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China's challenges

From necessity to opportunity
in the next phase of Chinese
development

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China's challenges

In the 7th century A.D., Wei Zheng, adviser to the Tang dynasty Emperor Taizong warned the Emperor about the dangers of squandering surpluses. He warned the Emperor, "If a tree is to grow tall, it must secure its roots. If a stream is to flow far, it must secure its source."

Rapid GDP growth has made China stronger but has also made it vulnerable

Chinese politics has a long memory, and his words still reverberate around the Great Hall of the People in Beijing. They were quoted by Minister Zhou Shengxian in a recent article about environmental protection.¹

Rapid GDP growth has made China stronger, but also made it vulnerable; environmental degradation, resource pressures, production capacity gluts, real estate spikes and inflation all threaten its future prosperity. The challenge facing the Politburo in the coming decade is to ensure that growth can be sustained. In turn this means the imbalances in the economy need to be addressed.

The government is sensitive to instability. Premier Wen's announcement early last year that the Chinese government's growth target for the year had been reduced from 7.5% to 7% was an explicit recognition of these imbalances, while concepts such as 'circular economy', which seeks to decouple economic growth from resource use, have become entrenched in government thinking.²

Concepts such as 'circular economy', which looks to decouple economic growth from resource use, are now entrenched in Chinese thinking

The upside of these imbalances, however, is opportunity. There are a number of industries or sectors which have potential for growth over the coming decade, through a combination of government intervention and consumer demand. These will benefit from the Chinese government's attention to addressing three significant gaps in the way its economy functions.

These are:

- **quality control**
- **sustainability**, and
- **logistics.**

These are all problems created by China's long period of growth. But only by addressing them can growth be sustained at anything like the historical levels we have seen. This is not just about structures, but also about building trust in institutions.

This paper sets out to analyze the opportunities that will emerge as China sets out on this path. It will do this by combining macro driver analysis and The Futures Company's Global MONITOR 2011 China data.

1. Quality control

Just over two years ago, the Chinese government launched a television advertisement which was seen around the world. The ad, called 'Made in China', drew attention to the high quality goods made by Chinese manufacturers, including mp3 players, sports shoes, and jet engines.

The safety scandals have led to gains for foreign manufacturers, which benefit from well-established reputations, at the expense of domestic producers. Many use the safety message to Chinese consumers as a core marketing platform. Amway, for example, deliberately sells its cleaning products in

scandal swept China in early 2011, Yurun Food, one of China's largest meat manufacturers, invited 100 consumers from Nanjing to visit its food production plants and report back on the standards it enforces. Each was given a copy of Yurun's 400-page manual, covering every check built into the production process. Yurun officials taught the visitors about pig certification, slaughtering hygiene, liquid chromatography, microbial sampling and hand disinfection⁴. The company's forensic attention to detail received positive write-ups in the press and online, and reinforced the company's reputation for quality.

Western businesses are using the safety message as a core marketing platform

By the time it was screened, delayed by repeated manufacturing scandals, it appeared as if the government was on the defensive.³ Each scandal had led to a sharp drop in exports, and as a result the government introduced in 2009 the death penalty for food safety violators, passed a sweeping new food safety law and inaugurated a risk evaluation system capable of monitoring 500,000 companies.

smaller volume at a premium price in China to emphasise quality; it also takes generous margins by reducing the unit size. L'Oréal uses its own brand name for hair care products in China, rather than the Elsève tag that's used elsewhere, to emphasise reputation.

Some domestic brands, however, have responded well to the consumer need for reassurance. For example, after the clenbuterol pork

Similarly, in 2009, the Chinese company American Dairy (ADY) grew rapidly following the melamine milk crisis, because it had emerged from it with an unimpeachable record for quality. The company had highlighted this with an aggressive advertising campaign in early 2009, running on Chinese Central Television (CCTV) channels 1,

2, 3 and 6, and on six provincial channels across China.⁵

During the coming decade, the stage is set for an escalating marketing war. Many Chinese brands are attempting to extend their product ranges upwards to compete with multinationals, and Chinese consumers are willing to pay for reassurance, so perceptions of quality and safety will be vital.

In order to reinforce confidence in Chinese products, domestic brands will have to invest heavily in independent certification, scientific analysis, quality control and public relations. Transparency will be highly influential. Foreign brands, meanwhile, can sustain an advantage over local rivals by emphasizing reputation, resisting price pressure, and – potentially – by working together to develop, define, and promote independent quality standards.

