
CHINA'S FMCG MARKET

LATEST TRENDS AND THE ROLE OF TECHNOLOGY

SUMMARY

China's \$190 billion fast-moving consumer goods (FMCG) market has acted as a caricature of changes going on in the country's wider economy. As mean incomes have ballooned, and the economy has begun to mature with slowing growth and a shift towards value-added industries, the tastes of consumers has similarly become more sophisticated, with luxury goods and personal care products driving growth in the market.

Retailers in turn face the prospect of revolutionizing their service provision and supply chains to meet the ever-growing demands of their customers and have found themselves caught in the high-speed arms race of "New Retail".

However, just as the country's economic growth is distributed unevenly, so too is the growth and nature of demand in the FMCG market. We see poorer regions in the West and South continuing as engines of growth in the market, but where effective distribution and retail strategies differ markedly from the big city powerhouses.

We also analyze an area where China is no longer playing catch-up with developed nations but has established clear dominance – that of mobile payments and fintech. Chinese households used their phones to pay for \$157 trillion of goods and services in 2016, with double-digit growth forecast for coming years. This combination of evolving consumers with a modern, competitive retail space make China's FMCG market a particularly interesting and valuable one to follow.

SECTION 1: STATE OF THE MARKET

1.1 Macroeconomic overview

China's macroeconomic position continues to display confidence and robustness despite the growing list of systemic risks that threaten to damage decades of rapid economic growth.

China started the year on the back of an estimate-beating 6.9% year-on-year growth for the economy in 2017, such momentum being largely upheld in the first quarter of 2018 with real GDP growth of 6.8%. At the National People's Congress in March policy makers set the country a target of 6.5% for the year, in line with 2017, though there has been a marked shift of emphasis towards "higher-quality growth" rather than sheer speed.

The yuan continues 2017's upwards trend to climb further against the dollar, already up 2% on the greenback for 2018. China's forex reserves have recently dropped, however, totaling \$3.125 trillion as of April.

Consumer prices have started the year roughly in line with the government's target of 3.0%, with food prices seeing a particularly large jump in January-February. With many of China's tariff proposals targeting US agricultural products, consumers may expect higher prices in the mid-term.

Beijing continues to intensify its crackdown on credit levels in the economy, regularly pushing out new regulations limiting debtors financing routes and putting into question its willingness to safeguard big businesses against credit default. Debt remains a toxic issue and one that is expected to bring considerable near-term pain as early as the second half of this year.

Other headwinds include a cooling property market and the uncertainty surrounding trade the future trade relationship between China and the US.

Market liberalisation has also been a key theme of Xi Jinping’s macroeconomic policy, dominating his speech at this year’s Boao Forum as the US includes accessibility to Chinese markets in its list of ongoing grievances. The highest-profile examples of action have so far been the lifting of foreign ownership caps in the auto and financial industries, as well as recent commitments to drop tariff proposals raised during the beginning of the year.

1.2 Drivers, trends and challenges

Spending in China’s fast-moving consumer goods (FMCG) market grew by 4.3% in 2017 (Kantar Worldpanel) to **(total size)**, a 0.7% acceleration from 2016.

Growth was led by sales in modern trade channels (namely hypermarkets, supermarkets, convenience stores), which still constitute the vast bulk of China FMCG retail. These saw a 3.5% jump in sales in Q2 and 2.6% growth for the year, extending from 1.6% in 2016.

This continues the trend towards more-frequent, faster shopping experiences displayed in previous years, as small business owners expand their business models by offering in-store pickup services and embracing other new retail methods. Customers are spending less time and money on each store visit. In 2012, the average household purchased 101.6 kilograms or liters of goods at hypermarkets. In 2016 this had dropped to below 90 kg. The pattern can be seen even within the modern trade field (figure 1): mini stores and individual convenience stores have consistently increased their representation amongst distribution channels, snatching share from hypermarkets alongside the rapidly growing but still small e-commerce sector (see below).

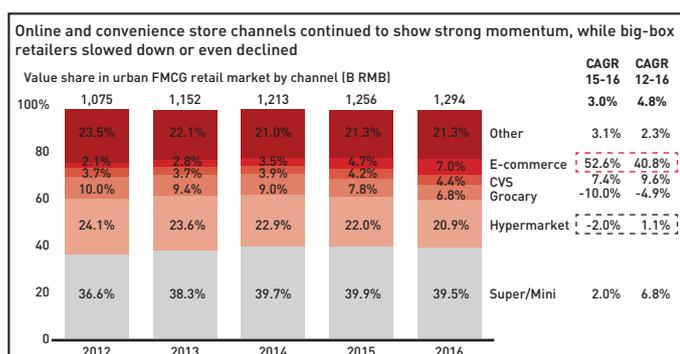


Figure 1/Bain & Co.

