International

China—An Extraordinary Opportunity Awaits

“The basis on which good repute in any highly organized industrial community ultimately rests is pecuniary strength; and the means of showing pecuniary strength, and so of gaining or retaining a good name, are leisure and a conspicuous consumption of goods.”

—Thorstein Veblen, The Theory of the Leisure Class (1899)

Articles from the Western press tend to focus on the difficulties of doing business with China. At the time this article is being written, the predominant story involves Google and whether it will completely withdraw from China to protect its reputation as a safe house for the vast amount of personal information it collects. Headlines from major dailies present Google’s dilemma as consistent with recent trends, suggesting that the climate for foreign businesses is worsening as China’s economic self-confidence grows.

China — An Extraordinary Opportunity Awaits

“Articles from the Western press tend to focus on the difficulties of doing business with China. At the time this article is being written, the predominant story involves Google and whether it will completely withdraw from China to protect its reputation as a safe house for the vast amount of personal information it collects. Headlines from major dailies present Google’s dilemma as consistent with recent trends, suggesting that the climate for foreign businesses is worsening as China’s economic self-confidence grows.

Rise of the Zhong Chan Jie Ji

Internet usage is only one indication of rapid transformation in China. As urban households’ annual disposable income has more than doubled since 2001, annual consumption expenditures have increased markedly.

China is now the world’s largest market for (among other items) automobiles, televisions, and cell phones. Consistent with Veblen’s observations from over 100 years ago, this rapid growth in Chinese consumption is a direct result of the economic progress and financial well-being of China’s growing zhong chan jie ji, or middle class.

Veblen’s observations regarding leisure are also being reflected in Chinese travel statistics, with an assist from the central government. The government has implemented seven-day “Golden Week” holidays during the Lunar New Year and around the National Day period in October 2009. Three-day holidays were also instituted during the Labour Day, Qing Ming, Dragon Boat, and Mid-Autumn festivals. Combined with successful large-scale development of transport infrastructure, these opportunities for leisure helped drive a 150% increase in aviation passenger flow in less than 10 years. During the 2008 October Golden Week alone, the Chinese National Tourism Administration reported 42 million overnight and 135 million one-day travelers, up 13.5% and 25% respectively from the same period in 2007.

The Middle Class: How Big?

An Emerging Markets Index published in the latter half of 2008 identified 65 key cities that were driving global business growth. Chinese cities dominated the index, taking four of the top 10 spots, nine of the top 20, and 15 of the top 30. Key placements included Shanghai at #1, Beijing at #2, Guangzhou at #6, Shenzhen at #10, and Xiamen at #16. Among other BRIC nations, top finishers were Sao Paulo at #12, Moscow at #14, and Mumbai at #19.

The emergence of China’s “second tier” cities is resulting in a growing geographic distribution of wealth. China’s population of high net worth individuals (HNWI) at 364,000, exceeds that of France and the United Kingdom and held an estimated wealth of US$1.7 trillion in 2008. However, forecasts estimate that the number of China’s HNWIs will more than triple by 2018—with a significant portion of newly minted HNWIs being located outside the cities of Shanghai, Beijing, and Guangzhou.

Based on the above, it is no surprise that China is also currently experiencing explosive growth in its middle class. China’s lower population growth rate is producing what demographers call a “demographic dividend,” meaning a jump in the rate of economic growth, due to a rising share of working age people in the population and other factors. In this scenario, a faster economic growth rate yields a larger middle class. While social institutions, financial conglomerates, and government agencies define “middle class” using minimum annual average income levels anywhere from US$1,300 to US$18,000, all expect this phenomenon to increase the absolute size of the middle class dramatically over the next 10-20

the World Bank estimates that China will account for 52% of the worldwide growth in the middle class by 2030. Further, some economists estimate that the size of China’s middle class will exceed the total population of the United States by 2015.

What gets lost in those headlines is why China matters to Google. While analysts estimate that China will account for just 1% of Google’s 2010 profits, China has the world’s largest Internet market, at an estimated 338 million on-line users. As the total population of the United States is estimated 308.5 million, it is reasonable to assume that China will dominate the future commercial development of the Internet.

30 Developments • March/April 2010
years. For example, the World Bank estimates that China will account for 52% of the worldwide growth in the middle class by 2030. Further, some economists estimate that the size of China’s middle class will exceed the total population of the United States by 2015.

