Invesco Investment Insights
China's lower-tier cities stepping up to fuel China's consumption upgrade

June 2019

Mike Shiao
CIO, Asia ex Japan

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 of China has observers wondering about the momentum of the country's transition to a consumption-driven economic model. But we are convinced that consumption remains a reliable driver of growth for the world's second-largest economy – and that the time is ripe for lower-tier cities to play a greater role in driving consumption growth in China.

Our optimism about China's consumption growth is based on economic realities, and not just news headlines. Although retail sales have lately been lower, this was largely due to a sharp fall in car sales following the end of a tax break for new car buyers. Moreover, retail sales data does not capture services, which account for more than half of total consumption. For instance, household expenditure on healthcare is still on the rise; it was 15.1% higher in 2018 following a 9% increase in 2017.[1] In all, private consumption in China amounted to roughly USD 5 trillion 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 share of China's GDP attributable to domestic consumption was at 39.1%, below the 68% in the US, 62.2% in India and 55.8% in the European Union.[2] At the same time, real incomes are expected to continue rising thanks to sustained high economic growth and supportive government policies. Strong real income growth of Chinese workers has been a key factor behind the rapid growth of China's consumer sector over the past few years. What these trends highlight is that the forces – which have helped create one of the world's largest consumer markets – are set to continue.

Explaining China's city tiers

Chinese cities are usually divided into multiple tiers. There is no agreement on an exact definition of the tiers as there is no official list. Different organizations have their own definitions based on a number of factors that often reflect the following three main considerations:

1) GDP: China's cities range from major urban centres with USD 350 trillion in GDP to minor cities with GDP under USD 20 billion.

2) Politics: Refers to how the city is administered. Directly administered municipalities are generally in the top tier, followed by provincial capitals, prefecture capitals, then county-level administrations.

3) Population: Takes into account the core city and urban areas surrounding the core. Top-tier cities often have upwards of 15 million inhabitants.

Based on these criteria, the more well-known
Chinese cities are assigned to the following tiers:

Tier 1: Beijing, Shanghai, Guangzhou and Shenzhen

Tier 2: Mainly provincial and sub-provincial capitals, such as Chengdu, Nanjing, Hangzhou, Xi'an, Wuhan, Harbin

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

Tier 4: Smaller county-level cities such as Jieyang, Yiwu, Ordos, etc

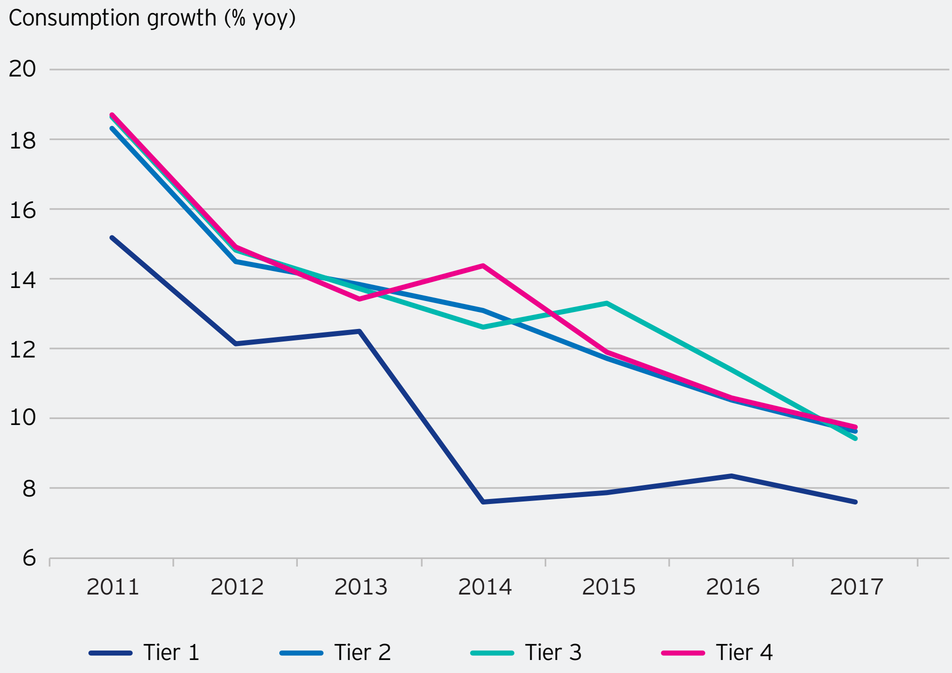
What we think will be different, however, are the dynamics of expansion in China's consumer sector: lower-tier cities are fast emerging as another key dynamo in China's consumption engine.