Trends vary significantly per product group and type. Food and beverages, for example, grew by just 0.5% and 2.0% y/y respectively (Bain Analysis), whilst personal and home care edge away at a different pace, growing 10.5% and 3.5% y/y. This applies to other goods perceived to be healthy or hygiene-related – a move expected of growing incomes and more sophisticated shopping priorities. Goods such as yoghurt, shampoo, facial wipes, packaged water, and children’s diapers managed to increase household penetration (percentage of households in a market buying a particular brand in a given year) through

2016 whilst snacks and ready meals saw penetration plateau or even drop at a time when China's mass expansion of retail is reaching its limit.

Instead, the most marked trend in food and dining retail is that away from grocery shopping and food preparation. More and more Chinese are now looking to food delivery and eating out instead of self-made meals. Between the years of 2013 and 2016 online-to-offline (O2O) food delivery boomed, achieving a 44% annual growth rate whilst restaurant dining rose 10%. The O2O food delivery business, dominated by Ele.me and Meituan, is being swallowed up by China's tech giants who want a greater share of the RMB 200 billion market. Ele.me, for instance, is on the verge of being taken under full Alibaba control after Baidu recently ceded its stake in the company.

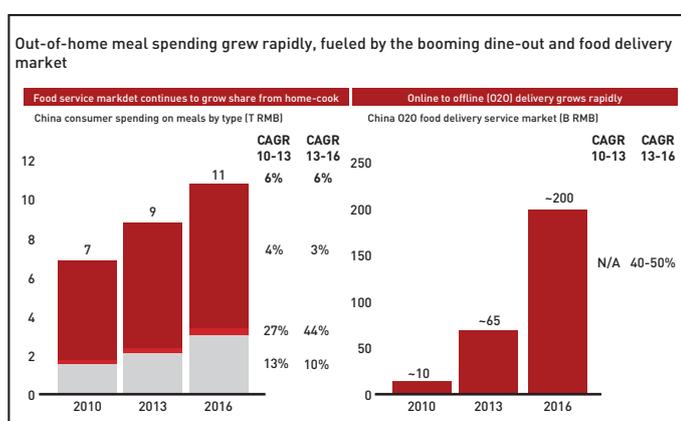


Figure 2/Bain & Co.

E-commerce spending rose 28.2% year-on-year (y/y) and accounted for just under 7% of the overall FMCG market at the close of the year – a 1.4% increase in share from the previous year. Despite being a small share of the entire market, e-commerce is a fast-mover and the sector to watch. Online spending is forecasted to grow by an average of 18% annually between 2017 and 2022 as incomes rise (figure 3), credit uptake grows, and the internet becomes more widely accessible for greater portions of the population. China's e-commerce is composed largely of apparel and accessories, and electronics and media products (figure below 4). As with the overall current of the market, products that are enjoying the highest growth in online penetration include skin care, shampoo, and diapers (figure below). These semi-luxury goods accounted for three-quarters of the sector's growth in 2016, without which would have only grown 1% for the year.

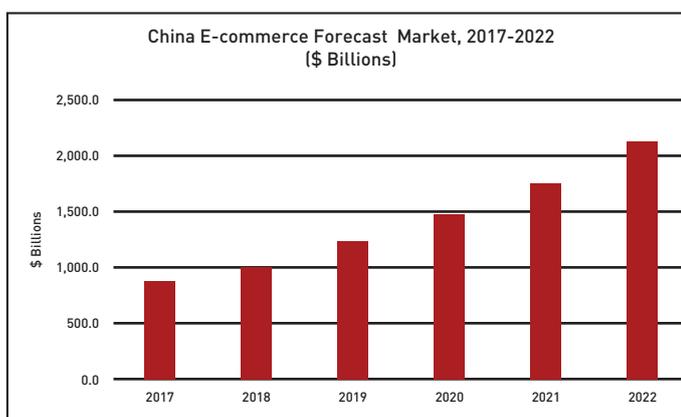


Figure 3/BCC Research, IMF, National Statistics Offices, Emarketer, IBEF

Geographically, northern and western regions continued to be key engines of FMCG sales growth, reflecting the wider economic growth distribution. Sales in the two regions was up 6.0% and 4.7% respectively for the year. Interestingly, this opposes the direction of mobile payment penetration (see later sections) which lags behind in these regions. This effect has intersected with rising internet penetration in rural areas with infrastructure development, facilitating e-commerce for large sections of the population. Rural internet users in China increased by 2.6% y/y in 2016 to a total of 201 million.

