Invesco Investment Insights

China's lower-tier cities step up in consumption upgrade

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Key takeaways

- Outlook for Chinese consumption growth remains bright with consumers in lower-tier cities becoming one of its key drivers.
- Favorable demographic, rapid income growth, improved accessibility and low penetration are releasing pent-up demand in China's lower-tier cities.
- Consumer companies are tapping into this market to capture growth potential in consumption trade-up and experience seeking, thereby ensuring the continued expansion of consumer sector.

Recent economic data coming out from China had observers wondering about the momentum of its transitioning to a consumption-driven economic model. Not only was its 6.6% annual growth last year the weakest since 1990, retail sales growth for 2018 also fell to 9.0% from 10.2% the year before.[1]

However, we think that consumption remains a reliable driver of growth for the world's second-largest economy. The time is ripe for lower-tier cities to play a bigger role in driving consumption growth in China and they, together with top-tier ones, will drive China's consumer sector's "upgrade" – or its continued expansion as demand intensifies for higher-quality, higher-priced goods and services.

1. National Bureau of Statistics of China.

The current state of China's consumer sector

Our optimism about China's consumption growth is based on economic realities and not just news headlines. Retail sales may have been lower, but this was due to a sharp fall in car sales following the end of a tax break for car buyers. At the same time, retail sales data do not capture services which account for more than half of total consumption. Household expenditure on healthcare was still on the rise, for example. It was up by 15.1% in 2018, compared to 9% in 2017.[2] All in all, private consumption in China amounted to about US$5 trillion as at end 2017. This is more than 10% of the world's total and makes China's consumer market the world's second largest.

Yet, the market's potential is far from being fully exploited. Data shows that private consumption's share of China's GDP still lags other major economies. In 2017, the sector's share of China's GDP was at 39.1%, below the 68% in the US, 62.2% in India, and 55.8% in the European Union.[3] At the same time, real incomes are expected to continue to rise thanks to sustained high economic growth and supportive government policies. Strong real income growth of Chinese workers has been a key factor behind rapid growth of China's consumer sector in the past few years. What these trends highlight is that the forces – those that have helped create one of the world's largest consumer markets – are set to continue.

What we think will be different, however, is that the dynamics of how China's consumer sector is expanding are changing: lower-tier cities are fast emerging as another key dynamo in China's consumption engine.

Ever since China embarked on economic reforms four decades ago, its largest cities have been taking the lead in the country's economic development. These Tier-1 cities including Beijing and Shanghai became centers of urbanization and development. Improvements in infrastructure in these cities supported growing industries and in turn, nurtured employment opportunities. Inhabitants of these cities saw their incomes rise rapidly, which then propelled the consumer sector's growth. Now, salaries in these upper-tier cities have reached high-income status based on the World Bank's definition of US$12,236 per capita.[4]

Explaining China's city tiers

Chinese cities are usually divided into multiple tiers. The exact definition is not agreed upon as there is no official list. Different organizations come up with their own definition using a number of factors that often fall under the following three main categories:

- **GDP:** China's cities range from US$350 billion to minor cities with GDP under US$20 billion
- **Politics:** How the city is administered. Direct-administered municipalities are generally in the top tier, followed by provincial capitals, prefectural capitals, then county-level ones.
- **Population:** The core city and urban areas surrounding the main city are taken into account. Top-tier cities often have upwards of 15 million people.

Based on these considerations, these are the tiers that more well-known Chinese cities fall under:

Tier 1: Beijing, Shanghai, Guangzhou and Shenzhen.

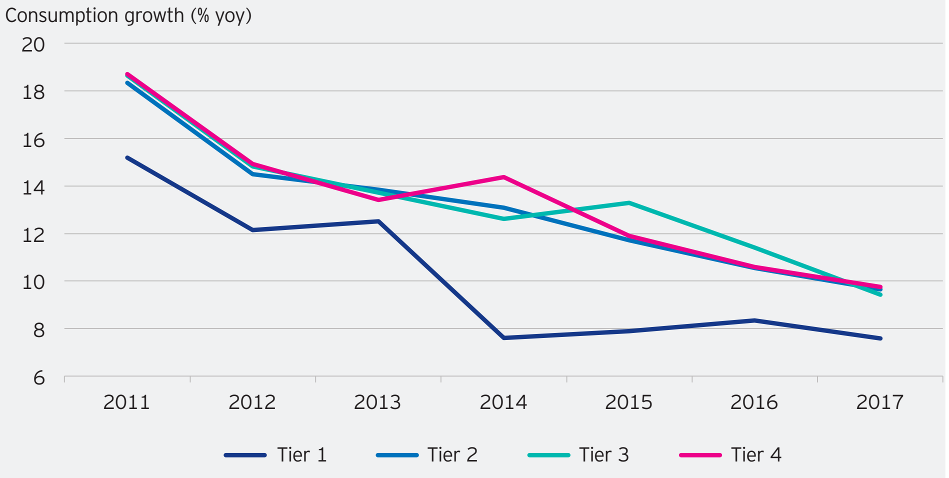
Tier 2: mainly provincial capital cities and sub-provincial capital cities, such as Chengdu, Nanjing, Hangzhou, Xi'an, Wuhan, Harbin, etc.

