SERVING UP A WINNER

Establishing a winning proposition in China's restaurant landscape

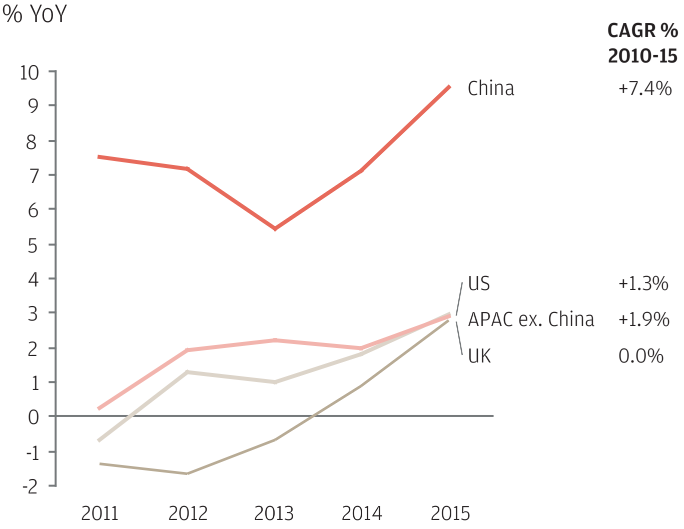
OC&C Strategy Consultants

China is home to almost 1.4 billion people, close to 8 million foodservice POS and dozens of unique local cuisines. The middle class is growing explosively and is expected to reach one billion people by 2030. As disposable incomes rise and a younger generation of middle class emerge, lifestyles are changing. Chinese consumers are eating out more frequently than ever before and developing an appetite for international cuisine. Restaurants are racing to stand out against a backdrop of increasing competition for a share of the 'Chinese stomach'. How does one begin to untangle the diverse and fragmented restaurant landscape to find a winning formula? OC&C delves into this topic with an in-depth study, covering consumer surveys and store audits, in search of the answer.

MACRO LANDSCAPE

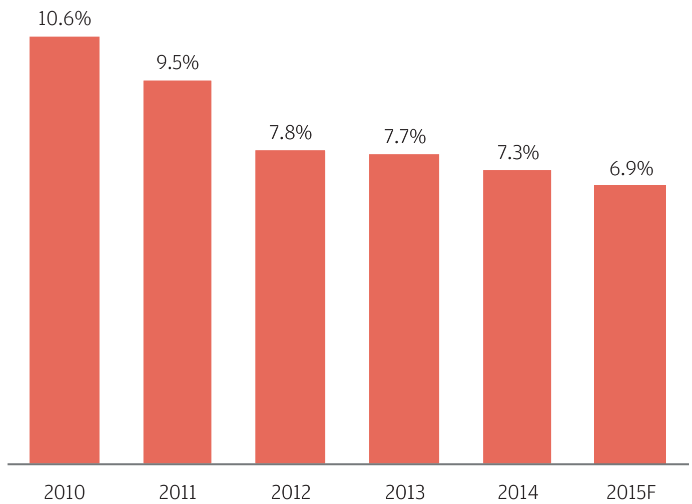
China's restaurant market is more vibrant than ever, with growth outstripping other major markets and showing extraordinary resilience in a time of lower GDP growth (Figure 1-2). In 2013, a series of food safety scandals shocked the nation and damaged consumer confidence; at the same time the government's crackdown on corruption drastically cut spending on extravagant banquets. Yet, the market quickly rebounded the following year, driven by the rise of the middle class and increasing consumption.

