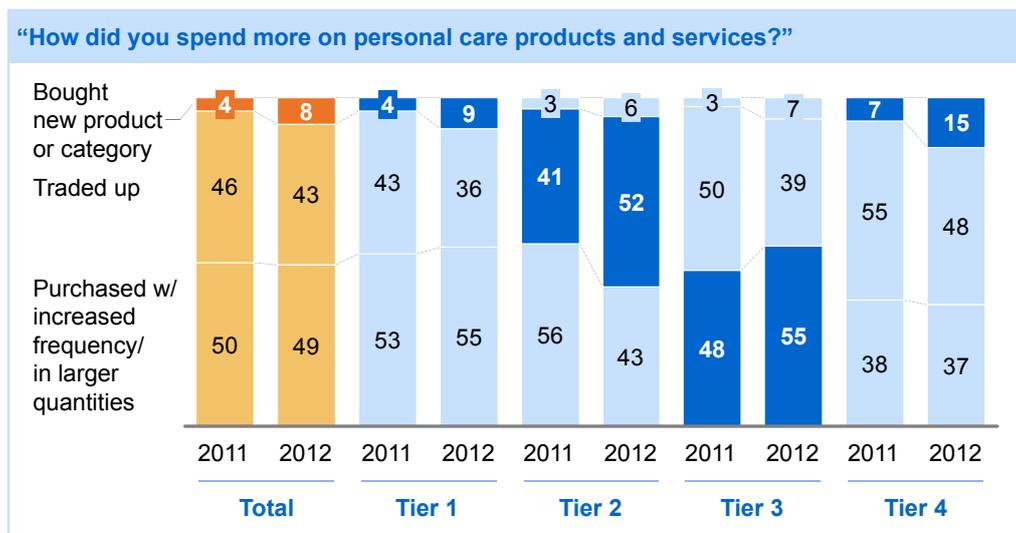
Interestingly, in personal care, more consumers in tier 1 and 4 cities were trying out new types of products, with the share citing that reason doubling to 9% in tier 1 and to 15% in tier

4. Higher-spending consumers in tier 2 cities were predominantly trading up; that factor was the main reason cited by a 52% share of them, up from 41% in 2011. Meanwhile, in tier 3, the lion's share of higher spending was attributable to consumers buying larger quantities more frequently — a 55% share named that reason, up seven percentage points from last year. To be sure, trying out new products may involve an entirely different form of consumption in a lower-city tier than a higher-tier one. In tier 4 cities, many consumers are making their first purchases in basic categories — skin moisturizers, for example — whereas in tier 1 cities, many are venturing into niches such as anti-aging creams. (see Exhibit 3).

Exhibit 3

Reasons for spending growth vary by city tier

PERSONAL CARE PRODUCTS



SOURCE: McKinsey Annual Chinese Consumer Survey (2011-2012)

These findings suggest that companies should consider focusing more heavily on product innovation in tier 1 cities. Meanwhile, in tier 2 cities — where many firms have been offering lower-end products on the assumption that affordability will boost sales — the data indicate that it is becoming advisable to upgrade product portfolios.

3. The Rapidly-Emerging Dichotomy in China's Consumer Class



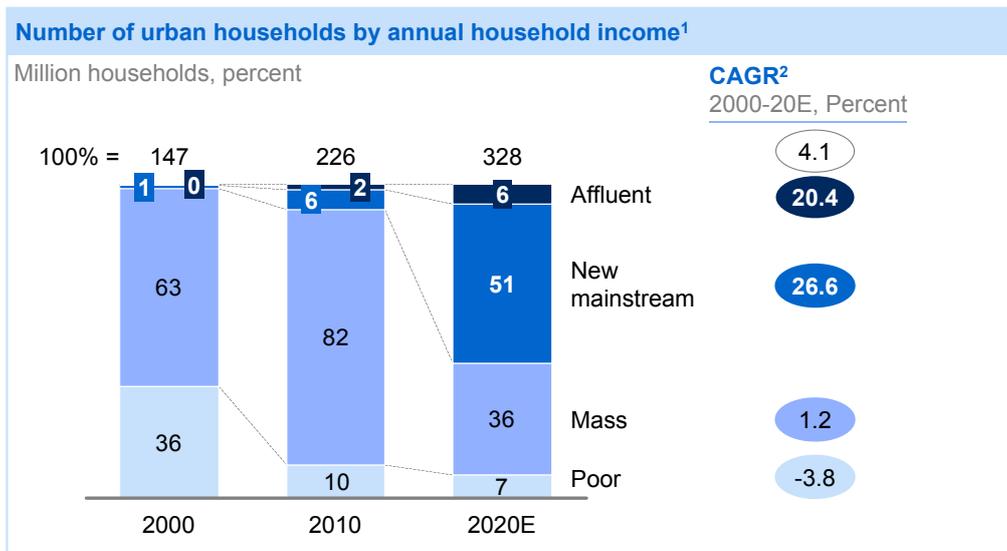
Beyond the current optimism and increased spending by Chinese consumers, our survey reveals a trend of more lasting and major significance — the growing manifestation of behavior usually associated with consumers in developed countries. Interest among Chinese in products that appeal to their individuality is clearly on the rise, as is loyalty to brands that they like. The consumers who exhibit these characteristics tend to have incomes well above average; they tend to be younger than the overall population; and they live mainly in wealthier cities, most of which are located along the coast of China. Although their numbers are increasing at eye-popping speed, they are still outnumbered by others whose behavior has yet to evolve in this manner. The result is a widening dichotomy that will oblige many companies to thoroughly rethink their strategies for tapping this vast market.