Tier 3: Mainly prefectural capitals and county-level cities such as Wenzhou, Guilin, Dongguan, Hohhot, etc.

Today, China's consumption sector is likely to find much-needed momentum from the emergence of lower-tier cities. Defined as those in second tier and below, or prefectural and county-level urban centers, these cities are riding on beneficial trends that turn them into fuel for China's next stage of consumption growth. We can already see traces of how consumption in lower-tier cities is poised to drive overall consumption growth in China: consumption growth in lower-tier cities is outstripping those in Tier-1 cities (Figure 1). Take Chengdu, the capital of Sichuan province in southwestern China, for example. It hosts a population of 16 million and its average retail sales growth reached 11.6% in the past five years (2013-2017). Comparatively, Beijing has a population of 22 million, but retail sales growth only averaged 7.4% during the same period.

2. "More and more signs point to slower spending in China. Analysts say not to worry," CNBC, Feb. 19, 2019. Accessed on March 13, 2019.
3. Latest data for each country taken from CEIC as of January 2019.
4. *Unleashing China's Consumption Boom,* Citi, Jan. 19, 2018.

Figure 1: Growth in spending in lower-tier cities is higher than top-tier ones

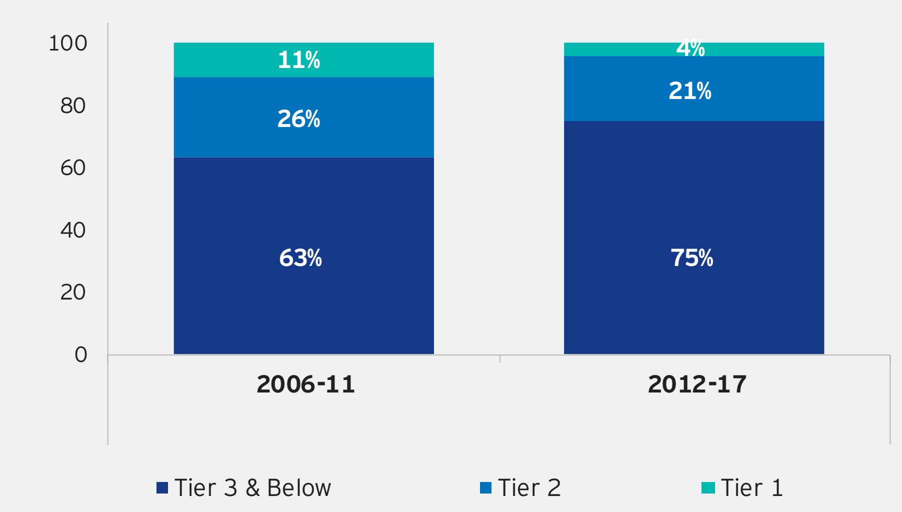


Source: CEIC, Wind, NBS, Goldman Sachs. Update on August 2018.

Lower-tier cities step up
Below, we detail the multiple reasons behind lower-tier cities' development that will ultimately boost consumption in these cities.

Favorable demographics
China is experiencing a shift in the gravity of population growth. The majority of the Chinese population are now living in lower-tier cities, where most of China's newly-increased urban population come from (Figure 2). This change is allowing the consumer sector to flourish in lower-tier cities.

Figure 2: Lower-tier cities account for most of China's newly-increased population
% contribution to newly-increased national urban population



Source: NBS, Morgan Stanley Research. Calculation is based on usual resident count.

