# What do EXPERTS Say?

## The Ten Highlights of China's Commercial Sector, 2009-2010

## 2009-2010 年中國商業十大熱點


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# "Ten Highlights of China's Commercial Sector, 2009-2010"

**Event organizer**

The Expert Committee of the China General Chamber of Commerce

**Report publications production**

Li & Fung Research Centre, Member of Li & Fung Group

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# Foreword

Hit by the worst global financial crisis since the Great Depression, China's macro-economy faces a great deal of challenges over the past year. Nonetheless, China has been in a relative good shape to weather the financial crisis compared to many economies. Relatively strong economic fundamentals and the government's initiatives to boost domestic consumption are bringing huge opportunities to commercial businesses.

To gear commercial enterprises up for the opportunities as well as challenges under the current economic weather, the Expert Committee of the China General Chamber of Commerce (ECCGCC 中國商業聯合會專家工作委員會) joined forces with Li & Fung Research Centre (利豐研究中心) of the Li & Fung Group for the sixth year to launch the ***"Ten Highlights of China's Commercial Sector, 2009-2010"*** (*the Ten Highlights*).

*The Ten Highlights*, of which selection and dissemination are conducted annually, offers enterprises a comprehensive overview of China's latest commercial developments. The event achieved tremendous success in previous years and the English reports on *the Ten Highlights* were highly regarded by foreign media and investors as useful handbooks to grasp the latest commercial issues and trends in China.

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# Chapter 1 Introduction

## Selection of the *"Ten Highlights of China's Commercial Sector 2009-2010"*

The ten highlights of China's commercial sector for 2009 and 2010 were identified after a series of voting and formal, in-depth panel discussions. This year, views of over 180 top-tier experts were collected.

This event is organized by the Expert Committee of the China General Chamber of Commerce, a prestigious association comprising government officials, scholars, consultants, commentators, industry association representatives and top management of commercial enterprises in China.

Li & Fung Research Centre is proud to publish this report together with the Secretariat of the ECCGCC; by amalgamating the best intellectual talent in China, we believe this report will shed some light on the key development trends of China's commercial sector.

## About the Organizations

### The China General Chamber of Commerce
### 中國商業聯合會

Founded in 1994, the China General Chamber of Commerce (CGCC) is a quasi-government association endorsed by the State Council. The CGCC has around 70,000 members, encompassing enterprises from retail, distribution, services and tourism sectors, local commercial chambers, national professional associations, intermediary organizations and individuals.

Commissioned by the Chinese Government, the CGCC consists of 14 committees, working on areas such as retailing, wholesaling, public relations and industry analyses etc.; it also supervises 40 national associations, and over 30 newspapers and magazines published both inside and outside China.

### The Expert Committee of the China General Chamber of Commerce
### 中國商業聯合會專家工作委員會

The Expert Committee of the China General Chamber of Commerce (ECCGCC), a sub-division of the CGCC, comprises over 180 prominent experts from various government departments, research institutes and universities, leading corporations, professional associations, consultancy firms and newspaper offices, which include the Ministry of Commerce, the Development Research Centre of the State Council, the National Development and Reform Commission, the Renmin University, the Tsing Hua University, and the Chinese Academy of Social Sciences, etc.

The ECCGCC serves as a platform for the experts to exchange ideas on the development of commercial enterprises and the distribution sector.

### Li & Fung Group
### 利豐集團

The Li & Fung Group is a Hong Kong-based multinational company with three distinct core businesses: export sourcing, distribution and logistics, and retailing. Founded in Guangzhou in 1906, the Li & Fung Group achieved an annual turnover of around USD 16.7 billion in 2008. Today, the Li & Fung Group operates in some 40 countries and regions and employs over 35,000 people worldwide. One of its core competencies is “Supply Chain Management” (SCM).

### Li & Fung Research Centre
### 利豐研究中心

Li & Fung Research Centre is the research institute of the Li & Fung Group. It serves as a knowledge bank on China’s economy, industries, logistics and distribution sector, with its research scope covering the whole spectrum of the entire supply chain, from ideas, production, distribution, retailing to consumers. It also offers research analyses and consulting services to colleagues and clients.

The Centre has been actively promoting the application of SCM. The Centre published the book “*The Orchestrator of Global Supply Chain Management (Second Edition)*” in 2009, which is regarded as a very useful reference among businessmen and academia in China. The Centre also supported the launch of “*100 Years of Li & Fung*” and “*Competing in a Flat World*” in China.