FIGURE 1:
Growth of Consumer Foodservices RSP, 2010-15
% YoY



Source: Euromonitor

FIGURE 2:
China Annual Nominal GDP Growth, 2010-15
%



Source: World Bank

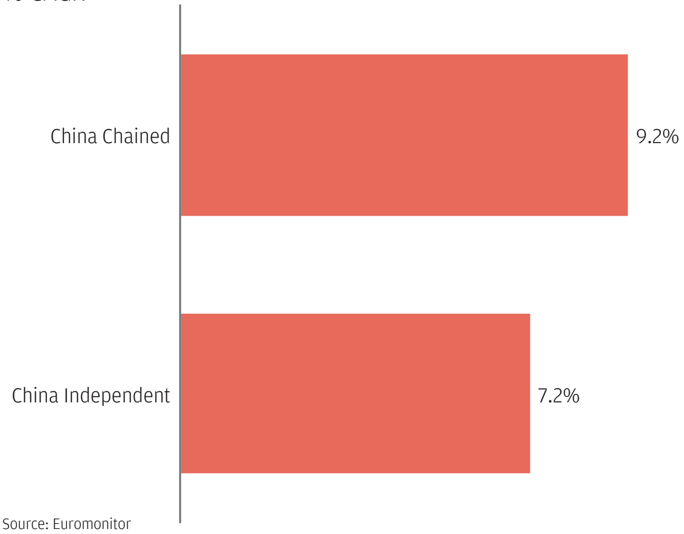
Chinese consumers are becoming more sophisticated. This leans in favour of chained restaurants, which are perceived as offering guaranteed quality. Chained restaurants have out-performed their independent counterparts in store growth, benefitting from their reputation of quality, trust-worthiness and consistency. As cities continue to modernise, smaller traditional establishments diminish, presenting restaurant chains with an opportunity to capture even more growth. The full potential of chained restaurants is far from being reached in China (Figure 3). Looking forward, restaurant chains are likely to continue gaining share, leveraging on brand recognition, experience sharing, buying power, and supply chain capabilities.

FOOD SCANDALS: Food safety scandals, including the melamine milk scandal in 2008 and the discovery of dead farm animals in the Huangpu River in 2013, have significantly undermined the confidence of Chinese consumers. In 2014, a food safety scandal involving a supplier for Western brands including McDonald's, Starbucks and Yum, served as a stark reminder that even foreign food companies, which generally hold a better reputation among Chinese consumers than domestic competitors, can lose credibility and struggle to regain it. The scandal hit Yum's KFC just as it was beginning to recover from the outbreak of avian flu and another food safety scandal the year before, causing renewed damage to sales and share value.

FIGURE 3:

Growth of China Foodservice RSP, 2010-15

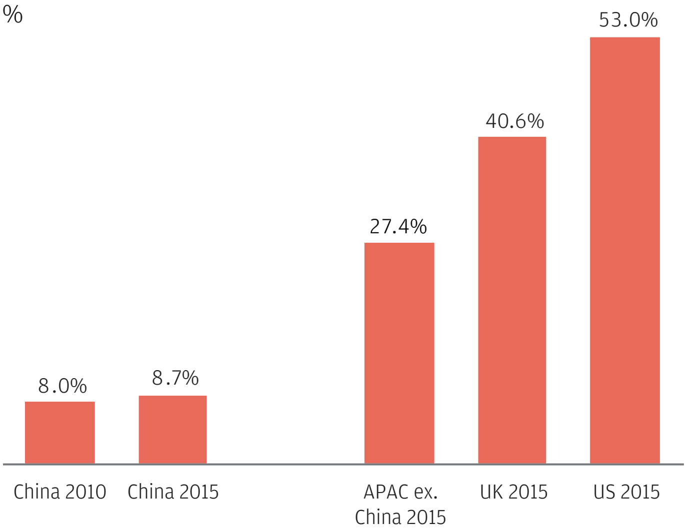
% CAGR



Source: Euromonitor

Share of Chained Foodservice RSP, 2010-15

%



Source: Euromonitor

Inside Miss Zhao restaurant, high-heel themed catering to young female clientele

New restaurant concepts have emerged in the market, such as restaurant theming, healthy lifestyle menus, use of organic produce, as well as fusion / innovative cuisine. For example, restaurants which offer themed food and décor based on a certain era, cartoon character or other pop culture reference have attracted a young and enthusiastic clientele. Restaurants that serve “light meals” and champion quality of produce are also receiving a warm welcome to China, thanks to growing health and environmental consciousness.

