



## Why digital interactive advertising spending in China should increase.

Brands in China are seriously overspending on TV and even more seriously under-spending on digital interactive advertising. Why do brands, their agencies and media planners behave so irrationally?

The argument I commonly hear is that China is a massive country, with a massive population and, therefore, you cannot build a brand without using such mass media – even given their high cost.

I will attempt to prove that the actual “available” market is not that massive since only 150,000,000 consumers are “profitable” right now and that brands need a fair dose of digital interactive advertising in their plans to reach an acceptable ROI.

### Only 150,000,000 “profitable” consumers?

Yes, only 150 million “profitable” consumers and 4 reasons why it’s reasonable to say so.

1. According to the Circulation and Consumer Research Office of the National Development and Reform Commission (NDRC) members of the middle class in China have an annual income of at least US\$ 4,250/Year. This group included roughly 130,000,000 people a few years ago.

2. Mastercard – for worldwide comparison purposes uses the somewhat higher US\$ 5,000 level as the bottom-line to define middle class.

3. Mc Kinsey’s figures for 2005 tell us that roughly 10% of the Chinese urban households earned more than this US\$ 5000/year and owned 35% of the total disposable urban income.

[http://www.mckinseyquarterly.com/article\\_abstract.aspx?ar=1798](http://www.mckinseyquarterly.com/article_abstract.aspx?ar=1798).

These consumers are said to be the only profitable consumers right now. Profitable to be understood here as “*they can buy a bit more than just the basic things they need to survive.*” It also means *brands & retailers get a substantial profit out of them.*

4. Hence, there is some logic to reduce the number of “profitable” Chinese consumers from 1,3 billion to only those who earn more than US\$ 5000 per year. That’s roughly RMB 3,300/month.

Of course, you could consider targeting consumers in 2<sup>nd</sup> and 3<sup>rd</sup> tier cities with incomes of RMB 2,900 and 2,500 / month. You could even imagine targeting the 400,000,000 people earning RMB 2,000/month. But the more you target these lower income groups, the riskier the short term benefits and the higher the cost.

That's why the RMB 3,300/month level is particularly attractive. With RMB 40,000/year in the wallet, Chinese consumers can buy the same amount of goods as a US middle class person in the US can do with US\$ 20,000. Is life in the US on average 4 x more expensive than in China? Should be! A Big Mac in the US is at US\$ 3.22 right now. In China US\$ 1,41. This Big Mac reflects the cost of bread, meat, vegetables as well as rent and labor.

[http://www.economist.com/markets/indicators/displaystory.cfm?story\\_id=8649005](http://www.economist.com/markets/indicators/displaystory.cfm?story_id=8649005)

### Where do these 150,000,000 live?

There are 3 regions in China where the average income reaches that minimum level. They are the well-known trio that encompasses 10 -12 % of the Chinese population.

1. *The Yangtze River Delta with Shanghai as main city - 82m inhabitants*
2. *The Pearl River Delta with Guangzhou and Shenzhen - 43m inhabitants*
3. *The Beijing-Tianjin corridor - 25m inhabitants*

Among them, the big spenders are the 29,000,000 million living in the urban centers of Shanghai, Beijing and Guangzhou. These "top earning 2%" of all Chinese own 13% of the disposable income.

### <Consuming China> according to Dragonomics

These 150 million middle class Chinese are labeled as "Consuming China" by Arthur Kroeber (managing editor of the China Economic Quarterly) and Matthew Crabbe and Paul French (directors of retail consultancy Access Asia). They published their views in the December 2006 issue of Dragonomics.

They multiply <average annual income> x <amount of inhabitants> and get the total available cash to spend per year. In China it will be <US\$ 5,000> x <150,000,000>.

- The authors conclude that the real "consumer market value of China" is about the size of Korea.
- Spain is 0.3 times bigger.
- Germany 3.5.
- Japan 6.
- The US is 14 times larger than China.

[In China probably 20-25% of this so called available cash is not available and is not spent, but saved!]