Fertility rates tend to be higher in lower-tier cities as the relaxation of the one-child policy and affordable cost of living are increasing the willingness of couples to have more children, giving lower-tier cities the momentum in expanding their consumer base. Indeed, natural population growth in cities of Tier 3 and below was higher than that in Tier-1 cities.[5]

5. *Lower-tier Cities – Bigger, Richer, More Eager to Spend*, Morgan Stanley, dated May 25, 2017.

At the same time, some policy initiatives, such as more flexible hukou (household registration system) policies are also giving the consumer sector's expansion in lower-tier cities a further push. In fact, lower-tier cities are taking advantage of these policy tweaks so that they can actively attract talent to reside in their cities. For example, Nanjing, the capital of Jiangsu province in eastern China, introduced in March 2018 a policy to attract those holding a bachelor's degree and aged 40 and below to transfer their hukou to the city.[6] The city government also expanded its talent program so that the most desirable potential new residents can get a 3-million yuan housing subsidy to help them relocate, while all fresh university graduates who travel to Nanjing for job interviews can claim 1,000 yuan to cover costs.[7]

Rapid income growth
Economic growth tends to be faster for lower-tier cities. For example, the major cities of Beijing and Shanghai both registered a 6.6% rate of growth in 2018. Smaller cities such as Chengdu and Xi'an recorded 8% and 8.2% respectively – faster than the top-tier cities and above the national growth rate.[8]

This faster rate of growth in the less developed regions has led to faster income growth. For the whole year of 2018, growth of rural disposal income per capita was at 8.8%, while that for urban population was at 7.8%.[9]

At the same time, the property sector's performance across lower-tier and upper-tier cities in relation to income growth also affect consumption. Even though higher property prices tend to correlate to higher consumption, high mortgage payments could crowd out consumption too. We think that a good balance of housing affordability and disposable income can be found in lower-tier cities.

Improved accessibility
There have been big improvements in accessibility and connectivity in China's smaller cities that bode well for consumption. Plans for mega urban conurbations, better transport infrastructure and improved communications networks all allow goods and services to be delivered more efficiently to an eager consumer base in these smaller cities, thereby unlocking pent-up demand.

China's central government has planned for multiple city clusters, with three of them as world-class ones by 2020. These three are: The Greater Bay Area, centered on the Pearl River Delta with Hong Kong, Shenzhen, Guangzhou, and Macao as its biggest cities; the Yangtze River Delta with key cities such as Shanghai, Suzhou, Hangzhou; and Jing-Jin-Ji that comprises Beijing, Tianjin, and Hebei province. These conurbations focus attention on the economic and employment opportunities in the area, and infrastructural projects are underway to speed up development of these conurbations. The country's top leadership has in fact stated that these city clusters will create "networks of cities and towns" and enable "the coordinated development of cities of different sizes and small towns."[10] We think that this underscores the political will to speed up the pace of urbanization in these mega city clusters, and lower-tier cities in these conurbations will no doubt benefit from rapid growth and development.

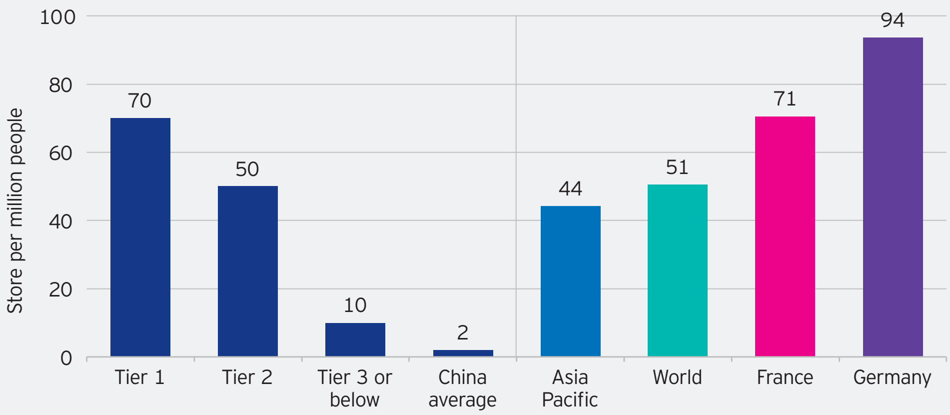
6. "Immediate implementation of policy for talents and skilled labour holding bachelor degrees and above to reside and seek employment in Nanjing city," Nanjing Municipal Public Security Bureau, March 1, 2018. Accessed on March 5, 2019.
7. "Chinese city seeks young blood: how ageing Nanjing lures new talent," The Guardian, Jan. 30, 2019. Accessed on March 4, 2019.
8. National Bureau of Statistics of China. Accessed on March 4, 2019.
9. "China's resident disposable income rises 6.5pct in 2018", Xinhua News Agency, Jan. 21, 2019. Accessed on March 4, 2019.
10. "Secure a Decisive Victory in Building a Moderately Prosperous Society in All Respects and Strive for the Great Success of Socialism with Chinese Characteristics for a New Era", Xi Jinping, Oct. 18, 2017. Accessed on March 5, 2019.

