

County-level city¹ economics: China's next three golden decades

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In 1978, Deng Xiaoping, a visionary Chinese politician and diplomat, initiated China's "reform and opening up policy" in order to revive the country's desolated economy and lay the foundation for China's following three golden decades. The policy brought more than 30 years of rapid economic development in China, especially in coastal and mid-to-large cities.

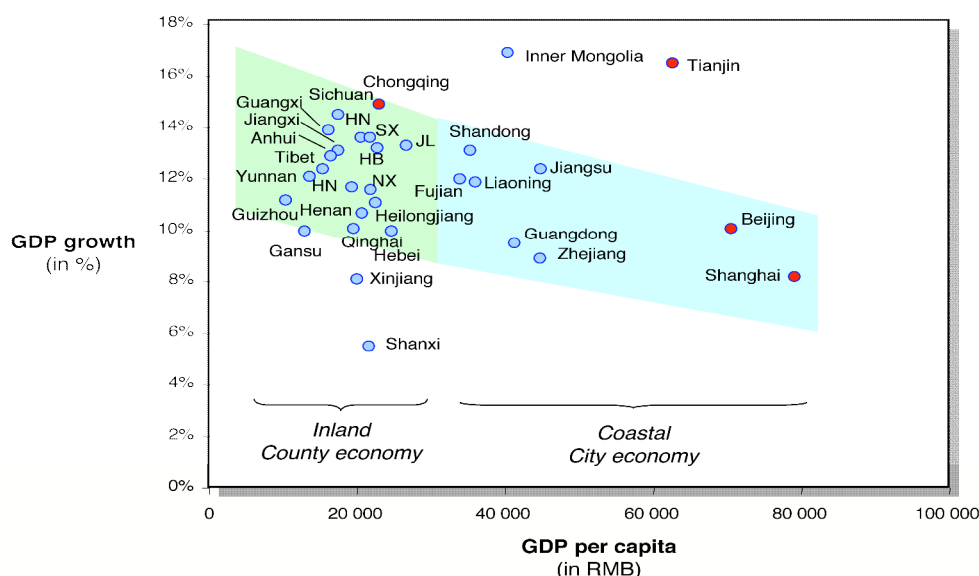
Over the past thirty years, China's economy has maintained a miracle double-digit annual growth rate. GDP per capita has grown from just US\$ 200 in 1978 to over US\$ 4,000 in 2010. There are many reasons behind this, but the key lies in the focus of China's opening up policy on coastal regions and Deng Xiaoping's 'let some people get rich first' philosophy. The average growth rate of coastal regions has been on average 12.4% p.a. versus 10.6% in central China and 10.2%¹ in western China, leading to large discrepancies in wealth.

Since the global economic crisis in 2008, the growth rate of coastal regions has dropped from 12.4% p.a. (1990-2007) to 12% p.a. (2008-2010), due to shrinking demand for exports. Meanwhile, China's inner regions are experiencing rapid growth (as shown in figure 1). Rising labor costs and other factors affecting coastal regional economies are diminishing their advantages over inner and county economies.

So what will be the engine of growth during China's next three golden decades? It surely will be the county level economies, given their huge scale, cost factor advantages, adoption of administrative reforms and increasing urbanization rates.