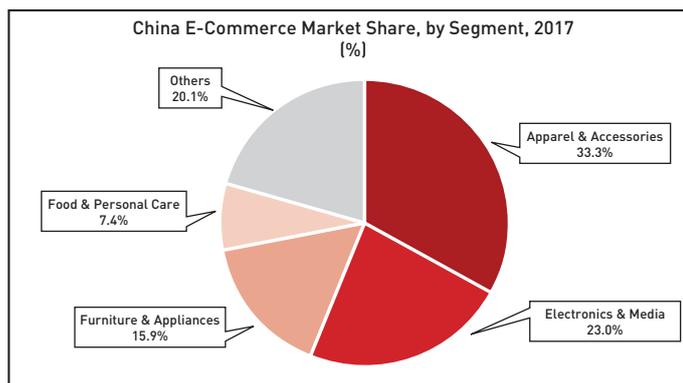


Figure 4/BCC Research, IMF, National Statistics Offices, Emarketer, IBEF

Businesses would do well to bear in mind the demographics of China's retail market. Expenditure is dominated by the increasingly less-thrifty and evermore tech-savvy 20-29 age bracket (56.4% of purchases made, see figure 5). Those of one generation previous, above the age of 40, drop off heavily in terms of influence on the market contributing only 11.3% of retail purchases.

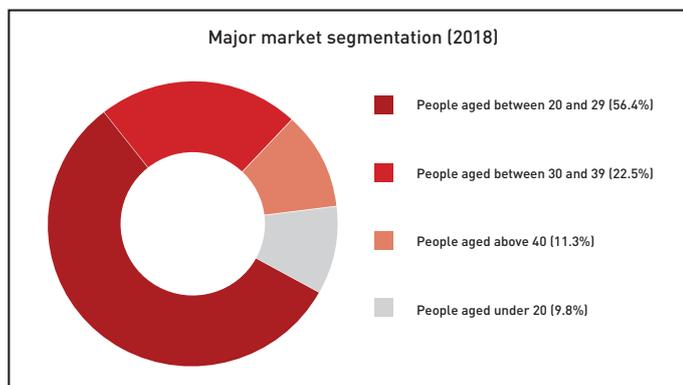


Figure 5/IBISWorld

1.3 Retail market's biggest players

Despite China's tech giants' intense competition in many areas of China's retail and services sector, FMCG in particular is still dominated by Alibaba group (figure 6) and its various owned subsidiaries such as SunArt group which itself manages Auchan and RT-Mart. Individual brands belonging to the group, however, have retained their identity and operate in competition with one another. The next leading group JD.com occupies 7.2% of the market or about one-tenth of that belonging to Alibaba Group.

Foreign brands are numerous but individually small, the most prominent being Amazon followed by household grocery stores Tesco, Walmart and Carrefour. Market share of foreign firms has been slipping relative to homegrown brands, with international compa-

nies notably slower in embracing the particular modern, tech-driven nature of the Chinese consumer market place.

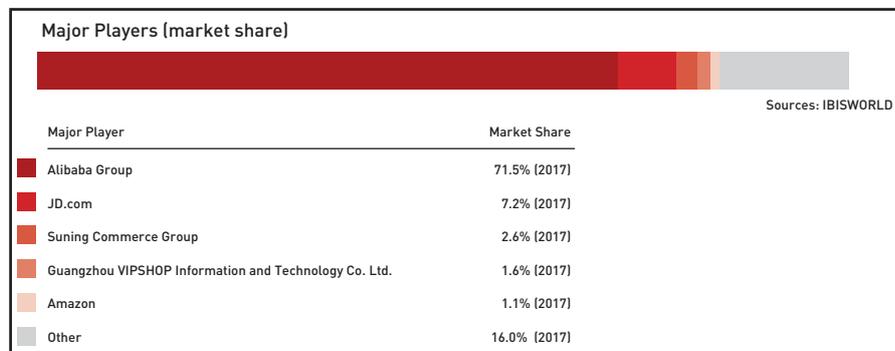


Figure 6/IBISWorld

1.4 What the big players are thinking

Firms are beginning to internalise these trends outlined above and are reformatting their corporate focus to meet the challenges at the market. Consider figure 7 below, displaying the organisational structure of Auchan, one of the constituents of the Sun Art retail group. Those divisions of the business in the middle layer are beginning to show a convergence in their operations with the integration of hypermarkets, supermarkets, shopping malls, and e-commerce in their targeted audience and consumer base.