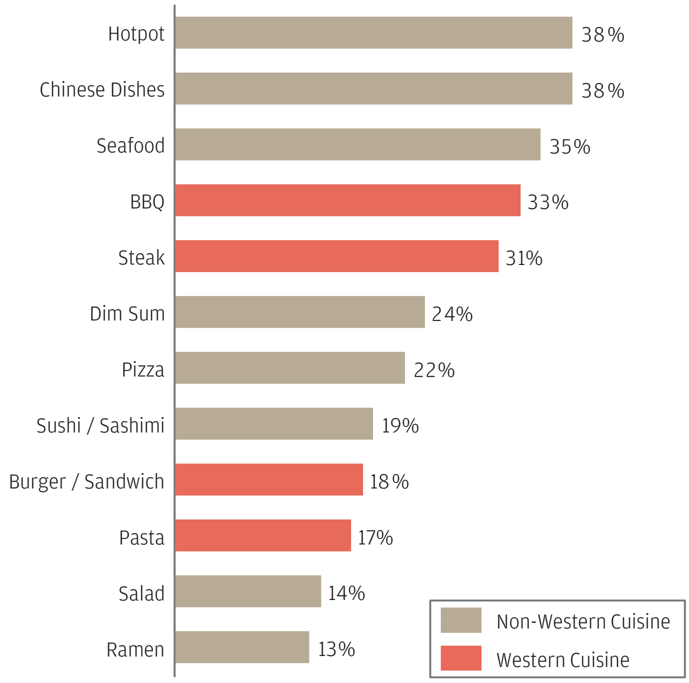
The middle class, with annual household incomes between US$9,000 and $34,000 has grown explosively and now account for 68 percent of all urban households. The increase in disposable incomes has meant that Chinese consumers now eat out more frequently. In OC&C’s research covering 21 cities spanning different regions and tier groups, people on average dine out almost three times a week. At the same time, Chinese consumers are now also more open to and eager for international cuisine. Exposure to international cuisine, through the media and overseas travel, has driven this trend. Outbound trips by mainland Chinese have grown at a CAGR of 19% over the last ten years, as discussed in our 2014 report titled “Journeys to the West”. Western dishes rank highly among preferred food types, with certain tastes such as steak and barbeque faring even better than the oriental flavours of Cantonese dim sum and Japanese ramen, despite their closeness to home.

Increased dining out, coupled with a willingness to try new foods and a more international outlook, have meant that the awareness of international brands has soared in recent years. Nevertheless, exposure and awareness can only do so much – the rapid arrival and expansion of international chains in the past few years have increased the competitiveness of the market. Despite heightened curiosity and receptiveness, getting a Chinese consumer to visit your restaurant has become ever-more challenging, and conversion rates for most international chains have fallen 5-10% as a result.

FIGURE 4:

Most Preferred Food Type

% Respondents Ranking Food Type as Most Preferred (5 of 5)



Source: OC&C Restaurant Proposition Index 2016 Survey

RESTAURANT RATINGS

In spite of the complex and increasingly competitive restaurant landscape, international chains can successfully win over the hearts of Chinese consumers. We asked Chinese consumers to rate restaurants on a five-point scoring system based on their strength under a range of different occasions. The highest rated restaurants are showcased below (Figure 5). The strong performance of international chains, ranging from fast food such as Pizza Hut to casual dining chains such as TGI Friday's, signals that success is achievable for foreign players; therefore, international chains should not be deterred by the Chinese market.

SURVEY METHODOLOGY: To better understand the restaurant preferences of Chinese consumers, we surveyed a sample of 2,600 respondents from 21 cities across regions and tiers. The survey took place during March 2016 and covered city residents above the age of 16.

FIGURE 5:
Top 10 Rated

Rank	Restaurant
1	Hai Di Lao
2	Pizza Hut
3	Little Sheep
4	South Beauty
5	Shanghai Min
6	Waipojia
7	McDonald's
8	TGI Friday's
9	KFC
10	Tairyo

Source: OC&C Restaurant Proposition Index 2016 Survey

3 SUCCESS FACTORS

Our survey and store audits have narrowed down three critical factors a restaurant must meet to be successful in China. These factors are service quality, menu breadth and innovation.

1 REDEFINING SERVICE QUALITY

The increasing sophistication of Chinese consumers has not only translated into heftier expectations for food quality and safety, but also pushed service quality to spectacular new heights. China's shift towards a service industry can be clearly seen in the food industry. Across all types of restaurants, simple greetings and pleasantries will no longer be enough to stand out. Once welcome bonuses, these gestures have now become standard expectations. We can see that restaurants are now going above and beyond to redefine values such as empathy and reliability.