Ever since China embarked on economic reforms four decades ago, its largest cities have led the country's economic development. These tier-1 cities, including Beijing and Shanghai, have grown to become centres of urbanization and development. Improvements in infrastructure in these cities support growing industries and in turn, nurture employment opportunities. The inhabitants of these cities have seen their incomes rise rapidly, which has 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 USD 12,236 per capita.[3]

1. More and more signs point to slower spending in China. Analysts say not to worry," CNBC, 19 Febuary 2019; accessed 13 March 2019.2. International Monetary Fund database April 2019.
2. Latest data for each country taken from CEIC as of January 2019.
3. "Unleashing China's Consumption Boom", Citi, 19 January 2018.

Today, China's domestic consumption is likely to find additional much-needed momentum from the emergence of its lower-tier cities. Defined as those in the second tier and below (prefecture and countylevel urban centres), these cities are riding beneficial trends that are turning them into sources of fuel for China's next stage of consumption growth. There are already initial signs emerging of how consumption in lower-tier cities is poised to drive overall consumption growth in the country: consumption growth in lowertier cities is outstripping that of tier-1 cities (figure 1). Take, for example, Chengdu – the capital of Sichuan province in southwestern China. It boasts a population of 16 million and its average retail sales growth reached 11.6% over the past five years (2013 - 2017). By comparison, Beijing has a population of 22 million but retail sales growth in the national capital averaged only 7.4% during the same period.

Figure 1: Spending growth in lower-tier cities outstrips tier-1 cities



Sources: CEIC, Wind, NBS, Goldman Sachs. Data as at August 2018.

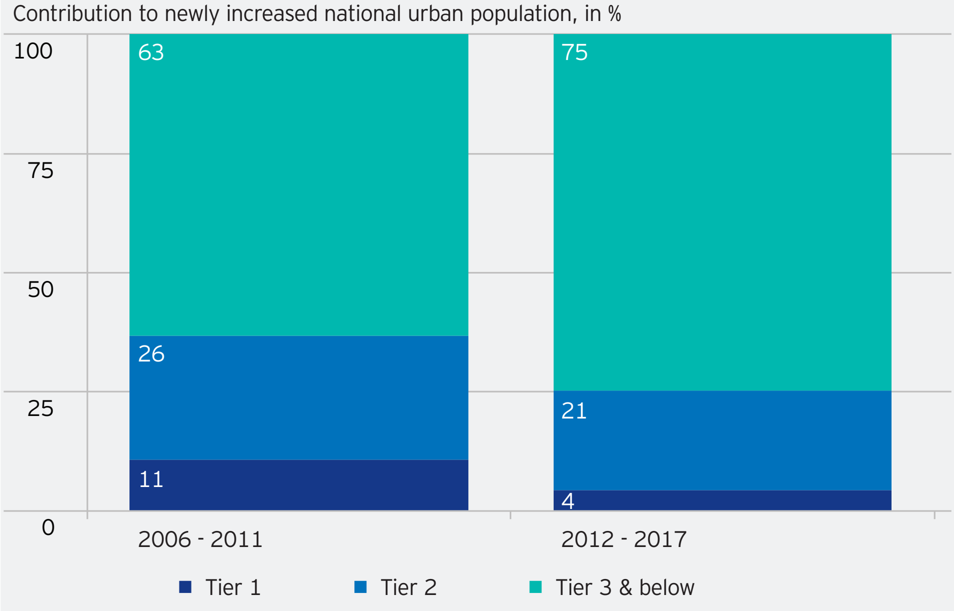
Lower-tier cities step up

Below, we detail the multiple reasons behind developments in lower-tier cities that will ultimately boost consumption in these markets.