China's plans to improve its high-speed rail network will also contribute to lower-tier cities' growth. As at end 2012, China only had 9,356km of high-speed rail.[11] Six years later, the high-speed rail network has reached 29,000km.[12] With the roll out of the high-speed rail network, several of the lower-tier cities will also fall into the orbit of key cities, thereby opening up new job opportunities or leisure options for inhabitants in the smaller cities. In the Greater Bay Area, for example, inhabitants of the smaller city Foshan will find it easy to reach Hong Kong or Shenzhen for work or leisure as these upper-tier cities are only a 70-minute high-speed train ride away. For Nanjing inhabitants, what was once a five-hour rail journey to Shanghai is now just slightly over an hour on the high-speed rail.

At the same time, better communications infrastructure is making it easier for inhabitants in lower-tier cities to jump on the consumption bandwagon. For decades, lower-tier cities have had their development held back due to poorer and smaller-scale infrastructural network when compared to their top-tier counterparts. Today, faster internet and mobile data speeds, proliferation of mobile phones and applications, and the ease of online and mobile payments allow lower-tier cities to overcome infrastructural limitations so that consumers there can also be in the market for attractive goods and services that their top-tier city peers do. This unlocks pent-up demand latent in lower-tier cities. Even though online penetration is the highest in Tier-1 cities at 73% in 2017, online penetration growth is shifting to lower-tier cities.[13] The proportion of e-payment users in lower-tier cities as compared to those in upper-tier cities have increased. In 2017: users in lower-tier cities accounted for 78.5% of all e-payment users in China, and a year later, this proportion increased to 84.3%.[14]

Low product penetration
With poor accessibility to goods and services, product-penetration rates in lower-tier cities have often been low for major retailers and consumer companies (Figure 3). Improved accessibility and connectivity are changing that: retailers and distributors can now find inroads to tap into the vast consumer base and pent-up demand that China's lower-tier cities have to offer.

Figure 3: Penetration of fast-food chains remains low in China, particularly in lower-tier cities



Source: Morgan Stanley.

Retail chains that are new to lower-tier cities will likely find a receptive audience in these smaller cities if they possess strong brands, better management, and execution capabilities. A study on baby products found that 60% of China's babies younger than three years are living in lower-tier cities, but consumer spending in lower-tier cities on baby products is only two-thirds that of upper-tier cities. In the infant milk formula, baby diaper and baby toiletry categories, for example, leading brands still don't command as big shares as they have achieved in upper-tier cities.[15]

11. China Railway Yearbook 2013, Ministry of Railways of China, August 2014. Accessed on March 4, 2019.
12. "China's economy: China to invest in 6,800 km of new rail in 2019, a 5% increase from a year ago", Reuters (in Chinese), Jan. 2, 2019. Accessed on March 4, 2019.
13. As Shoppers Upgrade, Growth Returns, Bain & Company, July 6, 2018. Accessed on March 5, 2019.
14. Annual Survey of Mobile-Payment Users 2018, Payment and Clearing Association of China, Dec. 24, 2018. Accessed on March 4, 2019.
15. "Growth potential of baby market in lower-tier cities", Kantar World Panel, Sept. 27, 2018. Accessed on March 4, 2019.

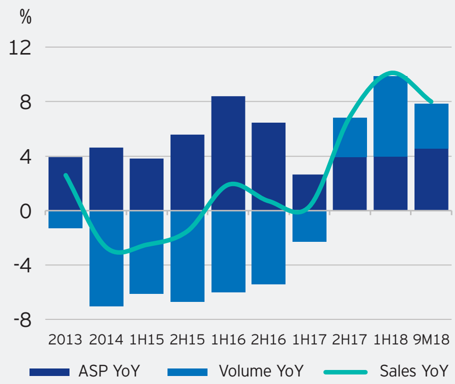
Trends that are driving consumption in China's lower-tier cities
With the above-mentioned driving factors in place, companies will find a ready consumer base in lower-tier cities for their products. We believe the emergence of consumption in lower-tier cities will lead to two notable trends in their spending patterns – a trade-up in consumption habits, and the growing preference for seeking experiences.