Next to <Consuming China> there is also a <Surviving China>. The Dragonomics authors describe them like this:” ...a billion or more people who essentially buy food and clothing at or slightly above subsistence level. They generate a large volume of retail sales, but these sales are meaningless from the standpoint of foreign consumer goods and retail companies. They are also not terribly interesting from a macro-economic perspective, because subsistence purchases can never become a driving force in the economy”

### How many RMB's should brands spend to sell to <Consuming China>?

Since I'm in advertising I wondered whether this insight into the real size of the market is reflected in advertising spending. If there is currently 14 times more money to earn in the US market than in the Chinese market, then brands should invest 14 times more in the US, or 14 times less in China.

I looked into some recent figures for both the Chinese and the US markets and I was amazed that brands completely ignore the “14:1 conclusion”. Brands behave really strange.

#### 1<sup>st</sup> fact

Advertising spending in the US is at about US\$ 150 billion/year. In China it was as high as US\$ 50 billion in 2006. It will probably be more this year. This 50 billion is not 14 times less than in the US but only 3. Brands are overspending in China. Why?

#### 2<sup>nd</sup> fact

TV spending in the US is at US\$ 66 billion. In China it was at US\$ 40 billion last year! Not 14 times less than in the US but only 1,6 times less. Unbelievable. Why? I don't know. Brands are hyper-overspending on Chinese TV. China is the 2<sup>nd</sup> TV-advertising country in the world.

#### 3<sup>rd</sup> fact

In 2005, web advertising in the US accounted for US\$ 12.5 billion and probably US\$14 – 15 billion in 2006. This year US\$ 19.5 billion is predicted. In China it was a mere US\$ 520,000,000 in 2006.

Not 14 times less than in the US but a staggering 24 times less.

Brands are hyper-hyper-under spending on the web in China - 24 times less than in the US and only 1% of the total ad spending in China!

- In 2007 brands in the US will probably invest **US\$ 70 - 80 per web user** (roughly 200m web users)
- In the UK probably **US\$ 110-120 per web user** (roughly 35m web users). According to WPP's Martin Sorrell the UK is “*the most advanced digital advertising market in the world, with 14 per cent of advertising budgets spent online last year, rising to 18 per cent in 2007*”.(Financial Times Feb 23.02.2007)
- In China probably only **US \$ 4.** (roughly 140m web users)

	US	China	ratio
Consumer Market Value. Base is China = 1.	14	1	14
Overall advertising spending per year in US\$ *	150	50	3
TV –advertising per year in US\$ *	66	40	1.6
Web advertising per year in US\$ *	12.5	0.52	24

(\* None of these figures are absolutely certain. They are fair guesses based on estimates of the research companies)

### **Why this huge difference? Future growth?**

Many reasons can be put forward why there is such huge difference in investments between the US and China.

The most important argument for the huge overspending cannot be the size of the market but the enormous growth potential of Consuming China. Right!

If the total income of Consuming China grows at a pace of 10 % per year during the next 15 years the <Chinese consumer market value> will be at the level of Germany now.

Since brands have to fight to get their share of that future market, the US\$ 50 billion ad spending becomes somewhat tolerable. Maybe it's wise to use 60 – 70% of that sum to target the actual Consuming China segment (they have the money now) and the remaining 30-40% to target – very locally, with deeply penetrated local media - the next 10% of the consumers that will have the money later ... when they join <Consuming China> during the next decade. This is the RMB 2,200 – 3,300/month group.

### **If this future consumer is the target too, then brands should double or triple the share of spending for interactive.**

If this bright FUTURE is the main reason to overspend now, then WEB ad investments should at least double or triple immediately. At the least! The future consumer has two faces. One group is living in tier 2 and tier 3 cities and using old media. Another group is younger, living in the <consuming China> region and using new media.

Let me explain.

1. The argument I hear and read so often is that you need huge amounts of TV time to reach the Chinese population. This is of no value when your immediate target is “only” the 150,000,000 consumers with an average income of RMB 40,000/year.

Probably 50% of them have an Internet connection and spend more time on the web than in front of their TV. The Internet accounts for 15 - 20% (or more?) of the average media time in China. Of the almost 9 hours Chinese spent with TV, radio, newspaper, magazines and web, 2.41 hours per day go to the web according to the latest CNNIC 2006 figures. Nevertheless, the web gets only 1% of the huge advertising budget.