This is no mean feat, as firms are facing unprecedented challenges from logistics and technology, as well as suffering from setbacks in the retail and FMCG market as a whole due to growing competition. As a result, we see how industry players have begun to localise their efforts in terms of very specific and defined focus points, target consumers, delivery time formats for different goods, location proximity convenience presences etc.

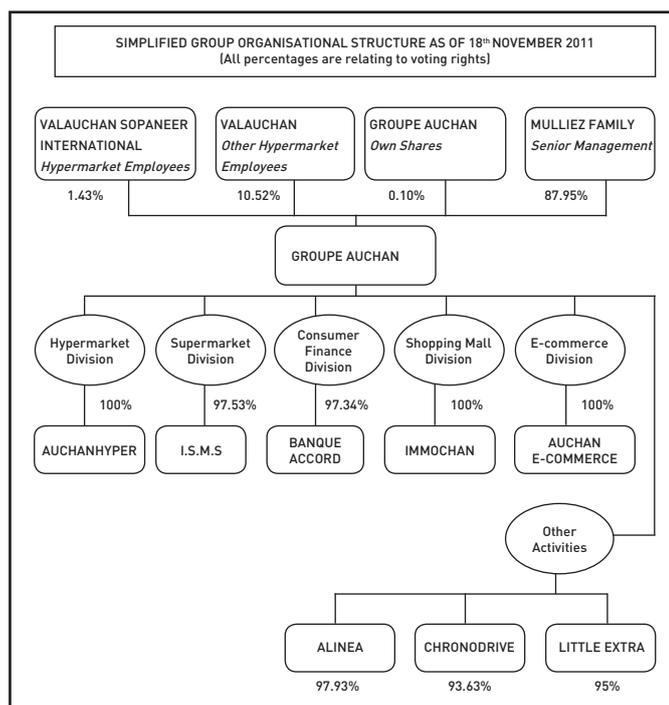


Figure 7

SECTION 2: THE GROWING ROLE OF TECHNOLOGY

2.1 Retail payments by type

The phenomenon of China’s mobile payments sector shows little sign of slowing. Payments via non-bank, third-party mobile platforms have grown at a three-digit annual rate for the past five years, totaling RMB 157.55 trillion in 2016 (figure 8). They are now more frequented than cash and cards taken together demonstrating China’s “leapfrogging” of card payments as the natural progression from cash as the primary payment medium. The market is dominated by Alibaba’s Alipay and Tencent’s WeChat, which make up 39.5% and 16.6% of total retail transactions respectively (figure 9). According to Alibaba’s own figures in 2016, Alipay was used in 175 million transactions per day, 60% of which were carried out using a mobile phone.

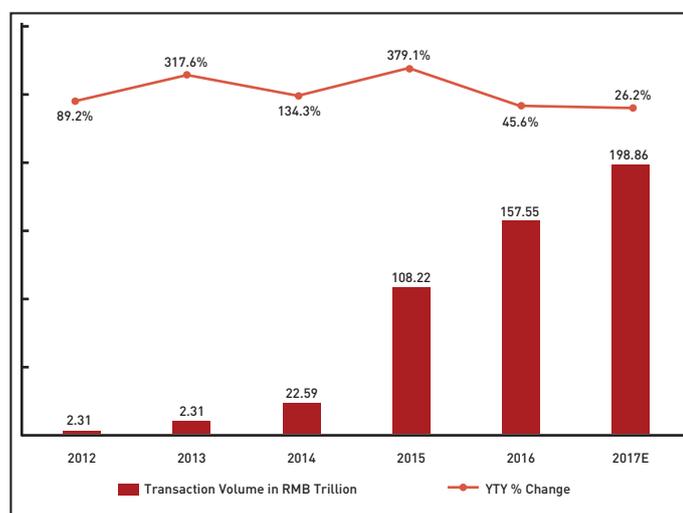


Figure 8/Brookings Institute

This trend is even more pronounced in certain retail sectors. In clothing, for instance, Alipay and WeChat constitute over 60% of payments (figure 10). Of this, the lion’s share comes from Alipay (48.7% of total transactions). Only 1 in every 10 yuan paid is done so in cash.