These are investments that will pay for themselves, at least for the companies which succeed.

Quality control: implications

- **Transparency:** radical transparency will be a highly persuasive marketing tool. If a company has nothing to hide, it shouldn't hide it. Give consumers a window looking onto the farm, the production line, or the supply chain. When it comes to product safety, there's no such thing as too much detail.
- **Training:** during the next five year there will be rapid growth of the market for training to meet the hygiene and safety standards introduced in 2009. China is likely to import knowledge.
- **Certification:** although government certification is important, there is also scope to go beyond this by creating independent quality standards, to improve competitive

positions. Such standards can be promoted as a core benefit to consumers.

- **Margins:** the primacy of safety and quality make the Chinese market ideal for extending brands upwards, with smaller format sizes at higher price points.

Making the most of quality control



http://www.tetrapak.com/about_tetra_pak/press_room/news/Pages/ProductDevelopmentCentre.aspx

TETRA PAK:

In 2008, the Chinese dairy industry was in crisis after the melamine milk scandal. Consumers were migrating to foreign brands in the belief that they were safer. Although Tetra Pak was not responsible for the scandal, declining sales of Chinese milk brands meant that sales suffered. Actual growth for Tetra Pak was 5% in China in 2008, against a projected figure of 16%.⁶

Recognising that many Chinese dairy farmers lacked the expertise or technology to meet strict quality control directives, Tetra Pak now offers training for Chinese farmers, and produces DVDs and books about

safe farming methods. More than 30 of the farms that the company works with in China have now reached EU quality standards, strengthening the relationship the company has with these customers.⁷



<http://www.myrelaxplace.com/2007/07/29/lawyer-sued-mcdonald-for-not-displaying-chinese-on-receipts/>

McDONALDS:

At the start of 2011, McDonalds released an advertising campaign highlighting the conditions at its chicken farms in China. Making a play on the Chinese term for Wikileaks, the 'Chickileaks' TV campaign features a voiceover with the words,

"The process of growing up has no shortcuts." On the campaign's microsite, a wooden door opens slowly to show how McDonald's chickens are treated.⁸ The microsite also features videos of young reporters traveling to McDonalds' farms to report on the conditions they find there, and even eating the feed used to rear the chickens.

2. Logistics

The Chinese government has, for a long time, taken a particular interest in improving infrastructure. It is aware that an inefficient logistics sector will be a bottleneck that constrains development. The eleventh five year plan (2006-10) prioritized transport infrastructure, with provision for new roads and railways, airport expansion, and almost US \$2 billion to dredge the mouth of the Yangtze River for shipping.⁹ But growth has not been complemented by improved efficiency.¹⁰ And so - as well as making logistics a priority of the twelfth five year plan - the government is now drafting a long-term plan for infrastructure investment to 2020.¹¹

Nevertheless the costs of logistics remain high. Local protectionism, industry fragmentation and rising oil prices have contributed to this, further exacerbated by the scale and complexity of the Chinese market. One of the sectors that loses most from this constraint is e-commerce. Taobao.com, for example, saw its user base increase from

176 million people in 2009 to 370 million in 2010, becoming China's largest online retailer. But late in 2010, the company was taught a hard lesson about its logistical limitations.

In November of that year, Taobao Mall ran its inaugural 'Singles Day' promotion, offering 50% discounts to unmarried adults, causing a surge of activity on the site during which 21 million shoppers spent US\$147 million.¹² Retailers hosted by Taobao Mall were surprised by their own sales figures and found themselves unable to service orders in time, because of a lack of staff in their warehouses and couriers on the road.

The Singles Day problems were a chastening reminder of the weaknesses of China's transport and logistics infrastructure. Jack Ma, the Chairman and CEO of Taobao's parent company, Alibaba Group, has since announced a plan to spend US\$4.6 billion to build a network of warehouses across China, with the ultimate aim of delivering products to anywhere in the country within eight hours.

Similarly, 360buy.com, a consumer electronics specialist, plans to spend US\$1.2 billion on improving its in-house operations over the next five years. More than two-thirds of the US\$500 million development finance recently raised from investors will be allocated to logistics development.¹² Alibaba and

Rising disposable income in lower tier cities means that the commercial opportunities inland are becoming sizable

360buy aren't just spending to protect themselves. They've learnt the hard way that there's a massive opportunity in logistics in China, and the country's infrastructural gaps have presented substantial scope for diversification.

