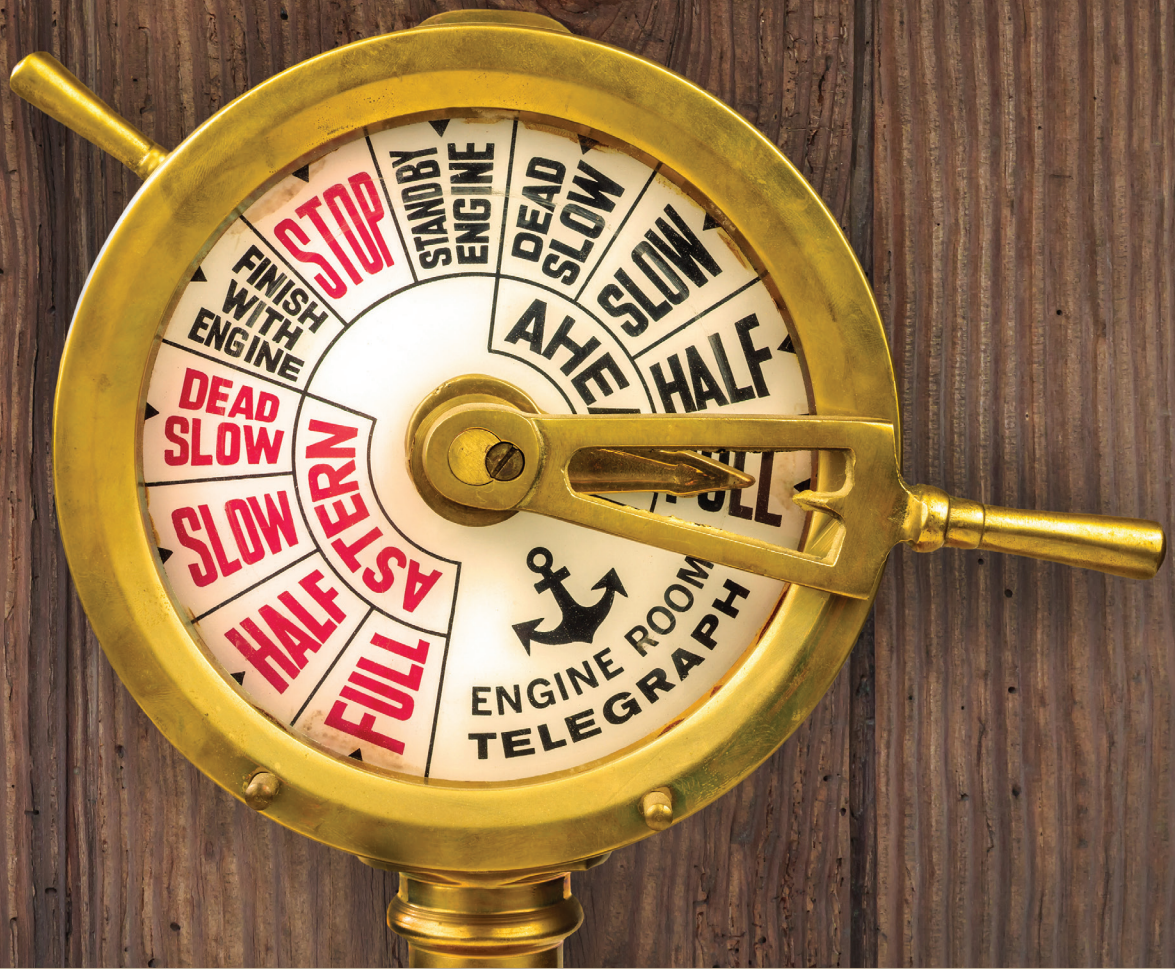




THE NEW NORMAL

Time to stop making excuses and adapt instead



For much of the past decade, China has offered retailers and consumer goods companies opportunities for unbridled growth and long-term potential. The last two years (and especially the past six months) however, have changed all this as many businesses have seen low-single-digit growth and negative like-for-likes