Favourable demographics

China is experiencing a gravitational shift in population growth. A majority of the Chinese population now lives in lower-tier cities, which account for most of China's newly increased urban population (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 urban population



Sources: NBS, Morgan Stanley Research. Calculation 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 people to have larger families, giving lower-tier cities needed momentum to expand their consumer base. Indeed, natural population growth in cities of tier-3 and below is higher than that of tier-1 cities.[4]

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 in order to actively attract talent to reside there. For example, Nanjing, the capital of Jiangsu province in eastern China, introduced a policy in March 2018 to attract those holding a bachelor's degree and aged 40 and below to transfer their hukou to the city.[5] 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.[6]

Rapid income growth

Economic growth tends to be faster in lower-tier cities. For example, while the major cities of Beijing and Shanghai both chalked up a 6.6% rate of growth in 2018, smaller cities such as Chengdu and Xi'an recorded 8% and 8.2% respectively. This is faster than the top-tier cities and above the national growth rate.[7]

The faster rate of growth in the less developed regions has also led to faster income growth. For the whole of 2018, growth in rural disposal income per capita was at 8.8%, while that for urban populations was at 7.8%.[8]

4. "Lower-tier Cities – Bigger, Richer, More Eager to Spend", Morgan Stanley, 25 May 2017.
5. "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, 1 March 2018; accessed 5 March 2019.
6. "Chinese city seeks young blood: how ageing Nanjing lures new talent", The Guardian, 30 January 2019; accessed 4 March 2019.
7. National Bureau of Statistics of China; accessed 4 March 2019.
8. "China's resident disposable income rises 6.5pct in 2018", Xinhua News Agency, 21 January 2019; accessed 4 March 2019.

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

Improved accessibility

There have been big improvements in accessibility and connectivity in China's smaller cities, which 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 to become worldclass metropolitan areas by 2020. These three are: The Greater Bay Area, centred 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 and Hangzhou; and Jing-Jin-Ji, which comprises Beijing, Tianjin and Hebei province. These conurbations focus attention on regional economic and employment opportunities, and infrastructural projects are underway to speed up their development. The country's top leadership has stated that these city clusters will create "networks of cities and towns" and enable "coordinated development of cities of different sizes and small towns."[9] We think that this underscores the political will to speed up the pace of urbanization in these mega city clusters, and lowertier cities in these conurbations will benefit from rapid growth and development.

China's plans to improve its high-speed rail network will also contribute to lower-tier cities' growth. At the end of 2012, China had only 9,356 km of highspeed rail.[10] Six years later, the high-speed rail network has reached 29,000 km.[11] With the rollout of the high-speed rail network, several of the lowertier cities now also fall into the orbit of key cities, opening up new job opportunities and leisure options for inhabitants. 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 highspeed train ride away. For Nanjing residents, what was once a five-hour rail journey to Shanghai is now just slightly over an hour on the high-speed rail.

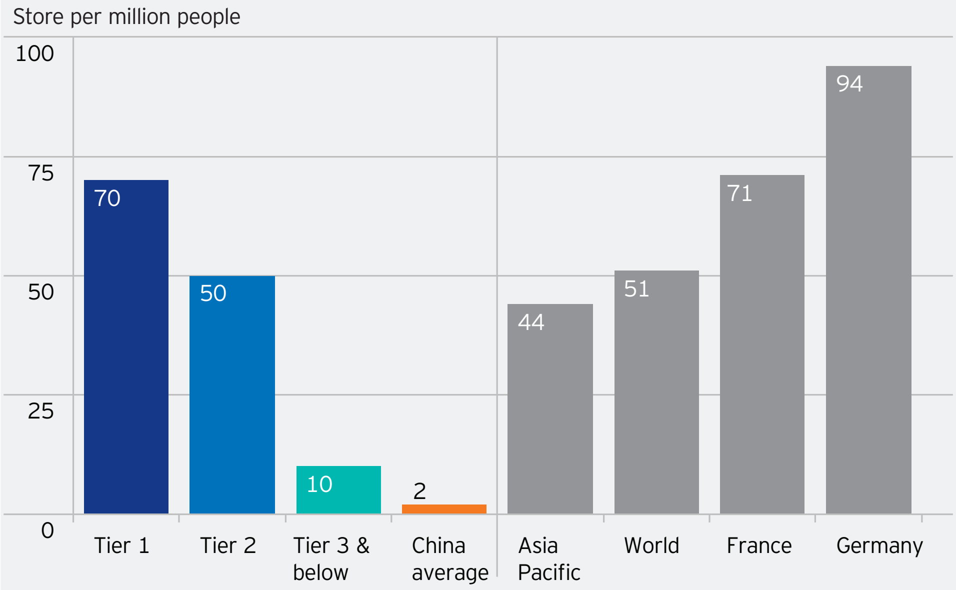
Moreover, better communications infrastructure is making it easier for people in lower-tier cities to jump on the consumption bandwagon. For decades, lower-tier cities had their development held back due to poorer-quality and smaller-scale infrastructural networks compared to their top-tier counterparts. Today, faster internet and mobile data speeds, a proliferation of mobile phones and apps and the ease of online and mobile payments have unlocked latent demand, allowing lower-tier cities to overcome infrastructural limitations so that consumers there can participate in the market for attractive goods and services alongside their peers in the top-tier cities. Even though online penetration is still highest in tier-1 cities (at 73% in 2017), online penetration growth is shifting to lower-tier cities.[12] The proportionof e-payment users in lower-tier cities has increased as compared to those in upper-tier cities: in 2017, users in lower-tier cities accounted for 78.5% of all e-payments in China; a year later, this proportion increased to 84.3%.[13]