How does the growth of logistics investment affect foreign retailers and manufacturers? First, it opens up opportunities for them in lower tier cities. The received wisdom is that foreign companies should start on the east coast, and spread to the provincial cities after they have consolidated there. In the past, this has been sensible, precisely because poor distribution has meant that brands can be well-known in one part of the country, but unknown to consumers elsewhere.¹⁴ But rising disposable income in lower tier cities means that the opportunities inland are becoming sizable. For example, for Taobao, second and third tier cities make up eight out of the top ten fastest growing cities, in terms of sales.

Second, it means that foreign companies may increasingly find themselves in competition with local rivals for distribution resources. Foreign companies could find themselves at a disadvantage in new markets within China if they fail to match the distribution investment of local rivals.

Third, it promises to put a rocket under the Chinese e-commerce market. According to The Futures Company's Global MONITOR (GM) 2011 data, currently only 21% of Chinese consumers shop online once a week or more, but we expect this to grow strongly. Improved distribution will create a more democratic consumer economy in which people will remain limited by price but need not be limited by access.

The next eight years will see furious activity in the logistics sector, supported by government policy, during which a small number of forward-thinking companies will build a platform for their long-term future.

Logistics: implications

- **Think locally:** even as cross-country networks improve, distribution from a small number of warehouses on the east coast will be insufficient. Companies looking to capture lower-tier markets must invest in local infrastructure, through acquisition or partnerships.
- **E-commerce:** ambitious companies such as Alibaba Group are driving down delivery times, and driving up consumer expectations. The convenience and reliability offered by improved logistics will be a boon to e-commerce.
- **Pragmatism:** there is scope for marriages of convenience in the logistics sector. Both foreign retailers and third-party logistics companies should look to invest in local rivals in exchange for access to distribution networks.



Making the most of Logistics



<http://www.wal-martchina.com/english/index.htm>



<http://www.liqungroup.com/intro2.html>

■ Sustainability:

Sustainability needs to be built in to all logistics plans, because environmental protection is at the heart of the twelfth five year plan and green taxes were introduced at the beginning of 2011.

WAL-MART:

In May 2011, Wal-Mart announced that it had purchased a minority stake in Chinese e-commerce company Yihaodian. Yihaodian has its own logistics operations in Shanghai, Beijing and Guangzhou, offering overnight delivery services to customers in these three cities. This purchase confirmed Wal-Mart's intention to build up its multi-channel operations in China, and may be followed by further acquisitions.¹⁵

LIQUN GROUP:

Liqun Group is a conglomerate in Shandong province that controls 800 convenience stores, more than 60 chain drugstores, 34 office buildings, 9 luxury hotels, and over 100 subsidiaries and branch companies. Since 2001, the company has been moving towards building up its own logistics operations. It now has a large network of warehouses, distribution centers and refrigerated trucks. John Zhang, General Manager of Liquid Logistics Division, Liqun says that although third party logistics providers have improved their service since 2001, he still favors in-house logistics because it allows for tailor-made solutions.¹⁶

“Within ten years, anyone placing an order online anywhere in China will receive their goods in eight hours”

3. Sustainability and environment

"In China's thousands of years of civilisation, the conflict between humanity and nature has never been as serious as it is today. The depletion, deterioration and exhaustion of resources and the deterioration of the environment have become serious bottlenecks constraining economic and social development."¹⁷

China's environmental record gets a bad press, but the government is taking aggressive steps to improve its key environmental indicators through binding targets¹⁸. In particular, China now leads the world in clean energy technologies. In 2010, China's total clean energy investment was more than one fifth of the world's total of US\$243 billion.

for a 5 trillion RMB (US\$760 billion) investment in new energy to help to reduce carbon intensity by 17% to 2015. It has also set an ambitious target of reducing water intensity by 30% to 2015.¹⁹

The government is betting that improving efficiency will be as important as restraining growth, and that two-fifths of the energy savings targeted during the 12th five year plan can come from technological changes alone. If it succeeds, the bet will also create sustained advantage for China across a range of sustainability sector industries, including renewable energy, smart grid, I.T. efficiency, and LED lighting, in which China already leads the world.