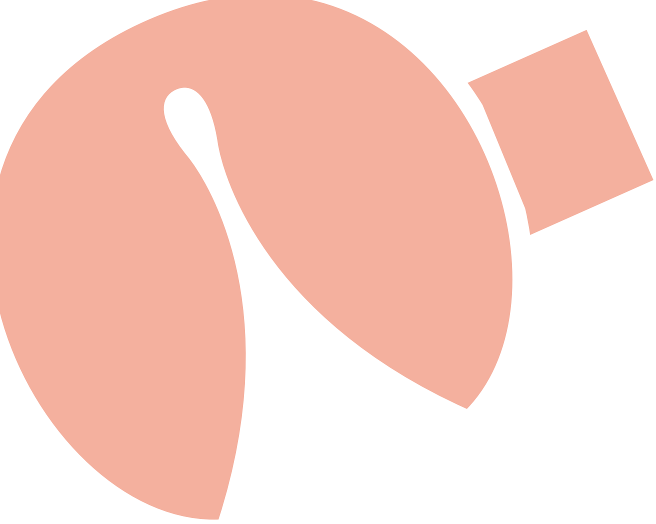
As the mantra goes, 'service comes from the heart' and employees who are guided by values, rather than strict written guidelines, are able to make creative, personalised decisions to delight guests. A company that hopes to be known for attentiveness and genuine care must exhibit these values both inside and out.

CASE STUDY

Hai Di Lao is the local front-runner in providing best-in-class service. Founded in 1994, the popular Chinese hotpot chain has taken the country by storm, reaching 130 stores in over 10 cities. Employees are provided with an extensive benefits package, including nanny services, educational allowances for their children, housing subsidies and access to an emergency fund. Besides attracting top talent and motivating employees to deliver exceptional service, this serves to enhance Hai Di Lao's reputation as "the restaurant that goes the extra mile for customers". During our visit, staff members offered to leave the restaurant to buy ice cream for us because the requested flavour was not on the menu. Hai Di Lao showcases how a company's treatment of staff may critically determine staff treatment of end-customers.

CASE STUDY

Another way to delight customers whilst motivating your staff can be seen at Xibei, a local restaurant chain specialising in Inner Mongolian cuisine. After taking orders, staff at Xibei place a sandglass on the table as a promise to consumers that food will arrive within 25 minutes. If they fail to serve in time, customers are treated to a round of desserts on the house. This not only brings a surprise element to the dining experience, but also keeps staff accountable, and creatively brings attention to the restaurant's commitment to quality service and consistency.



2 THE UN-PARADOX OF CHOICE

Food is a universal language, but palates are still different. We talked to consumers in China and abroad to better understand their decision making process when choosing a restaurant. The results were astoundingly clear: restaurants must broaden their menus to succeed in China because here, unlike in the UK, consumers like to be spoilt for choice (Figure 6).

