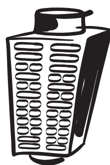

Hunting for Fortune In Postcrisis China

China has not been immune to the global economic downturn and some foreign investors are rethinking their strategy. Opportunities still exist, but investors may have to look in some less obvious places.

The Race for 'Small' Town China

by Bruno Lannes and Larry Zhu

A FUNNY THING HAPPENED to global consumer-products companies pegging future growth in China's biggest cities: competitors had the same idea. In Shanghai and Fuzhou, the retail space per household ratio now exceeds that of France and other developed countries. And the cost of advertising to stand out from the crowd is taking its toll on companies' operating margins in China, causing them to lag behind their global margins.

That's why multinationals have started looking to mainland China's more than 300 Tier-2 cities—120 of them have populations over one million—and approximately 1,200 county-level Tier-3 cities. The race is now on to sell in places like Yantai, Shaoxing, Wuxi, where middle-class incomes are rising the same way they rose in Tier-1 cities earlier in the decade. China's Tier-2 cities now represent about 88% of the country's GDP. As a group, those cities experienced a 12-fold increase in household disposable income per capita in the years 2002-06, while retail sales rose 79%. By comparison, in Tier-1 cities household disposable income rose 61% and retail sales increased by 80% in the same period.

China categorizes cities into the following administrative levels—four municipality directly under the Central Government (Beijing, Shanghai, Tianjin and Chongqing), 27 provincial capitals (Guangzhou, Hangzhou, Chengdu, etc.) and 310 prefecture cities. Within the municipality, provincial capitals and prefecture cities' territory are 856 city associated districts,

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369 county-level cities and 1,600 counties. When doing business in China, multinational companies adopt different ways to prioritize these city markets according to their specific criteria. A common approach is to put the four municipalities, 27 provincial capitals, and a handful prosperous prefecture cities such as Shenzhen, Dalian and Ningbo into Tier 1, the more than 300 prefecture cities into Tier 2, the 1,200 city associated districts & county-level cities into Tier 3, and 1,600 counties into Tier 4.

MODERN TRADE IS quickly making its way into these reaches as retailers, nearing the limits in China's larger cities, accelerate plans to expand into Tier-2. In October 2008, France's Carrefour announced it will open an outlet in Nanchong, in Southwestern China's Sichuan Province. It will be the first time the company set up business in a Tier-2 city since first entering the province in 1999. Meanwhile, U.S.-based Wal-Mart, watching consumers in its home market pull back on spending due to the economic slowdown, is targeting growth in China's smaller cities. Of the 30 stores the retail company opened in 2007, only two are in Shanghai and Beijing. While the global downturn has slowed China's growth to the lowest levels in five years, the country's November retail sales rose 20.8% over last year. China remains a bright spot for global retailers. At the start of 2009, consumer spending over the three-day New Year holiday increased 13% year-to-year, boosted by retail discounting. Only the luxury goods market experienced a decline. Development of modern trade from the likes of Carrefour and Wal-Mart is paving the way for branded goods.

Mars, Inc., the clear chocolate market leader in China—now sells its bars in 600 cities. But China's second land grab is trickier than the first, raising such issues as choosing from among hundreds of cities, determining the right product mix for regions that have not fully embraced modern trade, figuring out how to make the most of advertising investments in cities that lack scale, and crafting a distribution strategy that relies on the most effective mix of direct and nondirect distributors. Market leaders have learned that there's no one-size-fits-all strategy for China's second-tier cities. They're advancing into the mainland one city at a time. Here's how some of the most successful multinationals are doing it.

The appeal of China's smaller cities to MNCs is rapidly growing but there's no one-size-fits-all entry strategy.

- *Identifying only the best cities to enter.* Before setting foot in a new city, companies analyze the cost of competing by tackling such crucial issues as whether existing products need to be reconfigured or new products developed to meet the city's unique mix of traditional and modern trade channels. They also calculate the cost of advertising to establish their brands as market leaders, and assess distribution obstacles and opportunities. With this information in hand, consumer-product makers can then develop individual strategies tailored to each city or region's characteristics.