At first sight, this performance is difficult to explain given that headline retail growth has declined by only 2ppts from 14% in 2012 to 12% pa in 2014; much of which can be explained by slowing inflation. Consumer confidence was also remarkably robust over the past two years

A deeper look however shows that many businesses are no longer reaping the full market growth as their over-exposure to

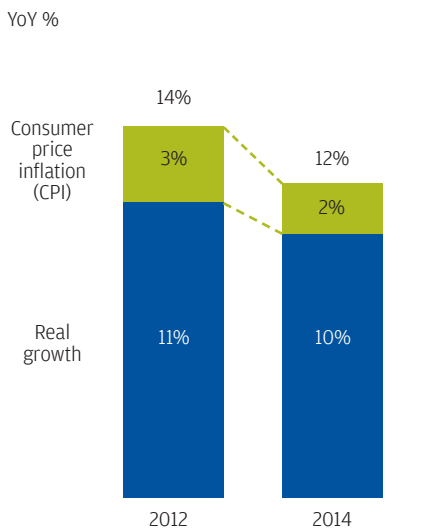
offline retail in Tier 1 and 2 cities drags down overall performance. The growth of online has been well-reported but its true, quantified, impact on offline growth less so. Offline focused businesses who have been used to seeing market tailwinds nearer 13-14% are now seeing closer to 7-8% today if they are nationally distributed or even as low as 3-4% if they are highly Tier 1 and 2 focused

While many commentators have questioned the official retail statistics we can see that they do correlate with business performance once the channel dynamics has been split out. Market wide online-only growth of c.50% pa 13-14 is broadly in line with recent growth in GMV (gross merchandising volume) reported

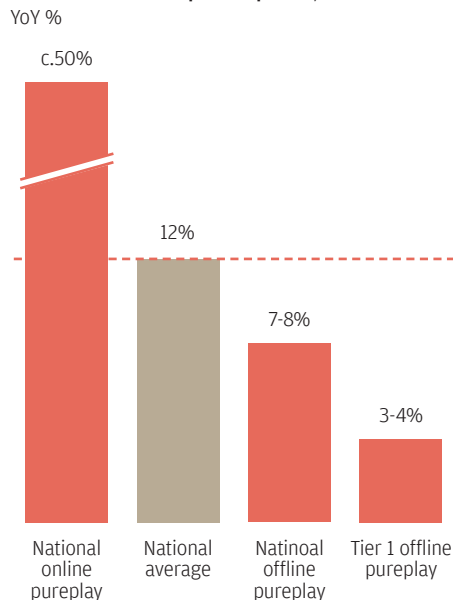
by Taobao/TMall (+55% FY14 vs FY13 and +49% Q2FY15 vs Q2FY14 respectively)

With most of the cost base inflating at far higher rates, notably urban wages, market growth of only 3-4% doesn't count for much. This will put heavy pressure on profit margins for many businesses

National retail sales growth by component, 2012-2014



Growth rate of example compaines, 2014



Source: National Bureau of Statistics, iResearch, OC&C estimates and analysis

While this research, including proprietary consumer research across Tier 1 to 3 cities, paints a dark future for some business models we must remember that China as a whole is still a great opportunity. Even with a slower pace of spending growth in

the 'new normal', China is still growing far quicker than most other world markets. Accessing all of this growth however is the challenge; businesses must adapt to the changing environment and be willing to invest to perform well online