Readers of our report “Meet the 2020 Chinese Consumer” will have known that these developments were in the offing. As explained in that report, more than four-fifths of China’s urban population currently consists of “mass consumers,” whose RMB 37,000 to RMB 106,000 in annual household income (equivalent to \$6,000 to \$16,000) gives them just enough to cover basic needs. But by the start of the next decade many mass consumers will have graduated into the class of new mainstream consumers, with incomes of RMB 106,000 to RMB 229,000 (equivalent to \$16,000 to \$34,000) — the level at which family cars and some other luxuries become affordable. Indeed, if China’s growth trends unfold as projected, the new mainstreamers will comprise nearly 400 million people by 2020, making them the standard setters for the nation’s consumption (see Exhibits 4 and 5).

Exhibit 4

New mainstream consumers will comprise more than half of all urban residents by 2020

URBAN CHINA



¹ Brackets are defined by disposable income per urban household per year, in 2010 real terms: affluent, more than RMB229,000 (equivalent to \$34,000); new mainstream, RMB106,000 to RMB229,000 (equivalent to \$16,000 to \$34,000); mass, RMB37,000 to RMB106,000 (equivalent to \$6,000 to \$16,000); poor, less than RMB37,000 (equivalent to \$6,000)

² Compound Annual Growth Rate

SOURCE: McKinsey Macroeconomic model update (Apr. 2012)

Exhibit 5

New mainstream consumers vs. Mass consumers: A comparison

		New mainstream consumers	Vs.	Mass consumers
Who they are	 Household income	↑ RMB106-229K		RMB 37-106 K
	% of consumers below age 35	↑ 45%		37%
Where they live	% of consumers living in tier 1 & 2 cities	↑ 74%		43%
	% of consumers living in inland clusters	17%		↑ 36%
What they are looking for	Durability ¹	36%		↑ 61%
	Emotional benefits ²	↑ 23%		15%
How they spend their money	Willingness to pay a premium ³	↑ 49%		39%
	Trading up ⁴	↑ 39%		21%

¹ 1 % of respondents who cited "durable" as one of the top 5 key buying factors in smart phone purchases

² 2 % of respondents who felt emotional benefits (e.g., "shows my taste") were an important consideration in choosing a mobile phone

³ 3 % of respondents who say they "pay premium price for the best consumer electronic products, within bounds of affordability"

⁴ 4 % of respondents who spent more in real terms (i.e., for reasons other than inflation) by trading up for white home appliance

SOURCE: McKinsey Annual Chinese Consumer Survey (2012)

Accordingly, we identified several of the most salient behavioral patterns that we expected to observe in new mainstream consumers as wealth rises. Not all of these traits involve departures from their past behavior; we predicted that these consumers will remain quintessentially Chinese in their pragmatism. Behavior for which the Chinese are renowned — seeking good value for money, resisting impulse buying, and spending considerable time researching purchases—will continue to distinguish them. But we also foresaw a transformation toward more consumption of the sort typified by westerners — and if anything, we underestimated how quickly evidence of these patterns would come to light.

An increasing emphasis on emotional considerations in driving consumer behavior was one of the most important of these trends. A few years ago, the Chinese were novices in the world of consumption, so they overwhelmingly sought basic functional benefits in their products. In apparel, for instance, they wanted comfort; in food and beverage, they craved taste; in consumer electronics, they prized durability. More recently, their discernment has grown, leading them to emphasize qualities such as health and well-being in the food they bought. By 2020, we predicted, the sophistication of Chinese consumers would advance to the point where the majority would be strongly affected by factors such as whether a product reflects the user's sense of individuality.

Striking signs of movement toward these behavioral attributes are apparent in the 2012 survey. The results show a sharp increase in the number of consumers who say they “would like to spend on personal care products for self indulgence” — 37% this year, versus 25% in 2011. When asked whether an important factor in their home-care purchases was “making me feel I am taking good care of my family,” the number agreeing rose by ten percentage points, to 39%. Likewise, there is a continued rise, from 38% in 2010 to 43% in 2012, in the number of consumers who agree with the more general statement, “I am willing to spend more on products and services to reward myself.” That figure is just a few percentage points below the number of Americans and Britons who agree with that statement.