FIGURE 6:
Comparison of KPC Importance

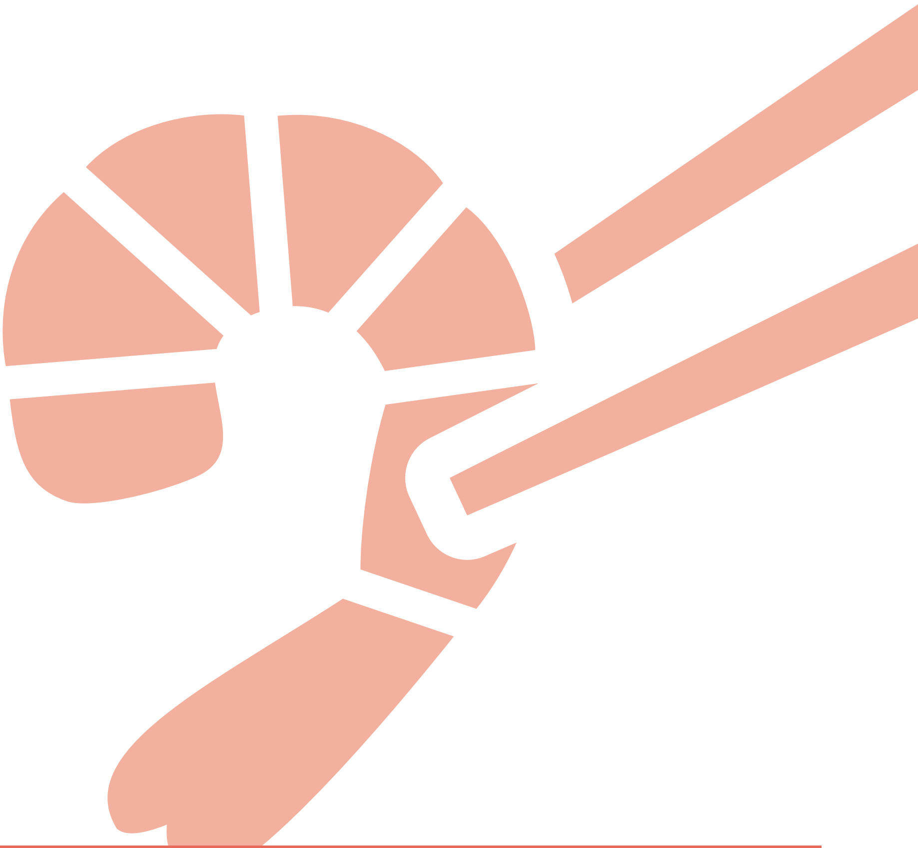
	Factor Rank in China	Factor Rank in UK
Food Quality & Presentation	1	3
Wide Choice of Categories	2	6[1]
Service Quality	3	4
Extensive Selection Within Category	4	6[1]
Restaurant Ambience	5	7
Food Suited to Me	6	1
Authenticity	7	10
Cleanliness & Safety	8	Not Tested
Consistency	9	5
Low Prices	10	9
Value for Money	11	2
Convenience	12	8

Source: OC&C Restaurant Proposition Index 2016 Survey

Realising and accommodating the preference for breadth before depth amongst consumers in China is a crucial factor of success. Consumers in China place great value on having choice. As opposed to 50 flavours of pizza, larger varieties in food groups can help achieve greater patronage. This helps to cater to the varying food preferences within a group, especially so for family and social gatherings where the group sizes are larger. It is not uncommon to see Western fast food restaurants serving Chinese congee and deep-fired dough sticks in a bid to cater to a wider range of tastes. KFC in China is one such example.

In contrast, consumers in the United Kingdom head out to eat 'on a mission'. Consumers often know what they want to eat before they enter a restaurant – they are more likely to crave a certain type of dish and then head to a restaurant to fulfil that craving. In a case like this, there is less harm in restaurants limiting their menus to specific food groups and focusing on depth.

Japan, which is known for having some extremely specialised restaurants, presents another interesting comparison. In Japan, typical ramen restaurants serve only ramen, dumplings and beer. Ramen restaurants in China, however, seem to have come to terms with the Chinese Un-Paradox of Choice, commonly serving broader product offerings such as traditional Chinese fried rice.



3 RACE TO INNOVATE

Standing out against an endless wave of new trends and competition is challenging. Restaurants in China must stay on their toes to keep their proposition fresh. Chinese consumers are fickle and appreciate things with novelty value. At the same time, while Chinese consumers may be excited to try out new experiences, they are accustomed to and proud of local foods and customs. Restaurants are thus faced with the double challenge of innovating whilst localising to the right degree. Both challenges are equally important and can mutually reinforce one another.

CASE STUDY

In 2010, Hai Di Lao launched their innovative hotpot delivery service called "HiLao" which they also tried during the SARS outbreak of 2003. The practical challenges of delivering an entire hotpot meal did not deter Hai Di Lao and HiLao has been very well received. HiLao even became a 24 hour service in 2012. These innovative moves by Hai Di Lao addresses the issue of long lines at restaurants, and recognises that there is a market for hassle-free hotpot in the intimate spaces of people's homes.