Impact of the Financial Crisis

The global financial crisis has had a much different impact in China than we saw here in the United States. Among the BRIC nations, China’s 7-point drop in consumer confidence was mild when compared to drops in Brazil (21), Russia (29), and India (15). Notably, only 1% of respondents in that consumer confidence survey listed debt as their “biggest concern” during the first half of 2009. In a related question, regarding uses of “spare cash,” only 3% of respondents reported that they had no spare cash, a number that remained unchanged from the first half of 2008. These results likely reflect China’s savings rate, which was nearly 60% in Q4 2008.

The story line of the Chinese television show, “Snail House,” likely provides better insight on middle class consumer concerns. The show details the fictional plight of “house slaves”—white collar workers struggling to claw together a down payment for a home. The plot has struck a nerve in Chinese cities, where discontent about runaway real estate prices is widespread. Pulled by censors from some Chinese television stations, it is being watched by up to 1.5 million viewers on some Internet sites.

The real estate run-up has been fueled by China’s stimulus program, implemented to avoid the effects of the global financial crisis. Measures enacted to support real-estate touched off a boom in home-buying and property values. As a consequence, property prices in 70 of China’s large and mid-size cities rose 7.8% year over year in December of 2009, even after increasing by 5.7% in the month earlier. The government has vowed to curb the rise in property prices by boosting the supply of affordable housing, ending preferential tax policies, and strengthening credit controls for second-home purchases.

The Potential for Shared Ownership

In 2007-2008, the U.S. Travel Association did a two-part study about emerging international travel markets, which demonstrated that more than half of Chinese residents surveyed are either “somewhat” or “very interested” in owning a vacation-apartment where they and their family can take a one-week vacation each year (versus staying at a hotel). More than half of the survey respondents are also “somewhat” or “very interested” in owning real estate that did not appreciate in value but gives them and their family a lifestyle with one-week of vacation each year at a vacation-apartment. (See Emerging International Travel Markets: China Studies, 2007 & 2008 editions, published by U.S. Travel Association.)

The potential for capturing these interested consumers appears strong, assuming that China can successfully deflate its property bubble. Among those with at least US$50,000 in annual income, surveys indicate that outbound and domestic travel are, by far, the most attractive options for discretionary spending. This consumer power has helped drive China’s luxury consumption to 25% of global demand, second only to Japan. In 2009, sales of luxury goods reached US$5 billion, up from US$3 billion in 2008.

Moreover, the Chinese government has just recently stated that tourism will be a top economic development agenda item, with the intention of reaching 83 million outbound trips by 2015. With over 46 million outbound trips in 2008 and an estimated 50 million outbound trips in 2009, this goal appears well within reach.

The question is how to shape strategies to most effectively reach and capture the market. While the data is dynamic, some strong trends have been identified:

- Travel patterns vary dramatically by region. As wealth has spread geographically, more Chinese from all over the country are traveling. However, spending habits appear to vary by region. While residents of South China are much more likely to travel, they have the lowest average expenditure per trip at US$2,597. Residents from North China have the highest average spend per trip at US$3,506. However, residents from East China appear to spend more on accommodations, with 20% choosing to stay at 5-star hotels, compared to a 12% national average.

- Unofficial gatekeepers are changing. Consumer studies indicate that travel agency use is on the wane, as more Chinese become comfortable with the Internet. Surprisingly, close to 70% of Chinese tourists could recall seeing travel advertisements on the Internet, as compared to 40% recalling ads channeled through other more expensive mediums, such as television and print. However, after reviewing destination Web sites for basic information, 48% will fine-tune their plans after consulting discussion forums. This suggests that opinions and comments about travel experiences posted to these forums are as likely to influence decisions as the destination Web sites themselves. When reviewing these forums, Chinese tourists will place a high value on information that demonstrates that the destination is safe and offers opportunities to tour scenic and cultural sites.

Finally, there is also an important lesson from the luxury goods market. TNS Global has identified status and self-reward as two particularly strong motivations in China. As a consequence and contrary to conventional wisdom, 70% of luxury good consumers will pay a premium for a luxury brand as a way to demonstrate their status and success. Or as Veblen put it, their good repute and pecuniary strength.

David Waller is a partner with Baker Hostetler LLP. His e-mail is dwaller@bakerlaw.com.