Intensified loyalty to brands is another trend that our 2020 report projected. Despite their well-known affinity for brand-name products, Chinese consumers have shown far less proclivity than their western counterparts to sticking with particular brands; they tend to choose from among a repertoire of favorite labels. This will change, we forecast, as companies increasingly promote the emotional benefits of their products to differentiate themselves from competitors, and as consumers gain more knowledge about what makes their favorite brands distinctive. Here again, the 2012 survey suggests that this shift is starting to occur over a remarkably short time horizon. The proportion of consumers describing themselves as tending to purchase the same brand in the food and beverage category soared to 35% in 2012, compared with 26% in 2011. In personal care, the increase in brand loyalists was even greater — 43% this year, vs. 31% last year. Among consumers of chocolate, one-third of those surveyed this year agreed with the statement “I only buy my favorite brand,” whereas only one-fifth said so in 2009 (see Exhibit 6).

Exhibit 6

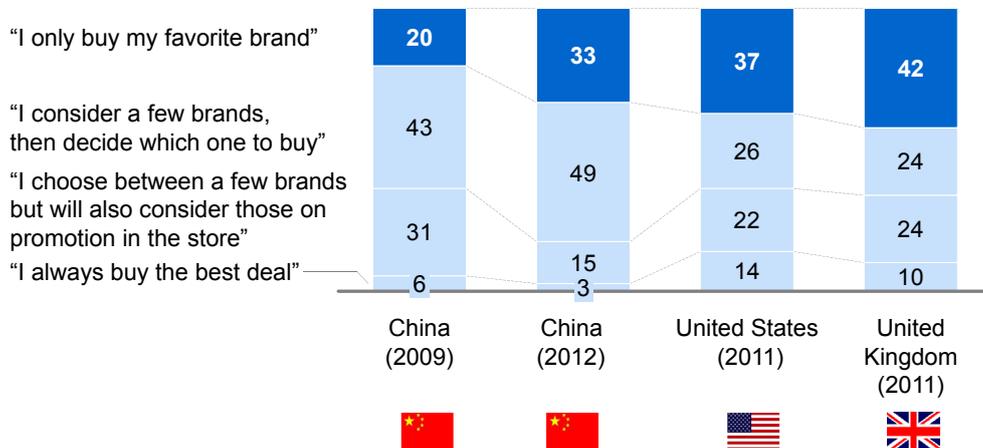
Brand loyalty levels are getting close to those in developed countries

EXAMPLES

Percent of respondents



Chocolate



SOURCE: McKinsey Annual Chinese Consumer Survey (2009-2012); Online Benchmark Survey (2011)

Yet another forecast from our 2020 study was that consumers will spend less time in stores, using other channels — notably the internet — for their purchases. This would be a sharp and important break from the past; the Chinese have embraced shopping as a form of entertainment, often bringing their families to wander through newly-built hypermarkets. As time goes by, we predicted, this love of “retail-tainment” will surely ebb as the novelty of mall trips wears off, other entertainment options arise and convenience becomes increasingly paramount for busy city dwellers. The 2012 survey reflects no diminution so far in the Chinese affinity for retail-tainment; 40% of participants described shopping as one of their “favorite leisure activities,” which was even higher than the 35% who said so last year. But that doesn’t undercut evidence showing online shopping on a steep upward trend; the number reporting that they have used the internet for purchases rose to 20% this year, up from 12% to 14% in surveys taken over the past three years. That figure helps explain why Alibaba Group, China’s largest e-commerce firm, expects that more merchandise will be sold on its Taobao site this year than on Amazon.com and eBay Inc. combined.

Who are these increasingly cosmopolitan and individualistic consumers, what sets them apart, and where can they be found? Digging deeper into the survey data provides useful revelations about the dichotomy between these consumers and those who still exhibit more traditional consumption needs and behaviors.

Income: it explains a lot, but not all

Divide China's urban consumers along income lines, and it soon becomes clear that the new behavior described above is emerging in tandem with rising affluence and longer experience in consumer markets. Conversely, more traditional Chinese consumerism — which reflects eagerness to fit in with others, and a strong emphasis on basic product benefits — is associated with lower incomes and newness to the world of consuming.