- Figure 1 -

2009 GDP per capita and GDP growth



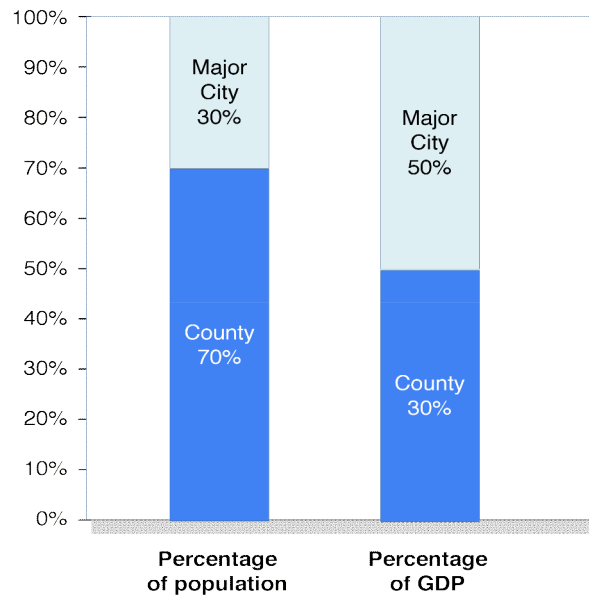
Note: Red refers to municipality cities. Chongqing is the newest municipality with more county-level population than others

¹According to the administrative structure of China, Provinces (including autonomous regions, municipal cities and special administrative zone) are under the central government, and prefecture-level cities under provinces, county-level cities under prefecture-level cities. Most of the rural areas are under county-level cities' management.

County-level cities' vast population as well as enormous GDP output will set them up to be the next key battle ground in China. By the end of 2010, there were 2,001 county-level cities in China, accounting for 50% of China's GDP and 70% of the total population. Nowadays, most of the rural population can be found in the county regions, which will act as the next springboard for further urbanization.

- Figure 2 -

Percentage of population and GDP for county economy

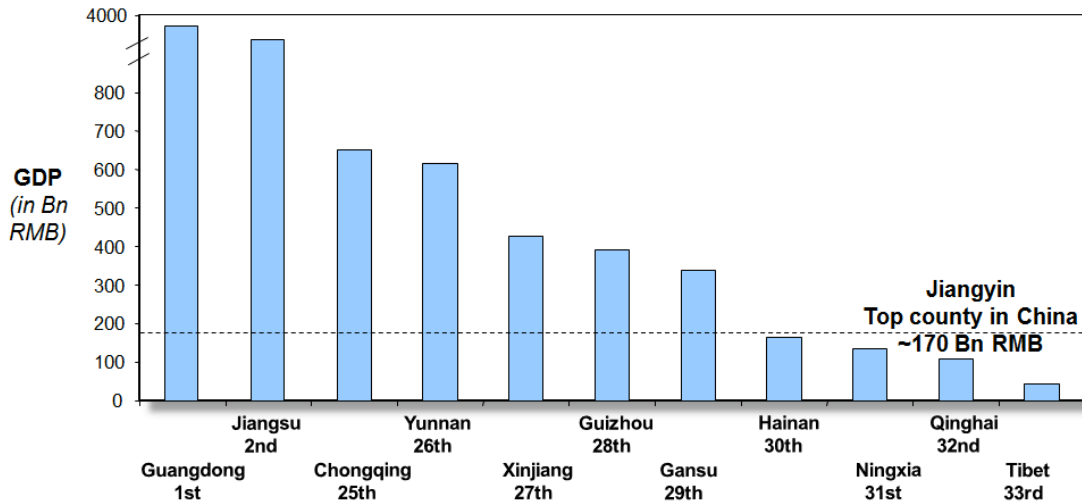


Many county-level cities are already of a significant economic scale and competitiveness. The top 100 county-level cities in China have an average population of 830,000 and GDP of 48 Bn RMB. Average income per capita has reached 22,170 RMB in county center and 10,560 RMB in the rural areas.

Jiangyin County in Jiangsu Province ranks 1st with a GDP of 170 Bn RMB and 13% annual growth. Its economic scale is even larger than the individual GDPs of provinces such as Qinghai, Hainan, Ningxia and Tibet. In addition, its purchasing power and market potential are even higher than some cities and provinces.