In addition, seven key 'strategic emerging industries' are to be given favorable treatment by the government, with tax cuts and subsidies. These are energy efficiency, alternative energy vehicles, next generation information technology, biotechnology, new energy, new materials,

Foreign business need to assume that their sustainability standards in the Chinese market are as high as in their home markets

These are the words of China's Minister for Environmental Protection, Zhou Shengxian, published on his Ministry's website in February 2011. These words were unusual for their explicit reference to the economic limitations imposed by environmental degradation.

This level of investment is not sentimental. The government sees the environment as part of a system, with inevitable influence on manufacturing, agriculture, social stability and defence. The concept of 'circular economy', referenced earlier, reflects this. During the next ten years, the Chinese government has budgeted

China moved ahead of the US in 2010 to top Ernst and Young's index of the most attractive countries for renewable energy projects.

and high-end equipment manufacturing. The growth of these industries will be a boon to component manufacturers, energy service companies, solar cell manufacturers and a host of other B2B suppliers.

What do these targets mean for consumer goods companies?

There's an immediate impact on operations. Foreign businesses will have to assume that the sustainability standards they need to plan for in their Chinese operations are as high – or higher – than those in their home markets.

Second, these ambitious targets will inevitably lead to raised expectations of responsibility. China is attempting a bold retrofit of the economy, transforming

the way energy and resources are used in supply chains, factories, offices and apartment blocks. This will lead to heightened awareness of environmental impact. Even now, according to The Futures Company's Global MONITOR 2011 survey, 78% of Chinese people agree with the statement: "I expect the companies whose products I buy to take steps to avoid damaging the environment." We expect this figure to rise.

Crucially, however, most Chinese consumers do not believe that, as individuals, they are responsible for environmental protection. Only 34% (versus a GM 21 country average of 59%) agree that individuals are most responsible for tackling climate change. Because of

the influence of strong central planning, the government (and to a lesser extent business) is seen as having responsibility for both the sickness and the cure. This may change, but only slowly, as China's environmental policy moves on from shuttering coal plants to influencing everyday behaviors.

Finally, sustainability and environmental protection have an emotive link to health. The Global MONITOR data reveals that 77% of Chinese consumers say that concern about their own and their family's health motivates them 'a great deal' to live a more environmentally conscious lifestyle. Air pollution remains a particular hazard: 53% of Chinese people describe air pollution as 'one of their greatest concerns for the future.'²⁰ If consumer goods companies can forge a link between their own environmental protection programs and improved health outcomes for their customers, they will benefit.

Sustainability: implications

- **Surrogacy:** Because most Chinese consumers do not see environmental protection as within their control, they will respond well to brands that take on the burden for them and make commitments to offset the impact of using their products.
- **Health:** air pollution is the hated consequence of suburban industrial development. Brands which can contribute to alleviating this problem (automobile, white goods, new energy) should make their efforts explicit.
- **Supporting industries:** although the US government has been complaining that the market for components in hardware such as turbines, photovoltaic cells and smart meters is being informally protected by the Chinese government, the US is likely to benefit from the growth of a host of supporting sectors, including clean coal, water treatment and energy service companies.

Making the most of Sustainability



[http://inhabitat.com/coke-and-world-wildlife-fund-turn-classic-red-soda-cans-white-in-honor-of-endangered-polar-bears//](http://inhabitat.com/coke-and-world-wildlife-fund-turn-classic-red-soda-cans-white-in-honor-of-endangered-polar-bears/)

COCA COLA COMPANY CHINA:

Recognizing that water security is a pillar of its future survival, Coca Cola China has entered into a partnership with the WWF to improve water quality in the western stretches of the Yangtze River. Amongst the partnership's projects are schemes that involve working with farmers to prevent pig waste running into fresh water, and helping Chinese farmers to harvest sugar cane while using less water.

Haier

<http://www.haier.com/cn/>

HAIER:

In January 2011, the building management company Honeywell signed a memorandum of understanding with Haier, the Chinese white goods manufacturer, to work together to develop energy efficient solutions to everything from household appliances to home construction. The deal, signed in Chicago during the 2011 US-China Trade and Economic Cooperation Forum, gives Honeywell a footing in the Chinese market for energy efficiency, while offering Haier the opportunity to improve the efficiency of its own products.