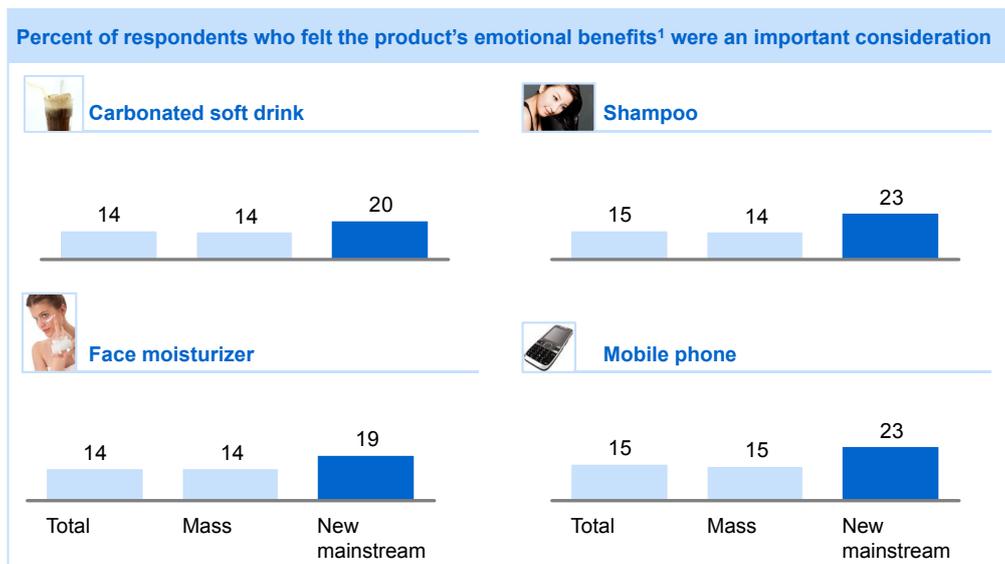
With their higher incomes, new mainstream consumers are naturally more seasoned shoppers than their compatriots in the mass segment. Nearly three-fifths of new mainstream consumers have bought digital cameras, compared with just 37% of mass consumers. Similar patterns prevail for laptops, which have been purchased by 51% of new mainstream consumers but only 30% of mass consumers; and for laundry softeners (56% new mainstream, vs. 34% mass). First-time purchasing in basic product categories is much more prevalent among mass consumers. Of the mass consumers who reported spending more on kitchen appliances, for example, 69% attributed it to a first-time purchase, whereas only 24% of new mainstream consumers did.

Disparities are correspondingly stark in attitudes about the features that make a product attractive. Basic functional benefits appeal to mass consumers, two-thirds of whom mention “durability” as one of their top five buying factors for a washing machine, compared with less than half of new mainstream consumers who cited it. When it comes to buying smartphones, durability is one of the top five factors for 61% of mass consumers, but only 36% of new mainstream consumers. Unsurprisingly, “low price” is an oft-cited factor for mass consumers; they are roughly twice as likely as new mainstream consumers to cite it as a major consideration for products such as laundry detergent, smartphones and instant noodles.

What, then, stimulates the purchasing instinct among new mainstream consumers? Emotional benefits are becoming increasingly important to them; they are more than 50% likelier than mass consumers to cite such considerations (“showing my taste,” “makes me feel that my family is living a better life”) when asked how they choose shampoo or mobile phones (see Exhibit 7).

Exhibit 7

Emotional considerations more strongly influence the purchasing decisions of the new mainstream consumers EXAMPLES



¹ Includes "shows my taste", "shows my status", "makes my life easier," "makes me feel that my family is living a better life", "energetic", "shows I am fashionable," "makes me feel I am fitting in with others"
 SOURCE: McKinsey Annual Chinese Consumer Survey (2012)

But income levels do not account for all of the dichotomies that we are finding in Chinese consumer behavior. In some ways, fairly similar responses to key survey questions come from these two major groups. New mainstream consumers are more likely to have become brand loyalists, but not by a huge margin; for example, 43% say they prefer to buy the same brand of consumer electronics, compared with 39% of mass consumers who say so.

Bright lights, big city

Another key explanatory variable of consumer behavior among urban Chinese is location — the type of city where they live. This presumably stems from network effects. When a major share of consumers in a city starts to enjoy mainstream-type purchasing power, factors such as peer influence, and the greater availability of higher-quality goods, drive behavioral changes on a broader scale than just among those whose incomes have risen.

China's tier 1 cities are where incomes and spending power tend to be the highest, and they thus provide a preview of how other cities are likely to change. As can be expected, they spend more, especially on discretionary categories. The monthly spending that consumers reported on dining out was 35% higher in tier 1 cities than in tier 2 cities, nearly 50% higher than in tier 3, and 77% higher than in tier 4. For personal care, tier 1 consumers reported spending amounts that were 30% higher than their tier 2 counterparts, 42% higher than in tier 3, and more than double the tier 4 levels. A similar pattern pertains in travel: Spending in this category was one-

third higher among tier 1 consumers compared with tier 2 consumers, and nearly two-fifths higher than tier 3 and four-fifths higher than tier 4.

Now consider the differences in the ways consumers responded to our questions about their needs and tastes. Emotional needs and individuality were substantially more important for consumers in Tier 1 cities, where 21% said “showing my unique taste” is one of the key factors influencing their buying decisions, in the flat panel television category, compared with only 7% to 11% in other cities. A Tier 1 consumer is more likely, for example, to express willingness to pay more for attractively-designed consumer electronics products. Innovative designs are less likely to work in lower tier cities, where consumers attach less importance to design —and might even trust a simpler one because it symbolizes basic reliability.

By contrast, “value for money” is a more important key buying factor among lower-tier consumers than those in Tier 1 cities. When it comes to buying shampoo, more than two-thirds of the respondents in lower tier cities said they attach high priority to whether their entire families can use the shampoo they buy; only about half of the Tier 1 consumers said the same. For facial moisturizers, only 23% of those in the biggest cities deem it important for the product to be usable by their families, whereas in lower-tier cities the number ranges from 37% to 44%.