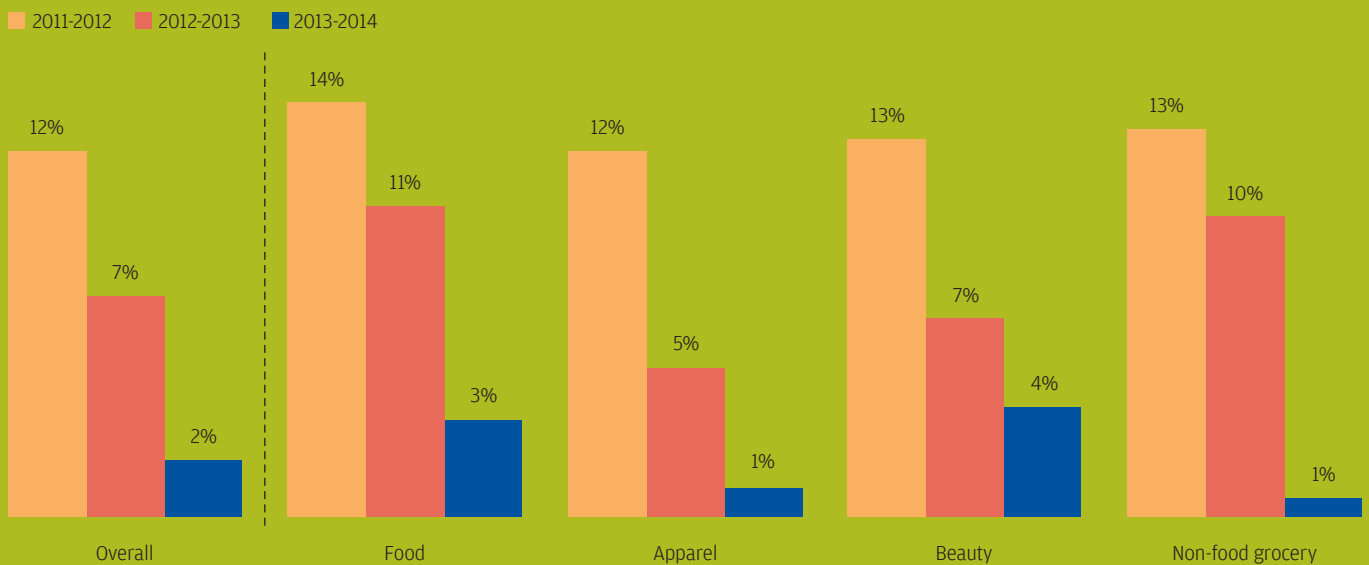
MIXED FORTUNES FOR BIG RETAILERS AND FMCG PLAYERS

2014 was a painful year for many retailers and consumer goods companies in China, particularly during the second half of the year. The double digit growth of the last decade or so was replaced by mid to low single digit growth overall and, for some, negative like-for-likes and sizable store

closures programs. The decline for many of China's largest offline retailers was stark with an average loss of 5 pts of growth from 12/13 to 13/14. Many of these players saw negative like-for-likes, notably grocers, department stores and electrical stores. OC&C's recent publication "In need of fresh

ideas" highlighted the recent plight of hypermarkets: a format which has become reliant on space expansion for growth against a backdrop of falling like-for-likes

Sales growth of China's 100 major offline retail businesses¹, 2012-2014
YoY %



1. Excluding jewelry & household electrical appliances given volatility impact from changes to government subsidies and gold prices

Source: CNCIC, NBS, OC&C analysis

It's not just the retailers who have been badly hit; many of the largest consumer goods companies are also suffering from declining sales, price pressures and overstocking issues. While not as extreme as the situation for offline retailers, it

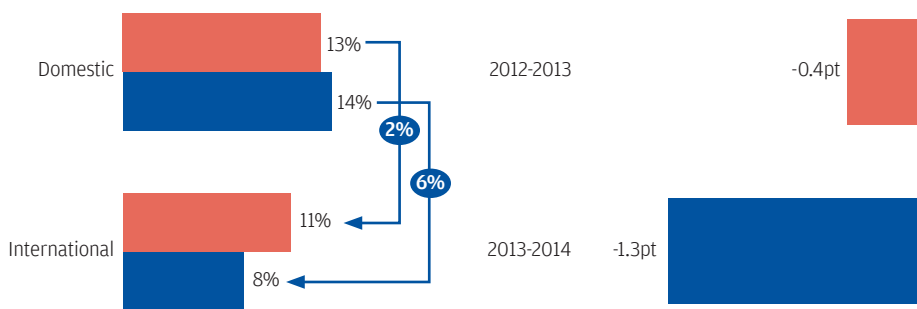
again highlights the pressures many businesses are facing and particularly the international retailers. Exhibit 2 shows the dramatic shift in performance over the past year with a widening gap between the MNC and domestic players