CASE STUDY

Pizza Hut is a steward of success in constantly innovating and localising, without distracting from their brand identity. Their introduction of durian-flavoured pizza and an entire category of milk teas demonstrates their innovative spirit: a willingness to try new things and challenge the status quo. They highlight that true innovation is the act of constantly taking risks and learning from trial and error. Furthermore, Pizza Hut not only serves localised offerings but also at service times that match local eating habits. Their afternoon tea set and late night snacks menu can speak to their commitment to finding their local niche and reinventing themselves in China.

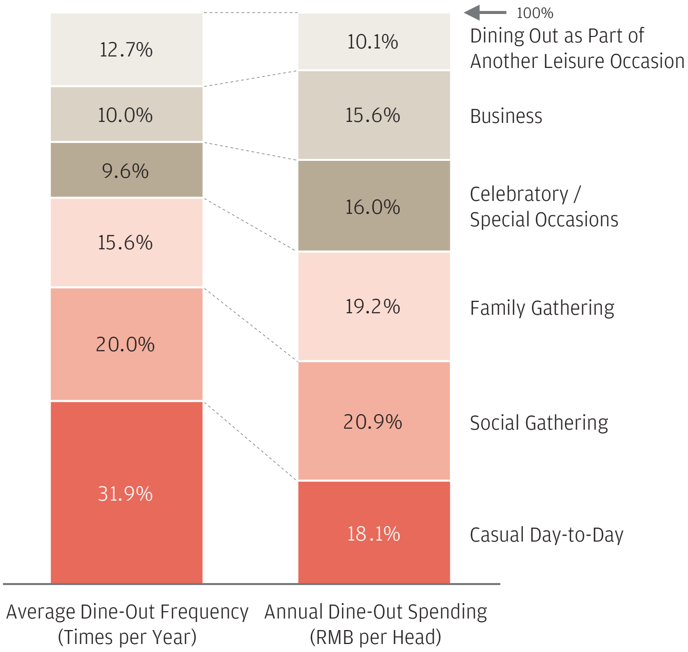
It is all about finding that sweet spot between innovating and localising, without diluting your brand essence. Timing and extent are crucial.

OCCASIONS

Many subtleties exist in the Chinese restaurant landscape. The fact that consumers make decisions based on occasions is often overlooked. Restaurants will need to be aware of and sensitive to these differences in order to succeed. Chinese consumers are willing to pay three times more for a celebratory or special occasion than for casual day-to-day dining, although the latter is still larger in absolute terms, driven by frequency (Figure 7).

For example, when comparing occasions, we see that authenticity (or at least the perceived authenticity) is the most important consideration for Chinese consumers on celebratory / special occasions. This is why South Beauty, a restaurant serving traditional Chinese cuisine, is the top rated restaurant for celebratory occasions (Figure 8). On the other hand, it is less crucial for casual day-to-day dining, coming in at 11th place in terms of importance.

FIGURE 7:
Consumer Dine-Out Behaviour by Occasion



1. Occasions such as pre / post movies, dine-out during shopping, after sports activities, etc
Source: OC&C Restaurant Proposition Index 2016 Survey

FIGURE 8:
Top 10 Rated Restaurants, by Occasion

Non Exhaustive List of Occasions

Rank	Casual Day by Day	Celebratory / Special Occasion
1	Pizza Hut	South Beauty
2	Hai Di Lao	Hai Di Lao
3	Shanghai Min	Shanghai Min
4	South Beauty	Tairyo
5	Waipojia	TGI Friday's
6	McDonald's	Little Sheep
7	KFC	Banana Leaf
8	TGI Friday's	Waipojia
9	Blue Frog	Wagas
10	Xibei	Xibei