Brand loyalty is also materializing at a markedly higher rate in Tier One cities than elsewhere. More than two-fifths of consumers in those cities say they buy only the brand of soft drink that they prefer; about a quarter of respondents in lower-tier cities say the same. The responses are very similar regarding loyalty to mobile phone brands.

A tale of two clusters

Important though city tiers may be, a better lens through which to analyze consumer behavior in China is often the city cluster. Our 2009 consumer survey introduced the McKinsey ClusterMap, which was designed to help companies organize China’s 815 cities into two dozen or more clusters, consisting of as few as two and as many as roughly 70 neighboring cities. As we explained in that report, those clusters are defined not only by income and geographic location, but by economic linkages, cultural similarities and common consumer attitudes and preferences. The differences between clusters can be enormously significant, even between some that are geographically close--the booming southern cities of Guangzhou and Shenzhen offering one of the most striking cases. Whereas in Guangzhou people speak primarily Cantonese, are older and enjoy going out to restaurants with family members, residents of Shenzhen tend overwhelmingly to be migrants under 35 who speak Mandarin to communicate across local dialects and prefer to drink in bars.

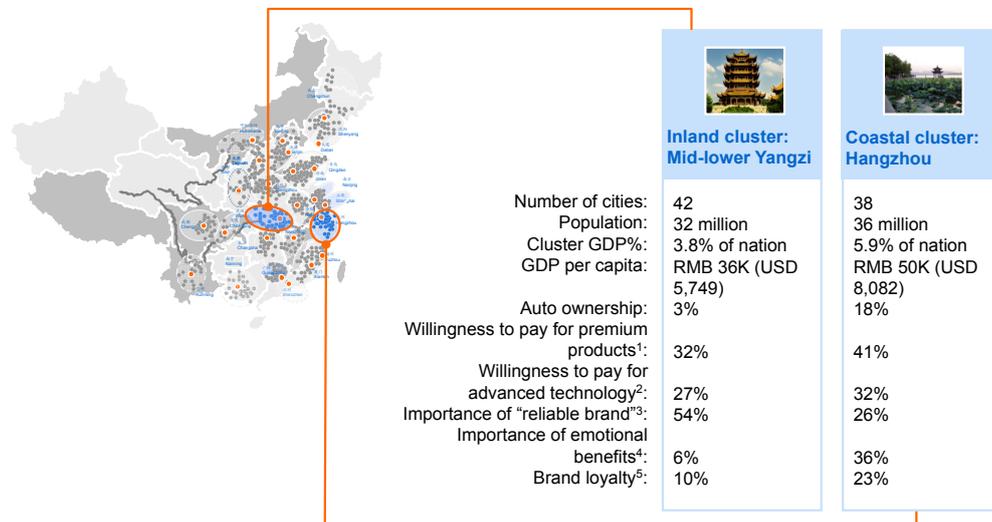
Sharp differences continue to exist across most clusters. This year’s survey shows that developed-country behavior patterns tend to be much more prevalent in clusters along the coast--where the economy has been prospering for a much longer period of time — than in clusters located inland. Again, network effects presumably account for a major portion of this phenomenon. Although some of the differences between coastal and inland clusters might be attributed to the fact that all the tier 1 cities are coastal, differences are wide even between

coastal and inland clusters containing no tier 1 cities — as the following comparison of two such clusters shows.

The Hangzhou cluster lies along China's Eastern coast, south of Shanghai, and along with scenic Hangzhou it includes the bustling seaport of Ningbo; its GDP in U.S. dollar terms is roughly the size of Finland's. It exemplifies many of the trends we identified in our report about Chinese consumers in 2020; in this cluster, consumers have become more individualistic, less concerned about the opinions of others, more likely to be influenced by emotional factors in making product choices and more likely to develop brand loyalty. These consumers stand in vivid contrast with those of the Mid-lower Yangzi cluster, whose main city, Wuhan--central China's most populous--lies about 700 kilometers to the west of Hangzhou. In this inland cluster, whose GDP is roughly the size of Romania's, consumers remain concerned primarily about reliability and other functional benefits (see Exhibit 8).

Exhibit 8

Consumer needs vary significantly in different clusters, in particular coastal versus inland clusters



1 % of respondents who are prepared "to pay premium for the most expensive and best electrical household appliance, within bounds of affordability"
 2 % of respondents who are "willing to pay more for a product with the latest technology"
 3 % of respondents who cited "reliable brand" as one of the top 5 key buying factors in instant noodle purchases
 4 % of respondents who feel the product's emotional benefits are an important consideration in purchasing shampoo
 5 % of respondents who only buy the brand they prefer in the ready-to-drink tea category

SOURCE: McKinsey Macroeconomic model update (Apr. 2012); McKinsey Annual Chinese Consumer Survey (2012)

Consider how consumers in these two clusters responded to questions about emotional connections to brands — that is, whether a product "shows my taste" or "makes me feel that my family is living a better life." The Hangzhou cluster's coastal consumers were seven times more likely than those in the inland cluster to view such factors as important in their decisions regarding their choice of soft drinks (37% vs. 5%), six times more likely in the case of shampoo (36% vs. 6%), and more than three times as likely regarding smart phones (47% vs. 15%).