9. "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, 18 October 2017; accessed 5 March 2019.
10. China Railway Yearbook 2013, Ministry of Railways of China, August 2014; accessed 4 March 2019.
11. "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), 2 January 2019; accessed 4 March 2019.
12. "As Shoppers Upgrade, Growth Returns", Bain & Company, 6 July 2018; accessed 5 March 2019.
13. Annual Survey of Mobile-Payment Users 2018, Payment and Clearing Association of China, 24 December 2018, accessed 4 March 2019.

Low product penetration

Given their poor accessibility to goods and services, product-penetration rates in lower-tier cities have historically been low for major retailers and consumer companies (figure 3). But improved accessibility and connectivity are changing that: retailers and distributors can now find inroads to the vast consumer base and demand potential 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. Data as at May 2017.

Retail chains that are new to lower-tier cities will likely find a receptive audience if they possess strong brands, good management and execution capabilities. A study on baby products found that 60% of China's infants younger than three years old live in lower-tier cities, whereas consumer spending on baby products in lower-tier cities is only twothirds that of upper-tier cities. In the infant formula, disposable diaper and baby toiletry categories, for example, leading brands still don't command shares as big as they have achieved in upper-tier cities.[14]

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 for their products in lower-tier cities. We believe that the emergence of consumption in lower-tier cities will lead to two notable trends in spending patterns: a trade-up in consumption habits and a growing preference for seeking experiences.

Lower-tier city inhabitants are primed to buy more premium products

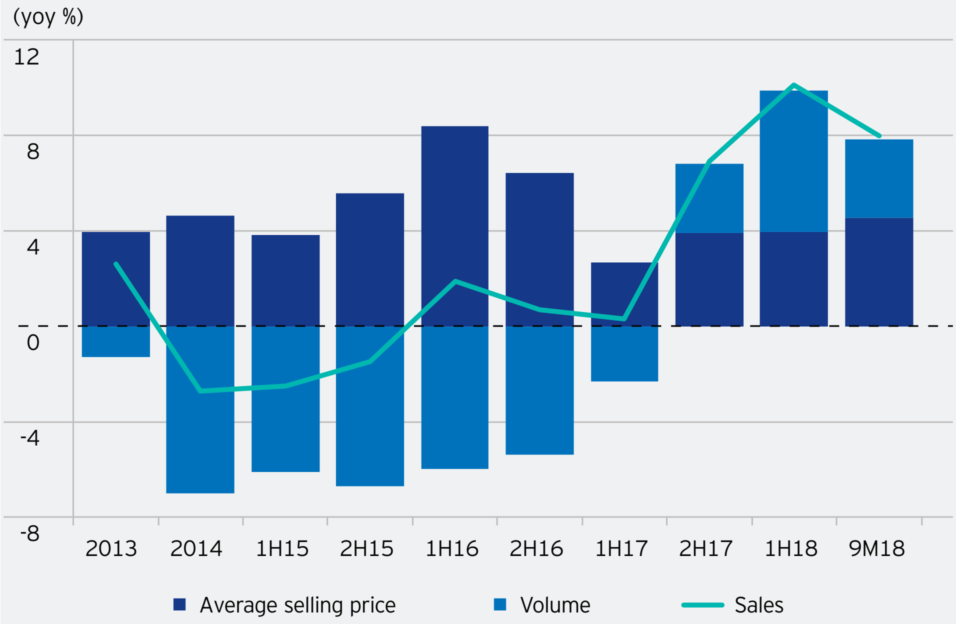
Wealth is rising in China's lower-tier cities. Consumers there are increasingly looking for better products and brands, which has spurred a growing number of consumer companies to position themselves in these markets. In addition to higher levels of wealth, these firms are also attracted by lower levels of product penetration and improved accessibility to the market in lower-tier cities.