- Figure 3 -

Comparison of GDP between provinces and Jiangyin County

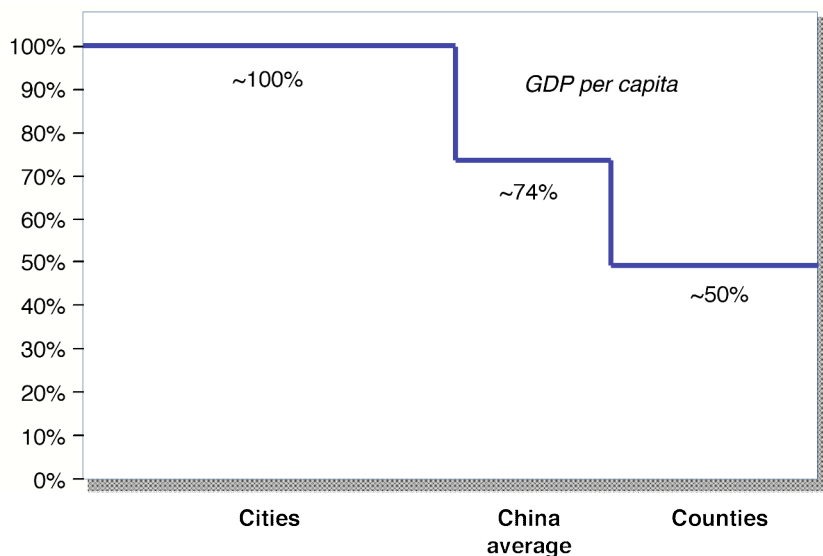


County regions have significant cost advantages leading to the relocation of production operations. Due to increases in labour costs and land prices, the cost advantages of coastal regions are being quickly eroded. Companies in China will not be able to compete with their competitors located in other low cost emerging countries (e.g. Vietnam) unless they transfer their production capabilities to lower cost areas. Increasingly, companies will relocate their factories from coastal areas and major cities to central and western parts of China mirroring the transfer of production from Japan and Korea to China during the past thirty years.

In 2010, the average salary in coastal provinces was approximately 40,000 RMB per year, almost 57% and 23% higher than central and western China respectively. In the county-level city economy, there is a vast agricultural population who are willing to relocate to areas relatively close to their home towns and villages. The low cost and abundant supply of labour is the county economy's key advantage.

- Figure 4 -

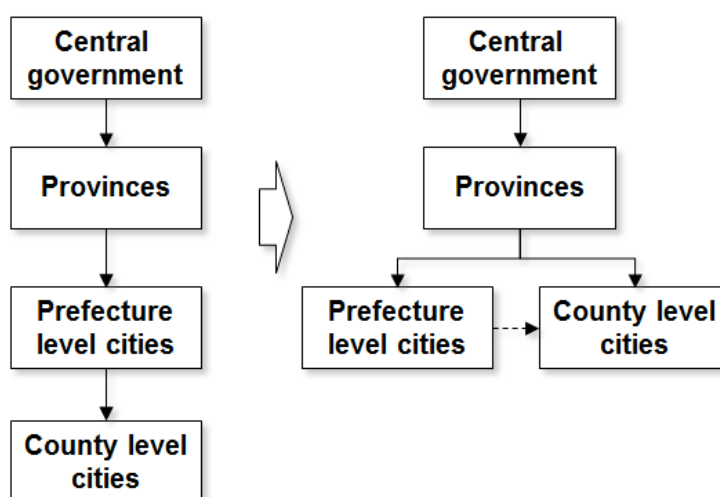
Lower county-level city GDP per capita



Administration reforms are supporting the development of the rural economy. China's administrative structure is formed of five levels: central government, provincial, prefecture-level city, county-level city, and town. Since 1982, power has increasingly been decentralised with greater responsibility and influence being delegated to the county administrative level. To further facilitate the delegation of administrative power two models have evolved: In the first model, county-level cities and prefecture-level cities are regarded as equivalent economic units and are directly managed by provincial administrators, as is the case in Hainan province. In the second model, counties are given their own economic self-jurisdiction while matters related to education, legal and healthcare issues remain the responsibility of prefecture-level city administrators such as is the case in Zhejiang province. Both these strategies aim to make the administrative structure flatter as well as boosting the number and scope of policy and financial benefits bestowed upon counties by provincial administrators. Since most of the counties are relatively economically underdeveloped, local governments are incentivised to provide favourable policies and support to attract companies in order to improve their own economic and fiscal standings.