Asked their feelings about the following statement--“I do whatever I like and disregard the opinions/expectations of others” — 30% of the Hangzhou cluster consumers agreed, twice as high a percentage as those in the Mid-lower Yangzi cluster. The coastal cluster consumers were also much more likely to see themselves as venturesome seekers of new products. In the case of consumer electronics, for example, 38% of the Hangzhou cluster group said they were “always the first among people around me” to try products when they are newly-introduced in the market, compared with only 9% of those in the inland cluster who said so. By a margin of 37% to 23%, the Hangzhou cluster was also more inclined to express willingness to pay extra for attractive design in electric appliances and gadgets.

Brand loyalty is another important trait on which the two clusters part ways. A Hangzhou cluster consumer is more than twice as likely (27% vs. 15%) to say “I only buy my preferred brand” of laptop computer; the numbers were almost the same for mobile phones.

Ask consumers in these clusters about basic functional benefits, and it is the ones from the Mid-lower Yangzi cluster who express the greatest enthusiasm. A “reliable brand” is among the top five buying factors for 54% of those inland consumers when they purchase instant noodles, more than twice as high a percentage as those who said so in the Hangzhou cluster. For laundry detergent, 49% of the inland cluster group ranked “reliable brand” highly among their buying factors, compared with 31% of the Hangzhou cluster consumers.

Furthermore, these disparities in attitude between the two clusters remain statistically significant even when consumers of similar income levels from each cluster are compared. By a ratio of well over two to one (29% vs. 12%), mass consumers in the Hangzhou cluster are more likely than mass consumers in the Mid-lower Yangzi cluster to concur with the statement about “doing whatever I like and disregarding opinions of others.” Nearly half of the mass consumers in the coastal cluster say they are willing to spend money on products and services to reward themselves for hard work; barely over a third of the mass consumers in the inland cluster say so. And while 54% of mass consumers in the inland cluster describe themselves as “actively sharing” opinions with family and friends about the products they buy, only 32% of mass consumers in the coastal cluster say that description applies to them.

The age factor: a little youthful indulgence

Finally, younger Chinese are more likely than their elders to manifest the characteristics of rich-country consumers. The variations by age are not nearly as pronounced as they are by cluster, but they show up clearly even within income groups. Among consumers whose incomes have reached the new mainstream level, 18 to 34 year-olds are more self-indulgent about their purchases, as witnessed by the larger share of them who said they enjoy spending for their own enjoyment on personal care products — 45% of them, compared with 37% of the new mainstream consumers who are 35 to 65 years old. Younger consumers within this upper-income group are also more likely, by a 41% to 31% margin, to say they always pay premium prices for the best products, compared with older consumers in the same income group.

Unsurprisingly, reliance on the internet is one factor that starkly differentiates young and old Chinese — again, regardless of income. New mainstream consumers in the 18-to-34 year-old group are nearly twice as likely as their elders in the same income group to research electronic appliances and gadgets on the internet, with 33% of younger consumers saying they regularly do so versus only 18% of those over age 35 (see Exhibit 9).

Exhibit 9

		New mainstream consumers		
		18-34 years	Vs.	35-65 years
Willing to pay		Willingness to pay for the best product ¹	↑ 41%	31%
		Willingness to pay for technology ²	↑ 42%	36%
Rising expectation		Desire for self-indulgence ³	↑ 45%	37%
Individualism		Expectation for products that meet specific requirements ⁴	↑ 39%	31%
Online activity		Need for Internet ⁵	↑ 44%	16%
		Intention to always check information online ⁶	↑ 33%	18%

1 % of respondents who "always pay premium for the best personal care products, within bounds of affordability"

2 % of respondents who are "willing to pay extra for a product with the latest technology"

3 % of respondents who are "willing to spend on personal care products to indulge myself"

4 % of respondents who feel it is "very important to receive targeted product information that is designed specifically for me/my requirements"

5 % of respondents who said they "cannot live without the internet"

6 % of respondents who "always check information online for consumer electronic products before purchasing"

SOURCE: McKinsey Annual Chinese Consumer Survey (2012)

4. Implications

Success stories in the Chinese market over the past decade have been all about scale — appealing to masses of value-hungry consumers. With the exception of luxury-goods firms that cater to the ultra-wealthy, the companies that have reaped the greatest rewards in China have built strong brands aimed at convincing consumers that their products offer the best value for money and basic benefits, especially reliability. In many cases, they have used an umbrella brand together with a number of sub-brands, and even when those sub-brands are aimed at different price points the underlying message is the same: Buy our brand, and you'll pay only for the tangible benefits that you want. Master Kong (Kangshifu), China's leading purveyor of packaged food, has executed this strategy well, selling an array of products ranging from instant noodles to drinks to cookies under the same brand. Multinational consumer-goods giants such as Procter & Gamble, Unilever and Coca-Cola emphasize their corporate identities on their products more in China than elsewhere, the goal also being to assure consumers that their brands represent big companies worthy of trust and offering excellent value.