China's top 25 FMCG players by origin, 2012 - 2014

YoY growth rate
YoY %

Share change of MNC
% point change in market

■ 2012-2013 ■ 2013-2014



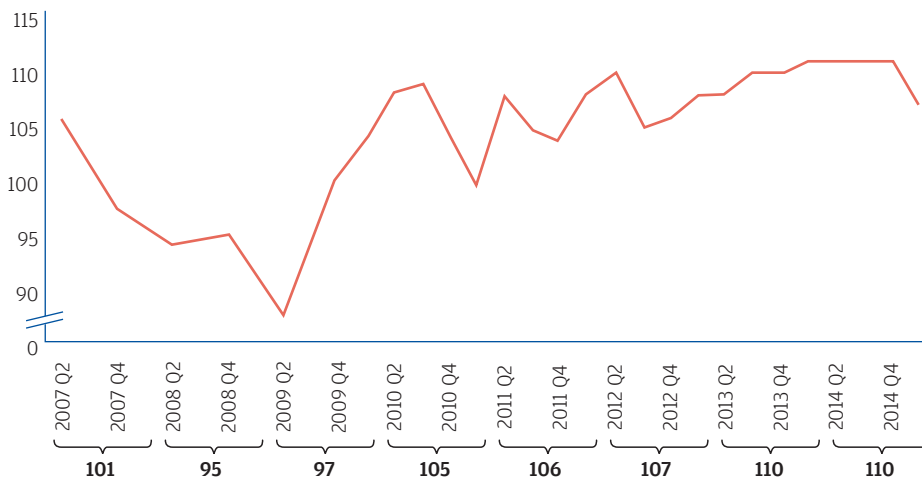
Source: Euromonitor, OC&C analysis

So, is the golden age of growth in China over? Far from it, if you look at the consumer base where personal disposable income growth remains strong at +11% YoY

from 2012 to 2014. Consumer confidence has also remained at consistently high levels for the past 2 to 3 years

Consumer confidence, 2007-14¹

100 = neutral



1. 2007-2008 only reports semi-annual data; quarterly data is interpolated from reported semi-annual data

Source: AC Nielsen, OC&C analysis

CHINA'S STILL ATTRACTIVE, BUT ONLY IF YOU'RE SUCCESSFUL ONLINE

So, if people still have money and are confident to spend it where is it all going? The answer is two-fold, both illustrating why today is the best time in history to be a Chinese consumer:

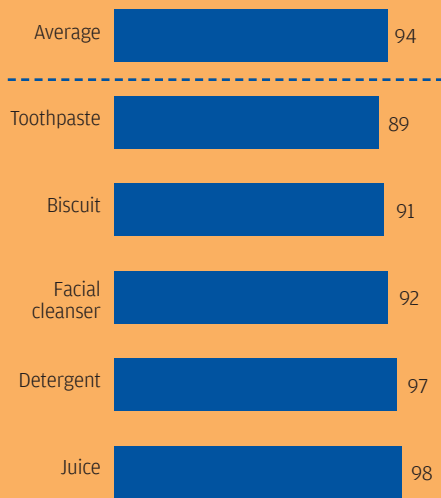
1. WEAKER INFLATION: Declining inflation rates have driven down overall value growth in the market; real retail sales growth has been similar in both 2014 and in 2013 at around 10%. While inflation has begun to rebound in 2015 it remains at around 1%, well below its historic, and target, levels of nearer to 3%

Not only are like-for-like goods cheaper online than offline but there is ongoing deflation in the online channel. OC&C's basket of leading FMCG products shows that the same product bought online is, on average, available 6% cheaper as online players compete aggressively on price. On top of this we see online deflation continuing at -2% pa over 2014. This price difference is putting pressure on offline retailers to follow suit to remain competitive

One of the key drivers of declining inflation has been the growth of online.