We have seen 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 offer the same high-end products to consumers residing in lower-tier cities.

14. "Growth potential of baby market in lower-tier cities", Kantar World Panel, 27 September 2018; accessed 4 March 2019.

The instant noodle market is a mature consumer segment in China, and not one often associated with China's consumption upgrade. However, growth in instant noodle sales has been driven predominantly by price increases (figure 4).

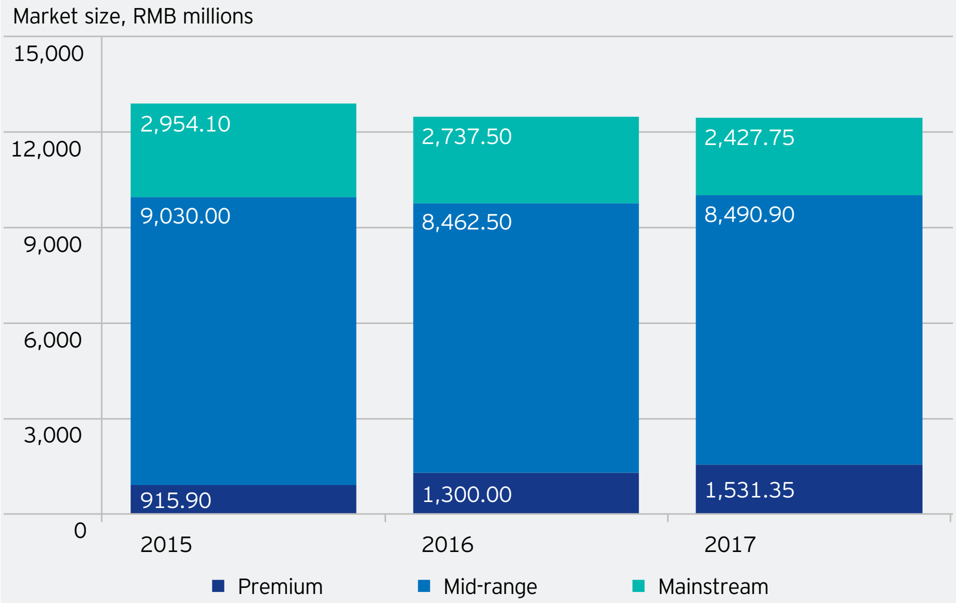
Figure 4: Average selling price increases are driving growth in China's instant noodle market



Sources: Euromonitor, Nielsen, Goldman Sachs. Data as at December 2018.

The premium segment for instant noodle makers has been outgrowing the mid-range 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 5: Growth in value of the premium instant noodle market outstrips other segments



Sources: 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 rather than low-end fast food. Instant noodle companies recognize that lifestyle habits are evolving and that living standards are improving. This has drastically changed consumers' expectations when it comes to food choices.

These changing consumer habits apply not only to consumers in the first-tier cities but also those from lower-tier ones, where consumers are eager for healthier and higher-quality products. We see major players in the segment focusing their efforts on research and promotion of premium instant noodles. For instance, one key maker has developed a way to separately package the noodles alongside 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 example of how 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 lowertier cities it is set to expand from 394.8 billion yuan to 639.2 billion yuan. The anticipated increase in market size in lower-tier cities is thus more than nine times what the tier-1 cities will experience.