Unlike its competitors who launched expensive, rapid expansion throughout China based on city size and wealth, Shanghai Danone Biscuits targeted regional clusters, an approach that allowed it to maximize distribution, advertising, and product picks for local consumers. For example, after establishing itself in Shanghai in the late 1990s, Danone took advantage of the city's advanced distribution infrastructure to expand into about a doz-

en neighboring cities in the Jiangsu and Zhejiang provinces. Over the next several years, Danone built up distribution to about 25,000 outlets in the region. This cluster strategy allowed it to reduce advertising costs because ad buys in hub cities were seen by customers throughout the region. Danone also cut supply-chain costs by piggy-backing off its sophisticated Shanghai operation, within 350 kilometers of its Tier-2 and Tier-3 cities. And, it was much easier for Danone to tailor its product line to local tastes and streamline its offerings since consumers had similar preferences within the cluster. Before Groupe Danone's global biscuit business was acquired by Kraft Foods Inc., its share in eastern China was about 27%—twice the size of its nearest competitor.

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❋ *Determining the right mix of products for all trade channels*. After deciding to enter a city, companies need to select the right product mix given the population's local preferences and incomes, and determine how and where they should be sold. Historically, multinationals have ignored traditional outlets that cater to lower-end shoppers, but in smaller markets, traditional grocery stores and Mom-and-Pop stores capture a higher share of the wallet—and often yield higher margins. They also typically are less expensive to serve than modern channels, especially hypermarkets, which may come with such costs of Western-style retailing as listing fees, tougher trading terms and expected merchandising and promotional support. To reach shoppers in China's traditional channels, in 2003 L'Oréal acquired Mini Nurse, whose low-end cosmetics were sold through about 180 distributors and in 300,000 outlets throughout China. Before the acquisition, L'Oréal had low brand recognition in China's Tier-2 cities. By tapping into the Mini Nurse network and getting its products on the shelves of traditional stores, the company raised its national brand ranking from 11th place to second place.

❋ *Maximizing advertising spend by making the right trade offs*. As they enter Tier-2 cities, global companies also need to reassess where and how to invest their advertising. A company can advertise its brand in Tier-2 cities for less than half of what it costs in Beijing. It might be worth diverting funds to pursue market leadership in a smaller city—if the other signs are positive. By quantifying the level of competition and sales potential, companies can prioritize the most cost-effective cities in which to advertise and also determine the optimal mix of advertising and trade or consumer promotions. If anything's clear in China it's that consumer product companies can't afford the expensive mistake that many made in the past of focusing on a few cities where intense competition dilutes the impact.

In 2000, Mars started testing different marketing approaches in northeast China for Snickers, advertising in four targeted cities. By 2003, its Snickers bar had become the No. 2 chocolate brand in the region with 12% share. Based on Snickers' growing success, Mars expanded its rollout to other Chinese regions the following year, and advertising spend increased nine fold from 2000 levels. Snickers now is the clear No. 2

national brand in China, even though its advertising coverage is not yet national.

- *Identifying a direct versus nondirect distribution strategy.* Companies entering China's Tier-2: need to determine when it makes sense to sell directly to trade channels and when it's more effective to use wholesalers. Companies often achieve better service levels selling and distributing directly, but the volumes for Tier-2 cities may not justify going direct. Meanwhile, there are no national wholesalers in China, and barely regional ones. In fact, companies like Kraft and Mars each work with several hundred wholesalers. Companies often need to select more than one wholesaler or distributor for each city they want to enter, to cover different channels and city suburbs, or to accommodate the special relationships that some wholesalers have with retailers and not with others. Managing the wholesaler relationship becomes important because most wholesalers are not exclusive to a particular company's brands.

Mars, L'Oréal and a few other multinationals have lived by a mantra that many players are only starting to learn: you can't win in China without discovering how to win in places like Yantai, Shaoxing and Luoyang.