Conclusion:

There is, clearly, much more that could be said about opportunities in the Chinese economy to 2020. This paper has focused on the three structural and institutional factors which we believe will have the most impact, and therefore offer the most opportunity. Quality control, logistics, and sustainability are all areas where the scale of the challenge is larger. They are all problems created by the sustained growth over the last three decades of disposable income, manufacturing, e-commerce, and heavy industry, and the government's decision to prioritize them is recognition that they are all barriers to continuing growth.

China's central planning model means that these industries will receive support through a combination of favorable legislation, taxation and investment. It is harder, however, to identify how the growth of industries such as logistics and renewable energy will affect broader consumer attitudes and behaviors. Over the period of the twelfth five year plan, and beyond,

The Government's decision to prioritize these three areas is a recognition that they are barriers to growth

The Futures Company will be tracking attitudes and behaviors related to these areas through our annual Global MONITOR survey, and the other analysis and insight in the MONITOR program. The body of data that we collect offers a way to track these attitudes and behaviors over time.

Currently, our data shows that 51% of Chinese respondents agree that they 'like to enjoy life and don't worry about the future'. The challenge for the government is to ensure that China's people can maintain this confidence over the next five year plan and beyond. Unlike Western governments, however, it has already shown a huge capacity to plan, and act, for the long-term.



Endnotes:

1. http://www.gov.cn/gzdt/2011-02/28/content_1812533.htm. Wei's proverbial stream, for example, makes for an appropriate metaphor; more than half of China's 660 cities suffer from water shortages. In the industrial city of Tianjin, residents have access to one tenth of the global average per capita water supply.
2. China and a Sustainable Future: Towards a Low Carbon Economy and Society. China Human Development Report 2009/10. United Nations Development Program, Beijing.
3. Including several recalls of lead-coated toys, exported to the US in 2007, the notorious melamine milk scandal of 2008, and an incidence of dumplings contaminated with insecticide that made 10 people ill in Japan in 2008.
4. <http://post.news.tom.com/DB001D44519.html>
5. Seeking Alpha, 'American Dairy: Finally Something Positive about Chinese Baby Milk', 22nd January 2009.
6. University of Exeter Business School, Morgan Witzel, 'A case of collaboration and sharing', 25th August 2011.
7. Ibid.
8. 'McDonald's Exposes 'Chickileaks' in China', Jerry Clode, AdAge Global, 31st March 2011.
- 9 'China's Key Transport Infrastructure Projects for 2006-10', www.gov.cn, 6th March 2006.
10. The ratio of total logistics cost to GDP only decreased by 0.5 percentage points between 2006 and 2010, from 18.3 per cent to 17.8 per cent. The USA, by comparison, had a ratio of 7.7% in 2010. 'China Logistics Industry Update 2011', Li & Fung Research Centre, May 2011.
11. http://big5.xinhuanet.com/gate/big5/www.cs.com.cn/ssgs/16/201107/t20110729_2986119.html
12. 'Discount craze tests Taobao's online mall', Caixin Online, 30th November 2010.
13. 'Walmart invests in 360buy.com', Supply Chain Times, 12th January 2011.
14. According to McKinsey & Co., for example, 97% of consumers in Chengdu and 87% in Hefei have heard of the beer brand 'SNOW', compared with just 4% in Nanjing and 9% in Guangzhou. 'The power of word of mouth in China', Harvard Business Review, May 2010.
15. After the Walton family invested in a \$1 billion venture capital fund to build up Chinese online retailer 360buy's logistics operations, 360buy Chairman and CEO Richard Liu expressed an interest in working with Wal-Mart on logistics operations in the future.
16. 'Taking control', Supply Chain Times, 14th July 2011.
17. http://www.gov.cn/gzdt/2011-02/28/content_1812533.htm
18. In this context, 'binding targets' means targets which the government use criteria for the promotion of provincial officials.
19. Carbon intensity is carbon emission per unit of GDP. Water intensity is water consumed per unit of value-added industrial output.
20. Economist Intelligence Unit, 'A better life? The wants and worries of China's consumers', 2010.

About The Futures Company

The Futures Company is the leading global foresight and futures consultancy. We are a team of consultants, researchers and futures experts who apply a foresight and futures approach to unlock new sources of growth for our clients. We offer a range of subscription services and research and consulting solutions. We have teams in the UK, US, Mexico, Brazil and Argentina and partnerships in China, India and Poland. We are a Kantar company within WPP.

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