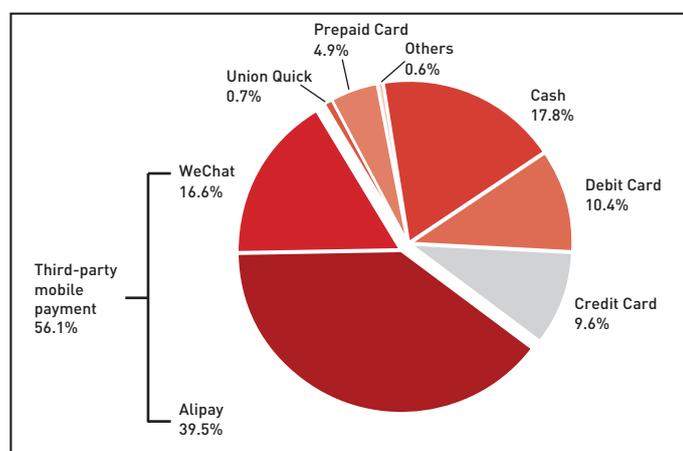


Figure 9/ECB

In the dining sector, there has been an almost complete takeover with even street vendors taking the majority of their payments from mobile payments due to the low investment cost for merchants (figure 11). At fruit vendors, for instance, only 2% of transactions are done in cash. The highest number of mobile payments as a proportion of total transaction value is found in fast-food restaurants at 74% - unsurprising given the premium placed on time-efficiency - next to 16% and 6% for cards and cash respectively.



Figure 10/ECB

Geographically, mobile payments have been more readily adopted in Northern and Eastern regions. Respectively, 55% and 54% of people in these areas use cash for less than 20% of their monthly spending, compared with the Northeast and Northwest where the proportion is around 42% [Ipsos, 2017], reinforcing the image of a “two worlds” China.

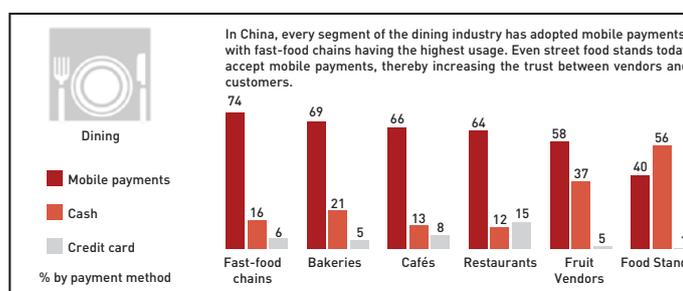


Figure 11/IPSOS

By retail outlet, convenience stores receive the highest frequency of mobile payments. 68% of total transactions are completed using mobile payments compared to just 4% from cards [Ipsos, 2017].

2.2 Fintech services in China

China continues to emerge as a world leader in the adoption of fintech. Mobile payments, whilst significant, constitute just one of a number of markets included in China’s fintech sector. Other areas include online lending, consumer finance, online money-market funds, online insurance, personal financial management, and online brokerages. In mid-2017, 27 of the world’s fintech unicorns – startups worth over \$1 billion – were Chinese or from Hong Kong, as the country leverages its tech-savvy population. At the close of last year China had 772 million internet users, 95% of which use mobile devices to get online [China Internet Network Information Center].

The country’s relatively underdeveloped banking and regulatory environments have also offered a fertile ground for fintech firms to radiate into, which have been able to capitalize upon the poor credit availability for individuals and SMEs. In 2014 less than 10% of Chinese adults could take out a loan from a financial institution, whereas SMEs only received one-quarter of all loans issued by Chinese banks despite their 60% contribution to GDP [World Bank].

China’s domestic online lending is now three-quarters of the global market, the majority being P2P which have proliferated rapidly in the past five years. From 2014 to 2015, for instance, P2P loans in China quadrupled from RMB 252.8 billion to RMB 982.3 billion. The online cash loan sector is forecast to reach as high as RMB 2.3 trillion by 2020 [iResearch].

However, the government’s wariness of toxic debt levels in the economy has forced a cooling of growth in the sector. New rules brought in July last year prevent online lenders from guaranteeing principal or interest on loans issued, and cap loans to RMB 1 million for individuals and RMB 5 million for companies. In November all online lending companies had approvals halted.