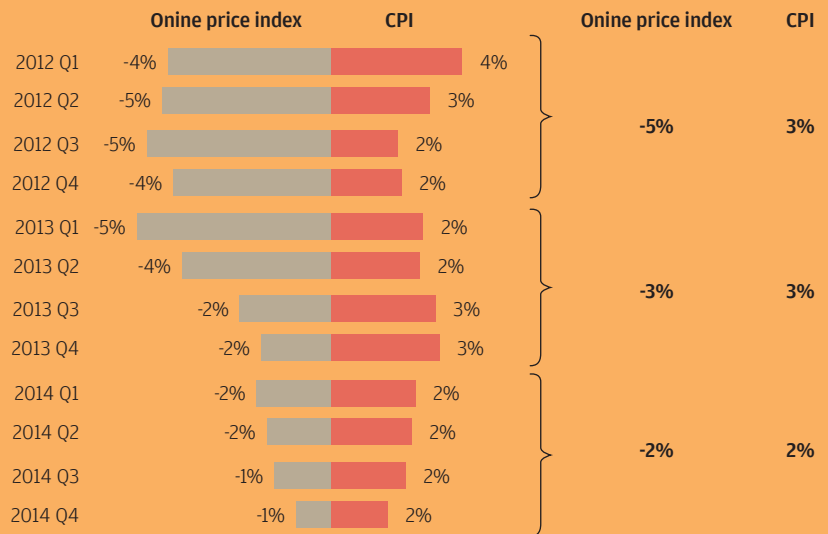
Price & inflation

Online price index vs offline, OC&C consumer price basket, Feb 2015
Offline = 100, Lowest price available by Channel



Source: OC&C consumer price basket

CPI and Online Price Index¹, 2012-2014
YoY %



1. Alibaba a SPI-core

Source: NBS, Aliresearch, OC&C analysis

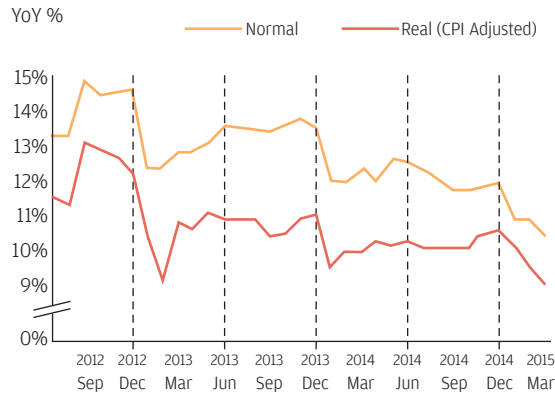
2. ONLINE GROWTH: Online now accounts for over half of the retail market growth given its strong performance during the past 6 months. Online has been the big story of Chinese retail for several years now but has been largely restricted to around a quarter of the total retail growth (c 3 pts out of an overall 12-14 pts). The past 6 to 9 months have seen online eat up much of the gap to represent around half of the retail market growth in Q4 2014. The ongoing growth of mCommerce has been a key

driver of this as OC&C reported on in our recent publication "Unblocked". Online is also expanding relatively newer categories such as grocery. The traditional strength of online generalists such as Alibaba and JD.com has been complemented firstly by their growth into the large grocery category, illustrated by the launch of TMall supermarket, and secondly the growth of powerful specialists such as Yihaodian (estimated over 16bn turnover in 2014)

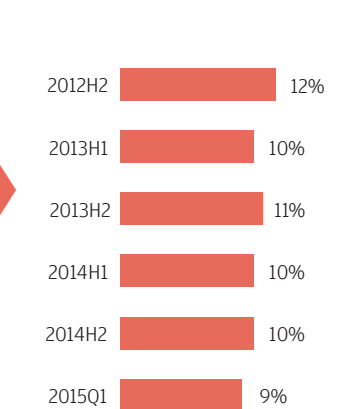
This gap in performance is clearest among the upper Tier cities where online represented nearly three quarters of the total growth in these upper tiers (vs closer to 30% for all China) during 2014. The high concentration of affluent consumers has allowed online to penetrate deeper than other areas, particularly in grocery