For many companies, the time for overhauling these strategies is fast approaching, given this survey's findings that the behavior and attributes of Chinese consumers are changing more rapidly than expected. A very large and lucrative mass market will remain, especially in China's interior and its lower-tier cities, which companies can still target using much the same approaches as before. But focusing chiefly on this segment will mean foregoing the opportunity for much greater gains among consumers whose numbers and levels of sophistication are advancing by leaps and bounds.

To maximize returns in China, companies will have to devote enormous energy and resources to reaching both the mass and new mainstream sides of the consumer dichotomy. Although this will entail a different set of decisions and actions for each category and company, the most important element for almost all marketers will be the development of more diverse portfolios of brands and sub-brands. And for many, the market dichotomy may require an almost bifurcated approach—one aimed at winning over the rapidly-multiplying new mainstream consumer, the other aimed at appealing to the still-large population of mass consumers.

Winning in the new mainstream

With the desire to express individuality rising so quickly among this growing segment of the population, marketers will have to move fast to cater to consumers with brands that “speak directly” to their emotional wants. As obvious as that may be for high-involvement products such as autos, it applies with almost equal force to consumer staples such as milk and detergent.

Extensive research to segment the consumer base granularly will be an essential first step so that companies can attain an in-depth understanding of what fuels consumer excitement about products in the category in question. The next step should be to start rolling out niche brands and marketing campaigns, targeting first the cities and clusters where individualism is taking root earliest to see what works before expanding elsewhere. Value propositions will

have to be more crisply defined to connect with each sub-group of consumers and stand out from competitors. Brands and sub-brands that don't appear to be making strong connections should be pruned, so that the brand portfolio can be adjusted to allow for the introduction of new ones that may prove more effective.

Further efforts to bolster regional customization will be necessary for companies that may have recently established "local" product development centers to adapt global products for the Chinese market or develop them from scratch. These firms will need to more fully empower their regional teams, thereby allowing more flexibility in how they bring these products to market and in particular how they connect those products personally with consumers.

Maintaining mass appeal

Even if they are no longer in the majority of urban consumers by 2020, mass consumers will still constitute 36% of a gigantic market and generate 23% of its consumption. Ignoring this segment of the market could be a fatal mistake for companies; the firms that secure the trust of these consumers will stand the best chance of retaining their loyalty over the long term as they rise up the income ladder, grow in sophistication and demand products with more emotional considerations. Big trustworthy brands, offering fewer frills but plenty of functional benefits, will continue to be critical for capturing this segment.

Two major caveats are in order here. First, no matter how much more sophisticated Chinese consumers become, many of their ingrained traits will remain salient, including one that we have repeatedly emphasized in our research--the potency of the in-store experience. Chinese consumers are much more likely than consumers in developed countries to trust the recommendations of store salespeople, especially those they have gotten to know over the years in the myriad small shops that dot urban neighborhoods. Indeed, this year's survey shows a three percentage point rise, to 32%, in the number of Chinese consumers who say they trust salespeople. Retail execution is thus critical; in addition to creating strong tailored brands, companies still need to spend more than elsewhere to ensure that their products are attractively displayed in stores and shop personnel are incentivized to promote sales. Without effective execution at the retail level, the investment a company makes in its brands may be wasted.

Second, pursuing both the new mainstream and mass segments of the Chinese consumer market is a high-cost, and potentially high-risk proposition. The operational complexity of pushing a variety of brands, in multiple geographical locations and through several channels, will require exceptionally careful skill in planning and implementation. Keeping supply chains flowing smoothly under such circumstances will pose a huge challenge.

The payoff for getting it right, however, will be more than commensurate. Now that it's clear how dynamically the Chinese consumer market is advancing, consumer marketers need to position themselves to make the most of it.

Foreign vs. domestic brands

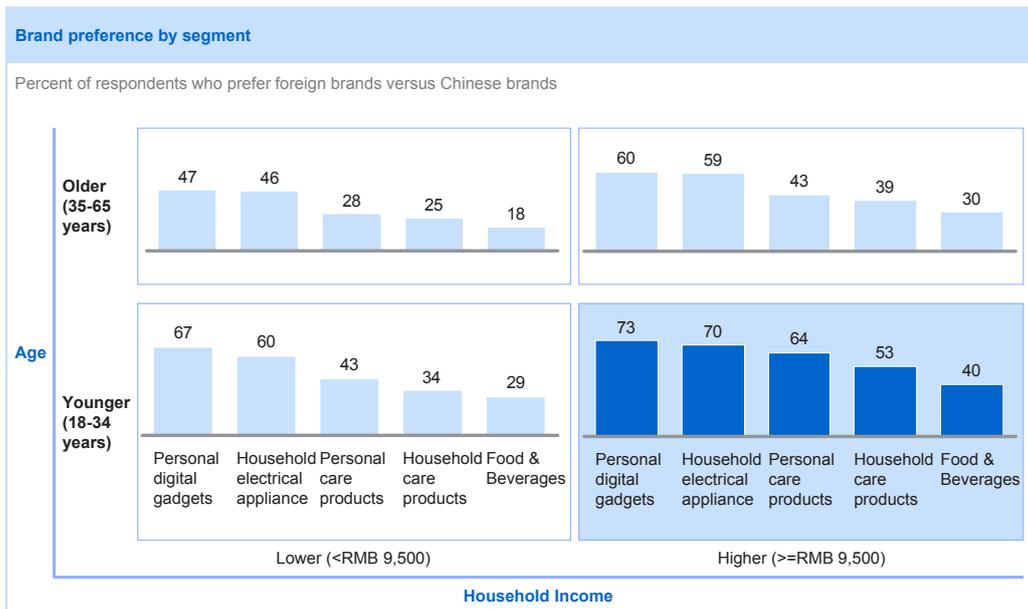
For multinational companies battling with local competitors to win the favor of Chinese consumers, our survey offers both encouraging news and some cautionary warnings to both categories of players. Overseas firms have a clear edge over domestic ones in some categories, notably electronics; more than half of the respondents say they prefer foreign brands of household appliances and personal digital devices over Chinese brands. But in other categories, foreign players face a distinct challenge. When consumers were asked about personal care products, household care products and food and beverages, the share saying they are partial to domestic brands ranged from 62% to 76%.