Lower-tier city inhabitants are seeking more premium products
Wealth is rising in China's lower-tier cities. Consumers there are increasingly looking for better products and brands, which has attracted a growing number of consumer companies to position themselves in these markets. Besides higher levels of wealth, those firms are also encouraged by lower levels of product penetration and better accessibility to the market in lower-tier cities.

We have been seeing a premiumization trend in several consumer segments. Consumer companies are responding to the demand for premium products by diversifying their product ranges through innovation and introducing higher-end products. In some cases, those that have already established a solid presence in China's top-tier cities are finding it easy to also offer the same high-end products to consumers residing in lower-tier cities.

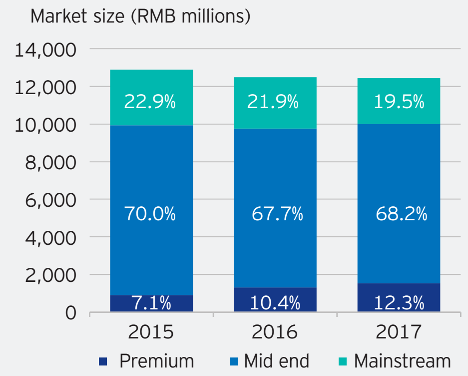
The instant-noodle market is a mature consumer segment in China, and not one that is often associated with China's "consumption upgrade" where the market moves towards high-end products. However, growth in the instant-noodle sector has been driven predominantly by price increase (Figure 4). The premium segment for instant-noodle makers has been outgrowing the mid-end and mainstream segments. The premium segment accounted for 12% of overall value in China's instant-noodle market in 2017, up from 7% in 2015 (Figure 5).

Figure 4: Average-selling price increase has been driving China's instant-noodle market growth



Source: Euromonitor, Nielsen, Goldman Sachs. December 2018.

Figure 5: Growth in value of premium instant noodles outstrips other segments



Source: Nielsen, Goldman Sachs, Invesco estimates.

We attribute the premiumization of instant noodles to companies' engagement in innovation and brand investment to shape public perception of their products in China, so that consumers are increasingly viewing instant noodles as high-end snacks and less as low-end fast food. Instant-noodle companies recognize that lifestyle habits are evolving, and that living standards are improving. These have drastically changed consumers' expectations towards food consumption.

These changing consumer habits don't only apply to consumers in the first-tier cities, but also those from lower-tier ones, where consumers are showing eagerness for healthier and premium products. We see major players in the segment focusing their efforts on the research and promotion of premium instant noodles. For instance, one such company has developed a way to separately package the noodles from stewed, imported beef. Separating the beef from the noodles provides consumers with a non-fried and nutritious ingredient to add to their noodles.

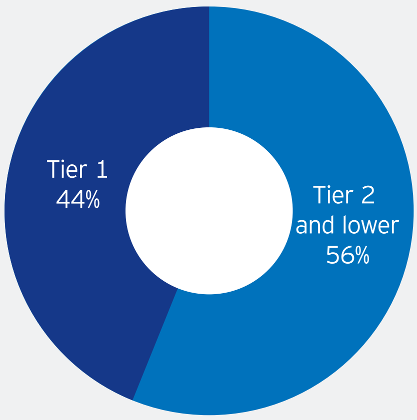
The hot pot restaurant segment is one sector where companies can benefit from the increasingly popular trend of dining out in lower-tier cities. Between 2017 to 2022, the market size of hot pot restaurants in Tier-1 cities is expected to grow from 41.4 billion yuan to 68.5 billion yuan, while in lower-tier cities it is expected to expand from 394.8 billion yuan to 639.2 billion yuan. The anticipated increase in market size in lower-tier cities is more than nine times that what the Tier-1 cities will experience.

Leading hot pot restaurant operators, attracted by the strong expansion potential in lower-tier cities, are deepening penetration into those cities. They are helped by the niche they have carved out for themselves in providing good service quality and complimentary services such as manicure and shoe-polishing services to waiting guests. Leading operators are also known to provide food and ingredients that are of high quality at affordable prices. This allays customers' concerns about food safety and generates a good overall dining experience. By leveraging on their expertise, experience, and strong brand, these leading operators are quickly establishing themselves in lower-tier cities.