Looking to 2015 we saw online rising to 58% of total retail growth year-on-year for the combined January / February and can expect this ratio to continue through the rest of the year. This would sustain online growth at close to 50% year-on-year, making up around 50-60% of total retail sales growth

Growth of China's total retail sales¹, Nominal vs. Real, Jul 2012 - Mar 2015



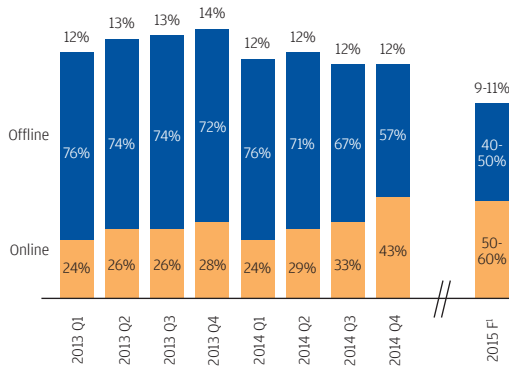
Real YoY growth rate



1. Include retail sales in wholesale, retail, lodging and catering sectors
Source: National Bureau of Statistics, OC&C analysis

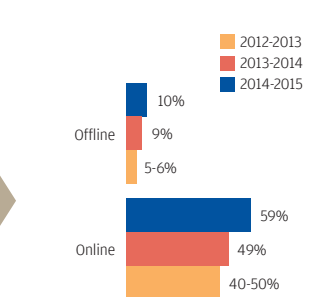
Exposure to retail growth by channel, 2013-2015F

YoY %, contribution to YoY growth



Nominal YoY growth rate, national

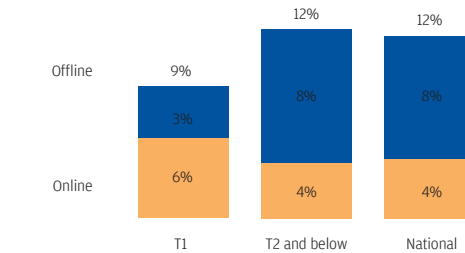
YoY %



1. Total retail value declines 2 ppt as historical, while share of online contribution grows at historical trend
Source: National Bureau of Statistics, iResearch, OC&C analysis

Contribution to retail growth by channel, 2014

YoY %, contribution to YoY growth

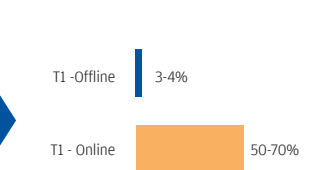


Share of online contribution 2014 vs. 2013

+19 pt. +14 pt. +7 pt.

Actual YoY growth rate, T1, 2013/2014

YoY %



Offline retail may still be growing but a tailwind of only 5% or less from market growth doesn't count for much in China

Source: NBS and Local Bureau of Statistics, iResearch, OC&C analysis

FAILURE TO INVEST IS COSTING MULTI-NATIONALS

The shift online has clearly been bad for the established offline retailers, but it also seems to have had a negative impact on many consumer goods companies. In principle, branded consumer goods companies should be much less vulnerable to channel shifts than retailers. Consumers still want to buy the branded goods and the producer makes the volume regardless

of the end channel. While generally true, it's important to remember the price deflation mentioned earlier will have a negative like-for-like impact on sales of the same product as they move online. In China we also see the emergence of many FMCG players cutting out traditional retailers and setting up their own online store via TMall.