International Cuisine

Source: OC&C Restaurant Proposition Index 2016 Survey

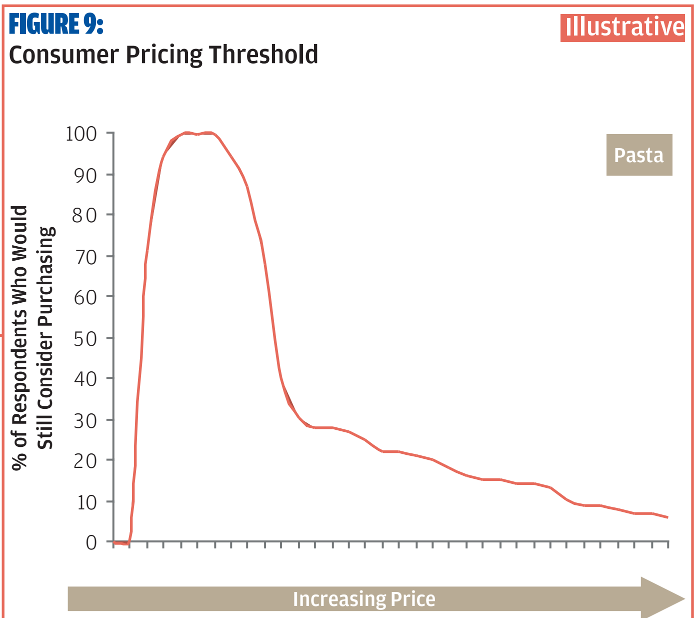
Another example of how occasions differ is illustrated in the case of family gatherings. For family gatherings, having a wide choice of food types is the most important factor to consumers. Chinese family gatherings consist of large multi-generational groups. As such, to be a preferred place for family gatherings, a restaurant must be able to cater to a wide variety of tastes.

OTHER CONSIDERATIONS AND PITFALLS

While taking into account the previous three factors and occasions-based subtleties will certainly point you in the right direction for success, there are also a host of other considerations to be aware of when forming a winning strategy:

1. **Distil regional preferences:** Understanding that there is no single 'China cuisine' and that tastes and preferences vary across regions and cities
2. **Determine the business model:** Choosing an appropriate business model, be it one of direct-owned stores or franchises, as it will impact the degree of control and speed of expansion
3. **Manage store operation complexity:** Catering to Chinese consumers who want wider choice will add complexity to store operations, inventory management, and supply chain
4. **Mode of expansion:** Determining how to expand (eg flag planting versus scattered approach) along with where to expand (high street versus malls, which of the c.1,700 malls) will vary based on your proposition and the customer group you want to target
5. **Set the optimal price:** Pricing to optimise returns by taking into account the 'Consumer Pricing Threshold'[1] which differ by cuisine type such as steaks, seafood, hotpot, etc...
6. **Menu development:** Offering the right mix of product bundles and upsell opportunities will help to unlock additional customer value
7. **Brand positioning:** Distinguishing oneself from the abundance of local chains and making sure your brand doesn't represent a singular product category which will limit your appeal for different occasions

FIGURE 9:
Consumer Pricing Threshold



1. The 'Consumer Price Threshold' for pasta illustrates the need to set a price that both instils confidence with consumers while being reasonable
Source: OC&C Restaurant Proposition Index 2016 Survey

OC&C RANKING OF RESTAURANTS BY OVERALL PROPOSITION

Rank	Restaurant	Opening Year	# of POS in Mainland China	Cuisine Type
1	Hai Di Lao	1994	126	Chinese hotpot
2	Pizza Hut	1990	1,422	Western - Pizza
3	Little Sheep	2000	226	Chinese hotpot
4	South Beauty	2000	63	Chinese casual
5	Shanghai Min	1987	68	Chinese casual
6	Waipojia	1998	83	Chinese casual
7	McDonald's	1990	2,202	Western fast food
8	TGI Friday's	1995	7	Western casual
9	KFC	1987	4,885	Western fast food
10	Tairyo	1995	33	Japanese casual
11	Bananaleaf	1990	16	SE Asian casual
12	Chamate	1994	94	Taiwanese casual
13	Pizza Express	2014	21	Western - Pizza
14	Xibei	2001	84	Chinese casual
15	Blue Frog	2003	26	Western casual
16	Spice Spirit	2002	30	Chinese casual
17	Element Fresh	2002	27	Western casual
18	Wagas	1999	51	Western casual
19	Xiabu Xiabu	1998	514	Chinese hotpot
20	Papa Johns	2003	255	Western - Pizza
21	HL Sushi	1997	198	Japanese casual
22	Yonghe King	1998	314	Chinese fast food
23	Ajisen Ramen	2001	634	Japanese casual
24	Da Niang Dumpling	1996	430	Chinese fast food

Source: OC&C Restaurant Proposition Index 2016 Survey

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