Lower-tier city consumers are seeking more experiences
Lower-tier city consumers are also looking for more intangible experiences when deciding where to spend their money.

Online travel agencies stand to gain from such a trend. Penetration of outbound travel is still low in China, and we believe travelers from lower-tier cities will be driving much of the sector's future growth. Outbound travel penetration in China is only 8.8% in 2016, or 4% if excluding trips to Hong Kong, Macao or Taiwan – a very low level compared to developed Asian countries. According to Ipsos (a global market research company), outbound travelers in China mainly come from its biggest cities, while inland provinces remain a relatively untapped market. This is because Tier-1 cities such as Shanghai and Beijing are better connected with more international routes in their airports and higher disposable income levels of its inhabitants. However, it's clear that lower-tier cities are ramping up their connections to international destinations. In 2016, they accounted for 56% of new international flights in China (Figure 6).

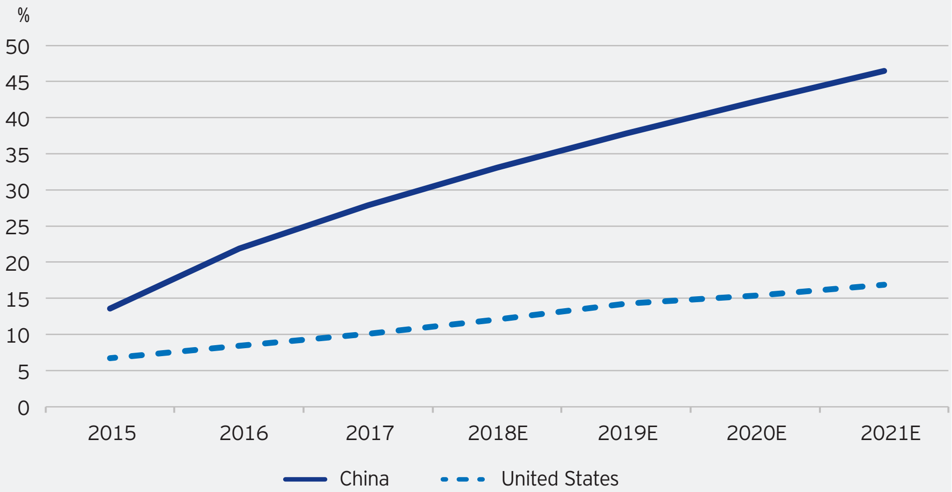
Figure 6: Lower-tier cities account for a higher share of new international flights



Source: OAG, Morgan Stanley Research.
Note: Data are based on OAG database released in 2016.

Increasing mobile phone penetration and income levels in lower-tier cities are likely to drive the growth of online travel agencies' presence in these smaller urban centers. Mobile-phone penetration for overall travel bookings in China are more than 16 times greater than levels seen in the United States (Figure 7).[16] Riding on this trend, a major online travel services provider has been expanding aggressively into lower-tier cities in 2018 by setting up offline franchise stores. Of the 1,500 stores set up by this company, 80% are in lower-tier cities.

Figure 7: Mobile-phone penetration for travel bookings in China far higher than in the US
Penetration rate from 2015 to 2021 (expected)



Source: McKinsey & Company.

Conclusion
Like its economy, China's consumption landscape has been diversifying over the past few decades. What was once a growth engine that relied on China's largest cities as fuel now needs more input from other sources.

Lower-tier cities thus offer the consumer market vast potential to tap into, and a confluence of several developments, ranging from demographic trends, increasing wealth, faster pace of urbanization, improved accessibility and connectivity, and low product-penetration rates, is facilitating the market's growth in these smaller cities.

Similar to their top-tier peers, residents from lower-tier cities are also looking for premium products and exploring varied experiences thanks to the above-mentioned favorable developments. We believe this trend will sweeten the ground for astute consumer companies that want to venture into China's smaller cities. We believe their efforts, together with the consumer market's steady growth in top-tier cities, will help maintain the momentum of the Chinese consumer sector's march in leading China's economic growth.

16. Chinese tourists: Dispelling the myths – An in-depth look at China's outbound tourist market, McKinsey & Company, Sept. 2018. Accessed on March 5, 2019.

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