- Figure 5 -

Administrative structure reform in China



Development of county-level cities will be the next driver of urbanisation in China

Over the past thirty years, China has experienced the largest mass migration of people and the fastest rate of urbanisation the world has ever seen. However since 50% of the population still resides in rural areas, China's urbanization level still has plenty of room for further growth. The increasing urban population has however put a considerable strain on the transportation networks, healthcare services and social security infrastructures of China's major metropolises. As a result, China's next round of urbanization will need to focus more on the country's county-level cities. Geographically, county-level cities are closer to rural areas and thus find it easier to accommodate future rural population migration. For the migrants not only are living expenses and real-estate prices more affordable but the "Hukou" resident permit systems are also much less rigid compared to those implemented in larger cities.

The influx of immigrants from rural areas will provide an additional "demographic dividend" for the county-level cities by increasing the ratio of productive workers in their population and growing consumer demand. This will become a key advantage for the county economy.

CLIP as a guideline for investment in the county economy

Since county economies are less developed than their prefecture-level city counterparts, there are significant risks involved in doing business in these regions. To be successful, it is important for companies to bear in mind several key ground rules. These essential points can be summarized as CLIP: Customization, Localisation, Infrastructure and Penetration.

Customization: tailor the product and brand strategy to meet the needs of the county market

Unlike consumers found in the larger cities, consumers in county economies have different affordability price points, buying behaviours, brand awareness and perceptions due to their differing educational backgrounds, living environments and life styles. Companies are suggested to 'tailor' the product and brand to the right target and explore new business models incorporating customised pricing strategies, distribution channels, after-sale services etc.

Haier presents a good example of a well-executed customization strategy. Based on their understanding of rural consumers, Haier tailored their refrigerator products to meet these consumers' needs. The new products are cheaper, more durable and less technology complex than those developed for the middle to large cities. Haier also launched the two new product lines "Joy" and "Happiness" for newly-weds and family use in rural areas. In addition, to better serve the county market, Haier has also built an after-sale service network in these markets from scratch.

Localisation: familiarize with localisation requirements

One of the key success factors for county market entry is to localize: It is essential to localize operations and management by building a local team who truly understand the market and are familiar with functions such as human resources, marketing, sales and after-sale services. Localisation will not only save cost, but also improve the efficiency and profitability of the company.

Infrastructure: only certain county markets benefit from developed infrastructure and favourable development policies

There are significant differences among the more than 2,000 counties in China. Companies should investigate the level of infrastructure development carefully when it comes to choosing which counties to invest in. A well-developed infrastructure not only refers to good physical transportation networks but also the openness, investment policy, social security framework, education level and purchasing power of the region.

Penetration: to penetrate the market through innovative channel strategies

In the county markets, the density of population is much lower than that of middle to large cities. Developing distribution channels is thus usually more difficult and expensive. At the county level a company's hard work and investment will be in vain unless they can reach their end customer, consequently distribution is even more vital than having a highly regarded brand image. A well-developed yet cost efficient distribution network is the key to winning at the county level.

50 years ago, millions of young Chinese city dwellers were moved to county and rural areas and hoped to eradicate the difference between city and countryside. 50 years later, companies may follow a similar migration from large city to county and countryside. However, unlike their city dweller predecessors, the first companies to successfully ride this wave will be greatly rewarded.

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Estin & Co is an international strategy consultancy based in Paris, London, Geneva and Shanghai. The firm assists the boards of major European, North American and Asian groups in their growth strategies, and private equity funds in analysing and improving the value of their investments.