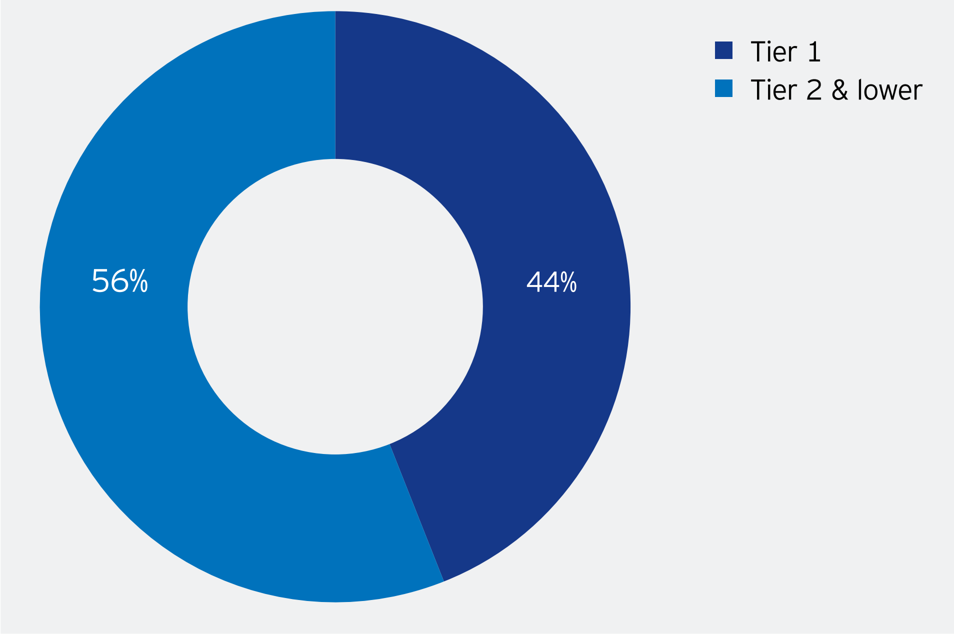
Leading hot pot restaurant operators, attracted by strong expansion potential in lower-tier cities, are deepening penetration into these cities. This process is helped along by the niche they have carved out for good service quality and complimentary services, such as manicure and shoe-polishing services for 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 brands, 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 this trend. Penetration of outbound travel is still low in China, and we believe travellers from lower-tier cities will be driving much of the sector's future growth. Outbound travel penetration in China was only 8.8% in 2016, or 4% excluding trips to Hong Kong, Macao or Taiwan – very low compared to developed Asian countries. According to Ipsos (a global market research company), outbound travellers in China come mainly 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 at their airports and higher disposable income levels among their inhabitants. However, lower-tier cities are clearly ramping up their connections to international destinations. In 2016, they accounted for 56% of new international flights in China (figure 6).

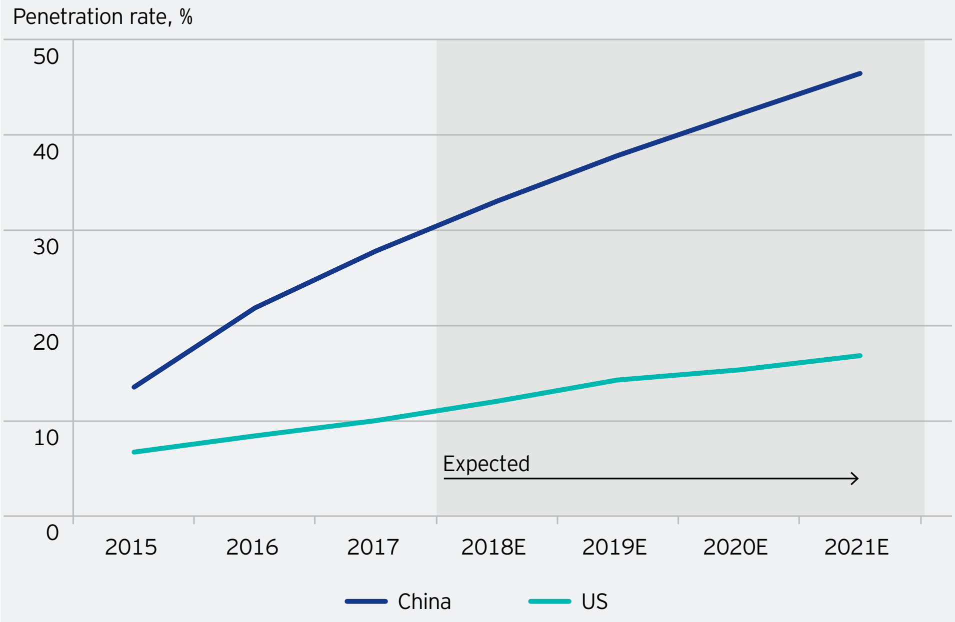
Figure 6: Lower-tier cities account for a higher share of new international flights