We saw earlier how it is the domestic players, not the MNCs who have been enjoying the best performance during 2014. Much of this problem is driven by underperformance online with many consumers are shifting away from foreign brands as they move online

Online penetration and trend, Domestic brand vs. MNC Brand, Shanghai

% of all respondents, N = 273

Online penetration of brand purchasing in past 12 months¹



Consumers Purchasing More of a Brand Since Migrating Online²



1. Which of the following brands have you purchased in the past year? For brands purchased in P12M, where did you shop the brand(s)?
 2. If you shopped the brand online only or in both channels in P12M, do you buy more, less or the same amount of these brands since you started to shop online?
 Source: OC&C Consumer Price Basket - February 2015, OC&C analysis

Many MNCs are off their home turf and not investing sufficiently to compete in a new and rapidly evolving environment. Most MNCs are experts in handling the big and small-box offline grocery channels, experience and skills built and perfected over decades in their home markets. The big players are used to being the masters of this space with category captancy,

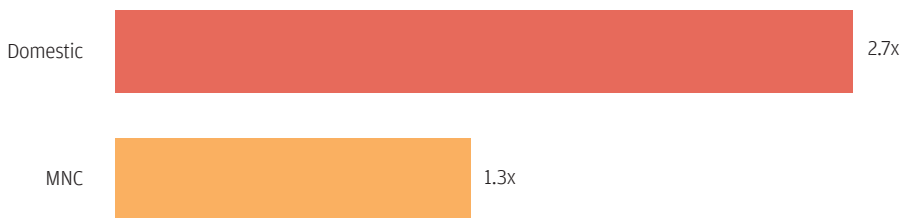
stand-out POS and promotional offerings to name but a few of their skill-set. This has allowed them to build strong positions across China's consumer goods landscape over the last two decades. The online shift however is taking the market away from the typical MNCs and hence eroding much of their retailing advantage

Most players, both domestic and multi-national, appreciate the need to invest more in price online than offline given the relative ease of price comparison and a more price aware consumer base. This said, we do see domestic players

shifting their investment significantly more towards online. This investment in growing channels is supporting their outperformance in the channel and hence overall top-line performance

Ratio of promotional breadth, Online vs Offline by brand origin, 2015

[% SKUs under promotion online] / [% SKUs under promotion offline]



1. OC&C Shopping Basket of 100 SKUs in 5 categories (Juice, Biscuit, Toothpaste, Detergent, Facial Cleanser) across 3 online platforms (YHD, JD.com, TmallSuper) and 2 offline hypermarkets (RT-Mart, Walmart)

Source: Online & offline store audit - February 2015, OC&C analysis

Also, domestic players are getting more additional products online relative to their multi-national counterparts. With a wider product range they not only get a greater sales opportunity from the additional products but also from the improved share

of eye-space online. This trend is true across a range of categories, both at the overall level and when isolated to look at just the top brands by category

Share of SKUs from Domestic Brands¹, 2015



1. OC&C Shopping Basket of 100 SKUs in 5 categories (Juice, Biscuit, Toothpaste, Detergent, Facial Cleanser) across 3 online platforms (YHD, JD.com, TmallSuper) and 2 offline hypermarkets (RT-Mart, Walmart)