2. "Half of the internet users are extremely young Chinese addicted to games" said a 4A boss recently here in Shanghai. The reality is that only 17% are younger than 18, that 35% is in between 18 and 24 ...and that the rest (65,000,000 Chinese!!) is older than 24 probably living in the area <consuming China> and a large part of them probably earning more than RMB 40,000/year. The recent survey conducted by the China Internet Network Center (CNNIC) proved even that the Chinese do exactly the same things as the rest of the world's users: check e-mail (56.1%), read the news (53.5%) and search for (51.5%) and acquire information (41.0%).

**Back to Dragonomics to check the relative price of TV in China.**

Let me come back to the Dragonomics article. I haven't yet referred to their MCU – the Malaysian Consumption Unit- that is "an analytical tool which combines population, per capita GDP and geographic concentration into a single indicator. (...) Malaysia, a country small enough to be considered a single market, had in 2005 a population of 25m and per capita GDP of US\$5,000. An MCU is the product of these two numbers. A country's MCU score tells us how much discretionary consumer expenditure we can expect it from it, in multiples of the Malaysian market" (Dragonomics- December 2006 issue)

United States	84
Japan	37
Germany	22
Spain	8
South Korea	6
China	6

Source: CEQ estimates

<Consuming China> (the one part with 150,000,000 consumers and an average income of Rmb 3,300/month) is the equivalent of 6 MCU. The US is 84 MCU's.

In an MCU everything has a certain price, including TV-commercials. Interesting figures appear when you compare the cost per ratings point (CPRP) of different countries using the base US\$ 300 of CPRP in Malaysia, multiplied by the Dragonomics value for each of the countries. The calculated CPRP for the US, Japan and Germany reflects more or less the real CPRP. The real CPRP for US and Japan are even 15% lower. Germany is 7% more expensive. However, the difference between the two figures for China is immense. The real CPRP in China is 70% higher than what is calculated based on the MCU index. It proves again what everybody knows - TV in China is TOO EXPENSIVE.

- o Moreover, when you take into consideration the high rate of ad-avoidance in China the CPRP is even astronomical: "The problem is that many Chinese consumers are tuning out this bombardment of marketing messages and now resist them even more fiercely than people in Western markets do. To give one example, in 2004 Chinese television viewers left the room or changed channels 72 percent of the time when ads were aired—more than viewers in other major countries—compared with 42 percent in 1999." (Mc Kinsey – building brands in

China – 2006)

<b>country</b>	<b>cprp-cost unit</b>	<b>size of country in MCU</b>	<b>cprp based on MCU</b>	<b>real cprp</b>
Malaysia	330	1	330	330*
USA	330	84	27720	23354*
Japan	330	37	12210	10,302*
Germany	330	22	7260	7790*
China	330	6	1980	<b>3381*</b>

[\* the real CPRP are Mindshare – figures of summer 2006]

I wonder how McDonald's profits differ in China and Malaysia. In the latter the Big Mac price is at US\$1,57 (more expensive than the US\$ 1.41 in China). To make matters worse, McDonalds has to spend 70% more per CPRP than in Malaysia. Spend more, earn less?

**Conclusion? Spend more on line and less on TV.**

The conclusion of the honorable Nielsen in their ChinaTrendwatch 2007 gets my support. "Given the astounding growth in China's online population, the Internet will become the most efficient way to quickly understand consumers across China's vast markets. We may also see innovations in how marketers use the web to reach consumers as standard online advertising may not be enough to catch the eye of China's technology-savvy online population."

Nielsen is far from being the only researcher who's convinced this change is about to happen. Read Steven Fredericks, president and CEO of TNS Media Intelligence: "The shift to digital media is due to more fragmentation. [Advertisers] get more effectiveness out of their ad dollars, [which] can go a longer way. It's cheaper to advertise on digital than traditional media."

Forbes however wrote during this 2007 Chinese New Year holiday that this TV-dominance in the ad world is very good news for broadcasters in China: "TV took the lion's share of the ad market, with 81% of total revenue. That's good news for broadcasters, many of which continue to invest in infrastructure and improved programming with the expectation that ad growth will continue at these rates for several years to come."

That's not my expectation. The phenomenal share of TV in China and the high CPRP is so irrational from a sound business logic point of view, that over the years it should change. At the beginning of this Year of the Pig I can only hope that this year should already be an auspicious one for all digital players. The 140,000,000 Chinese internetusers included.

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