Sources: OAG, Morgan Stanley Research. 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 centres. Mobile phone penetration as a share of overall travel bookings in China is more than 16 times greater than levels seen in the United States (figure 7).[15] Riding this trend, one major online travel service provider has been expanding aggressively into lower-tier cities, setting up numerous offline franchise stores in 2018. Of the 1,500 stores set up by this company, 80% are in lower-tier cities.

Figure 7: Mobile phone travel bookings in China far higher than in the US



Source: McKinsey & Company.

Conclusion

Like its economy, China's consumption landscape has been diversifying over the past few decades. The growth engine that once relied on China's largest cities for 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 developments, ranging from demographic trends, increasing wealth, a 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 lowertier cities are also looking for premium products and exploring varied experiences on the strength of these favourable developments. We believe this trend will serve to attract astute consumer companies into China's smaller cities. Their efforts, together with the consumer market's steady growth in top-tier cities, will help maintain the momentum of the Chinese consumer sector as it leads China's economic growth.

15. "Chinese tourists: Dispelling the myths – An in-depth look at China's outbound tourist market", McKinsey & Company, September 2018; accessed 5 March 2019.

About risk
The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Important information

The publication is intended only for Professional Clients and Financial Advisers in Continental Europe (as defined below); for Qualified Investors in Switzerland, Turkey and Russia; for Professional Clients in Dubai, Ireland, the Isle of Man, Jersey and Guernsey, and the UK; for Institutional Investors in Australia; for Professional Investors in Hong Kong; for Qualified Institutional Investors, pension funds and distributing companies in Japan; for Institutional Investors and/or Accredited Investors in Singapore; for certain specific Qualified Institutions/Sophisticated Investors only in Taiwan and for Institutional Investors in the USA. The document is intended only for accredited investors as defined under National Instrument 45-106 in Canada. It is not intended for and should not be distributed to, or relied upon, by the public or retail investors. By accepting this document, you consent to communicate with us in English, unless you inform us otherwise.

The publication is marketing material and is not intended as a recommendation to invest in any particular asset class, security or strategy. Regulatory requirements that require impartiality of investment/investment strategy recommendations are therefore not applicable nor are any prohibitions to trade before publication. The information provided is for illustrative purposes only, it should not be relied upon as recommendations to buy or sell securities.

For the distribution of this document, Continental Europe is defined as Austria, Belgium, Bulgaria, Croatia, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Italy, Luxembourg, Netherlands, Norway, Poland, Romania, Slovenia, Slovakia, Spain and Sweden.

All articles in this publication are written, unless otherwise stated, by Invesco professionals. The opinions expressed are those of the author or Invesco, are based upon current market conditions and are subject to change without notice. This publication does not form part of any prospectus. This publication contains general information only and does not take into account individual objectives, taxation position or financial needs. Nor does this constitute a recommendation of the suitability of any investment strategy for a particular investor. Neither Invesco Ltd. nor any of its member companies guarantee the return of capital, distribution of income or the performance of any fund or strategy. Past performance is not a guide to future returns.

This publication is not an invitation to subscribe for shares in a fund nor is it to be construed as an offer to buy or sell any financial instruments. As with all investments, there are associated inherent risks. This publication is by way of information only. This document has been prepared only for those persons to whom Invesco has provided it. It should not be relied upon by anyone else and you may only reproduce, circulate and use this document (or any part of it) with the consent of Invesco. Asset management services are provided by Invesco in accordance with appropriate local legislation and regulations.