The PBOC has also been cranking up the reserve funds ratio of third-party payments to deposit in accounts controlled by the central bank, which currently stands at 50%. This was taken a step further in May of this year with the suggestion from Chinese policy-makers of centralized custody accounts for funds from third-party platforms, effectively imposing a 100% reserve rate requirement as non-bank firms’ freedom to invest deposits would be removed.

2.3 Innovation in China ‘New Retail’

We believe the most useful characterization of ‘new retail’ was offered by Alibaba CEO Daniel Zhang who said that Big Data analytics will redefine the relationship among the three core retail elements (consumers, merchandise, stores), leading to a more collaborative experience between consumer and producer in meeting the former’s demands with higher resolution and a seamless, omnichannel market environment where offline-stores, online-stores, social media and events achieve closer integration. Here we will look at several examples of innovative strategies that exemplify this interpretation of new retail.

One of the highest-profile projects pioneered by Alibaba are smart pop-up stores. These outlets require an online payment system to be scanned for customers to enter, such as Alipay for Alibaba’s stores. Price tags are all electronic, and facial recognition technology is used to track customers and allow them to “smile to pay” in some cases. The focus of the shopping experience is again on convenience and interaction – delivery data will be stored on the store’s system so details don’t need to be entered, and customers can even virtually “try on” clothes and accessories using augmented reality technology, all to be saved in the “Cloud Shelf” of personalized consumer information. For more generic goods, customers can just scan a QR code at a vending machine. Apps for Taobao and Tmall can also send notifications to users on where the nearest discounts are and recommend the nearest offline stores.

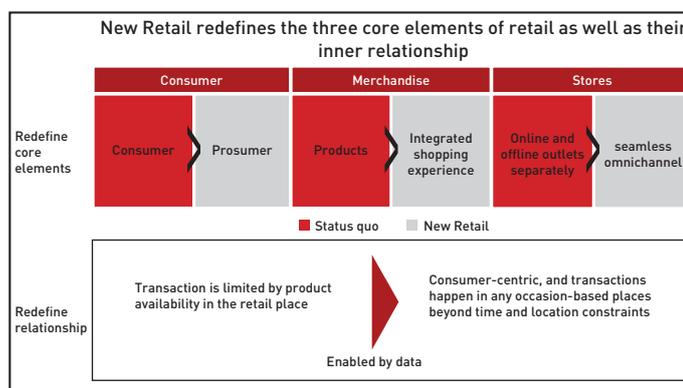


Figure 12/Bain & Co.

Primarily intended to expand digitization to small, privately-owned, mom-and-pop shops, Alibaba has also opened thousands of LST stores throughout China. Unlike the idea of physical stores owned by Alibaba or Amazon, the LST system allows retail store owners monitor purchasing behaviours of nearby customers and give recommendations for in-demand products they have in stock.

The view of retail as an experience has allowed some retailers to capitalise on public events to drive sales. “See Now, Buy Now” fashion shows have attracted attention from world leading brands such as MAC, Pandora, TAG Heuer. Here audience watch displays of merchandise and can buy instantly online or on apps, sometimes with just a shake of their phone. As with smart stores, virtual fitting rooms allows customers to ‘try’ on what they see instantly, and have the product shipped to their doorstep in a matter of hours.

Despite Alibaba’s prominence as a pioneer and ambassador for new retail, rivals in the Chinese tech arena are coming up with their own initiatives on a similar vision of leveraging China’s tech savvy nation to blur the divides between online and offline retail. On November 8th, 2017, Tencent unveiled its ‘Smart+’ strategy, including a retail arm that will use big data, cloud computing and AI to help merchants better understand their customers and give more personalized experiences. Tencent’s advantage as it breaks into this field is the prominence of WeChat both in supporting merchants and offering official accounts and mini programs to customers. It is estimated that 55% of total Chinese on-line time is spent on Tencent-operated sites. JD.com, China’s second largest e-commerce platform and partner of Tencent in combatting Alibaba, gave its own brand the title of “Unbounded Retail”.

The utilization of such new technologies to meet consumer needs with higher resolution offers considerable upsides for firms willing to take the financial hit in establishing a modern, e-commerce aspect to their business. New Retail ultimately hopes to generate efficiencies, both by smoothing out supply chains and give a closer match between what the retailer provides and what the consumer desires. The creation of new lines of business with more distribution channels and retail platforms can provide new sources of digital revenue whilst maximizing non-price techniques such as customer loyalty and brand recognition. As the sector matures in this respect and competition intensifies, the downsides for firms unwilling to embrace New Retail will only increase.