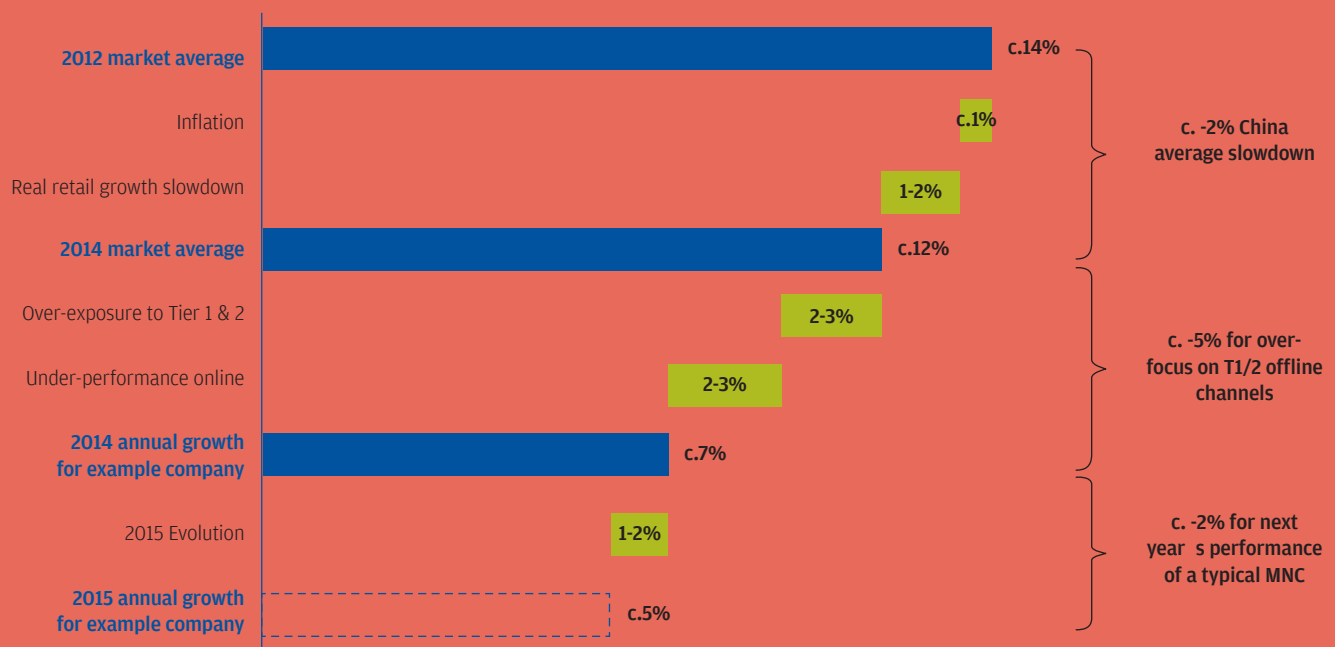
Source: Online & offline store audit - February 2015, OC&C analysis



Retail and consumer goods businesses who are under-exposed to the growth areas of the market have seen their underlying

growth rates halved over the past two years and can expect to see it decline to close to 5% in the coming year

Slowdown impact on an example upper-tier city, offline focused company



1. Example company: revenue split between online and offline - 5% : 95%, between T1/T2 and other cities - 80% : 20%
Source: OC&C analysis

There are 4 key actions that consumer businesses in China need to be considering as part of dealing with this change in growth dynamic

1. Be realistic about your underlying market and budget appropriately

China is no longer the land of unbridled growth it used to be. Accepting this, understanding true exposure to market growth and then planning correctly for the future will put businesses on a stronger footing. An offline, upper-tier focused business cannot expect to perform like the overall market without the growth pillars of online and lower-tier cities. For many multi-nationals this can be a tough sell back to home offices but it is a challenge better faced up to now than later

2. Offline is far from dead but does deserve less focus

The expertise and culture of many MNCs is, and remains, focused in offline modern trade. It's still the biggest channel for most so cannot be forgotten but too strong a focus many hold back the business for embracing the faster moving online. If online isn't getting the focus it needs then it may require a senior level carve-out, in both P&L and personnel, to give it the focus it needs

3. Look to lower tier cities

Lower tier cities are more attractive than ever as a source of growth in China and businesses need to ensure they have access to these consumers. The scale of opportunity will be very different for each business thus impacting their approach. All players should look to serve these cities via online but those with more suitable propositions will need to ensure they have a solid offline retail strategy to make the most of the opportunity

4. Building the right proposition for growth in each channel

The growth and pricing dynamics of each channel are radically different and need to be assessed individually vs both your own and your competitors performance

- Focus on blockbuster brands

Front of mind awareness is more important than ever in the online world. Front of mind, blockbuster brands are best placed to push through the overwhelming range of choice online. Focusing harder on the marketing of your blockbuster brands will help them cut through and become destination items online

- Leverage a full range online

Online allows players to offer a broader range of products than offline. These specialist products can be destination products in their own right if they are suitably specialist and often unavailable offline. Aside from sales they can help to "pad" out the brands presence in a category and gain eye-space

- Invest in Promotions

Online is a more cut-throat world than offline and in turn requires a greater level of promotional investment. If businesses want to hold / gain share online they need to be willing to invest in promotions to get there. It's not just a case of the depth of promotions but also a creative range of mechanisms

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