Certain products mentioned are available via other affiliated entities. Not all products are available in all jurisdictions.

This publication is issued:

– in **Australia** by Invesco Australia Limited (ABN 48 001 693 232), Level 26, 333 Collins Street, Melbourne, Victoria, 3000, Australia which holds an Australian Financial Services Licence number 239916.

  The information in this document has been prepared without taking into account any investor's investment objectives, financial situation or particular needs. Before acting on the information the investor should consider its appropriateness having regard to their investment objectives, financial situation and needs.

  This document has not been prepared specifically for Australian investors. It:
  - may contain references to dollar amounts which are not Australian dollars;
  - may contain financial information which is not prepared in accordance with Australian law or practices;
  - may not address risks associated with investment in foreign currency denominated investments; and - does not address Australian tax issues.

– in **Austria** by Invesco Asset Management Österreich – Zweigniederlassung der Invesco Asset Management Deutschland GmbH, Rotenturmstraße 16–18, 1010 Vienna, Austria.
– in **Belgium** by Invesco Asset Management SA Belgian Branch (France), Avenue Louise 235, 1050 Bruxelles, Belgium.
– in **Canada** by Invesco Canada Ltd., 5140 Yonge Street, Suite 800, Toronto, Ontario, M2N 6X7.
– in **Denmark, Finland, France, Luxembourg, Greece** and **Norway** by Invesco Asset Management SA, 16-18 rue de Londres, 75009 Paris, France.
– in **Dubai** by Invesco Asset Management Limited. PO Box 506599, DIFC Precinct Building No 4, Level 3, Office 305, Dubai, UAE. Regulated by the Dubai Financial Services Authority.
– in **Germany** by Invesco Asset Management Deutschland GmbH, An der Welle 5, 60322 Frankfurt am Main, Germany.
– in **Hong Kong** by INVESCO HONG KONG LIMITED 景順投資管理有限公司, 41/F, Champion Tower, Three Garden Road, Central, Hong Kong.
– in **Italy** by Invesco Asset Management SA, Sede Secondaria, Via Bocchetto 6, 20123 Milan, Italy.
– in **Japan** by Invesco Asset Management (Japan) Limited, Roppongi Hills Mori Tower 14F, 6-10-1 Roppongi, Minato-ku, Tokyo 106-6114; Registration Number: The Director-General of Kanto Local Finance Bureau (Kin-sho) 306; Member of the Investment Trusts Association, Japan and the Japan Investment Advisers Association.

- in **Jersey** and **Guernsey** by Invesco International Limited, 2nd Floor, Orviss House, 17a Queen Street, St. Helier, Jersey, JE2 4WD. Invesco International Limited is regulated by the Jersey Financial Services Commission.
- in **Netherlands** by Invesco Asset Management S.A. Dutch Branch, Vinoly Building, Claude Debussylaan 26, 1082 MD Amsterdam, The Netherlands.
- in **Singapore** by Invesco Asset Management Singapore Ltd, 9 Raffles Place, #18-01 Republic Plaza, Singapore 048619.
- in **Switzerland** by Invesco Asset Management (Schweiz) AG, Talacker 34, 8001 Zurich, Switzerland.
- in **Spain** by Invesco Asset Management SA, Sucursal en España, C/ GOYA, 6 - 3°, 28001 Madrid, Spain.
- in **Sweden** by Invesco Asset Management SA (France) Swedish Filial, c/o Convendum, Jakobsbergsgatan 16, Box 16404, 111 43 Stockholm, Sweden.
- in **Taiwan** by Invesco Taiwan Limited, 22F, No.1, Songzhi Road, Taipei 11047, Taiwan (0800-045-066). Invesco Taiwan Limited is operated and managed independently.
- in **Ireland,** the **Isle of Man** and the **UK** by Invesco Asset Management Limited, Perpetual Park, Perpetual Park Drive, Henley-on-Thames, Oxfordshire, RG9 1HH, United Kingdom. Authorised and regulated by the Financial Conduct Authority.
- in the **US** by Invesco Advisers, Inc., Two Peachtree Pointe, 1555 Peachtree Street, N.E., Suite 1800, Atlanta, GA 30309.

Data as at 31 May 2019, unless otherwise stated.

GL350/2019