These preferences stem from differences that Chinese consumers discern in the strength of brands coming from different countries of origin. In our survey, we asked consumers to rate various foreign branded products (laptops and facial moisturizers, for example) against equivalent Chinese-branded ones. Their responses showed that they perceive global brands as strong at delivering sophisticated functional benefits, such as quality and advanced technology; local brands are perceived as offering good value for money and providing better understanding of Chinese peoples' needs. It is hardly surprising, then, that electronics should be a stronghold for foreign brands, while Chinese brands should have the upper hand in categories such as personal care. As for food and beverage products, although Chinese brands fared well in the survey, they are obviously vulnerable to fears that have arisen in the aftermath of scandals involving the contamination and adulteration of various food items. When we asked consumers about the key factors that influence their chocolate purchases, "safety" was the third most often cited factor — with 57% citing it, following only "good taste" and "healthiness."

Look more closely at how consumers differ by age and income, and promising signs emerge for global brands. The younger and more affluent consumers are, the more favorably disposed toward foreign brands they are likely to be. Among consumers aged 18 to 34 with monthly incomes above RMB 9,500, 64% prefer foreign brands for their personal care products, and even in the food and beverage category, the figure is 40%. Those ratios are more than twice as high as the comparable figures for older consumers with lower incomes. Since the tastes of younger, upper-income consumers presumably reflect China's future consumption trends, companies selling foreign brands may take heart (see Exhibit 10).

Exhibit 10

More affluent and younger consumers value foreign brands over local brands



SOURCE: McKinsey Annual Chinese Consumer Survey (2012)

To be sure, these survey responses don't necessarily predict how consumers will actually choose a brand when the time comes to spend their money. Moreover, the line between foreign and domestic brands is starting to blur somewhat, thanks to increasing foreign ownership or part-ownership of some famous Chinese brands. (For example, the Belgian-Brazilian beverage giant Anheuser-Busch InBev has bought the maker of Harbin beer, which is still positioned in the market as a domestic brew; another popular "local" beer, Snow, is brewed by a joint venture between China Resources Enterprises and the U.K.-based SABMiller.)

Despite the evidence suggesting that demographic and economic trends may favor their brands in the long run, multinational firms can hardly afford to relax in the face of challenges from domestic rivals. Chinese firms, notoriously weak in the past at building brands, are starting to become more skilled at it — Haier and Lenovo being two leaders in the electronics sector. Our survey shows for example that in the flat-panel TV market, a segment where foreign brands have long enjoyed premium reputations, the Chinese brands Changhong and Skyworth have made significant progress at converting relatively high levels of name recognition into growing numbers of consumers who say they would consider buying their brands and in some cases have already done so.

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McKinsey Insights China

McKinsey Insights China provides businesses with the data, analytics and rapid, customized problem-solving and decision-making support to help build robust strategies for China's rapidly changing marketplace. The data and analysis combine results from McKinsey's annual Chinese consumer studies with proprietary macroeconomic and demographic data and analysis from the McKinsey Global Institute (MGI).

McKinsey Insights China updates the macroeconomic models regularly – the national model every six months and city level model annually to retain the most recent view of the Chinese market at a highly granular level. These frequent updates ensure that the latest economic activities and policy changes are reflected in our forecasts of demographic, economic and consumption variables at the individual city level.

Since 2005, we have conducted the largest study of Chinese consumers on an annual basis. We have interviewed more than 70,000 Chinese consumers across over 60 cities, giving us a deep understanding of Chinese consumers' attitudes and spending behavior in more than 100 product categories. The respondents come from a wide range of incomes, ages, regions, city-clusters and city-tiers, and represent 74 percent of China's total GDP and 47 percent of the total population.

In 2008 and 2010, we conducted additional studies of over 3,200 wealthy consumers with annual household incomes in excess of RMB 250,000, giving us unprecedented insight into the behavior of this fast expanding and economically important segment.

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