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# Chapter 2 Executive Summary

2009 was a testing year for China. Hit by the worst financial crisis since the Great Depression, the country's macroeconomic outlook has turned cloudier. We have witnessed more difficult times for China's commercial enterprises unseen in past several years.

However, with huge government-inspired measures to stimulate the economy, China is fortunate enough to achieve its target of economic growth. Among the government initiatives, boosting domestic consumption is, and will continue to be, high on the agenda. This has profound implications on the developments of China's commercial sector.

Meanwhile, many commercial enterprises in China have learnt some important lessons over the past year and are rethinking their strategies. China's commercial landscape is changing fast.

Here is a brief summary of the Ten Highlights of Commercial Sector, 2009-2010:

## Retail sales set to reach new heights with huge government initiatives to boost consumption

With a series of government initiatives to boost domestic consumption, China's real growth in retail sales in 2009 has been the fastest since 1985, beating market expectations. Looking forward, as China strives to reorient its economy to become more consumption-driven, policy environment will continue to be favorable for commercial businesses. Retail sales in China look set to reach new heights in the coming year.

## Export-oriented enterprises eyeing the domestic market; growing calls for accelerating integration of domestic and foreign trade

To weather the challenges of shrinking global demand, many export-oriented enterprises are eyeing China's ever-growing domestic market. Over the past year, the Chinese government, export-oriented manufacturers, retail and distribution enterprises and industry experts have made concerted efforts to help export-oriented enterprises embark on domestic sale, bringing new changes in China's commercial landscape. Nonetheless, there are still many obstacles in launching domestic sales. New changes in enterprises' mindset and more fundamental reform to integrate domestic and foreign trade are needed.

## Great strides in improving China's rural commercial and distribution networks; continuous efforts still needed

Domestic consumption in China has been primarily urban-driven. However, to stimulate and sustain domestic consumption, tapping rural demand is essential. The Mainland authorities have actively taken a series of initiatives to improve the rural distribution landscape over the past few years and those measures are constantly reviewed and further strengthened in 2009. Government-inspired measures are much appreciated; however, effective coordination between the government and the market is the key for success.

## Retailer direct-farm sourcing will continue to grow

Direct-farm sourcing is increasingly adopted by leading retailers in China. With its many benefits such as shortening retail supply chains, enhancing consumption safety and boosting farmers' income, direct-farm sourcing has received strong government support. Today, retailer direct-farm sourcing is relatively new in China, retailers are still experimenting different modes of cooperation with farmers. We expect retailer direct-farm sourcing continues to receive huge attention in the coming year.

## Domestic and foreign retail chain operators seek to improve competitiveness in different ways, exerting growing pressures on smaller players

Intensifying competition is prompting retailers in China to improve their competitiveness. Domestic and foreign retail chain operators are observed to give different priorities in respective strategies in China - growing number of domestic players are paying attention to strengthening internal management such as transforming merchandising practices and enhancing supply chain efficiency through better use of information technology; meanwhile, foreign retailers in general continue to accelerate expansion into second- and third-tier cities. These undoubtedly would cast pressure on smaller businesses. Market consolidation is set to accelerate.

## Growing calls to change retailers' profit structure and build win-win relationship with suppliers

In recent years, the profit structure of many retailers in China has changed significantly. Many retailers no longer derive their major profits from direct merchandise sales. Instead, cumbersome charges laid on suppliers become predominant source of income for many. More and more retailers now recognize that the strained relationship with suppliers is detrimental to the health of retail sector in the long run and are trying to change the picture. However, the problem is deeply rooted and involves many vested interests. Concerted efforts between the government, industry associations and enterprises must be made. Nonetheless, this is definitely a good step in the right direction.

## Going green to enhance profitability as well as to improve corporate image is catching real attention

Going green has been catching commercial businesses' real attention in recent years. Foreign retailers are observed to be more proactive than their domestic counterparts to go green. Going green helps retailers save costs by cutting energy bills and enhance efficiency; it also helps build socially responsible corporate image. We believe that domestic and foreign retailers will accelerate their pace for adopting green initiatives in China.

## Luxury sales demonstrate strong growth momentum; lowering consumption tax and import duties on luxuries can boost domestic sales further

Global financial downturn has caused only a temporary dip in China's luxury retail sales. China's appetite for luxury goods has remained strong and China is now indeed the world's second largest luxury market. Currently luxury products in China are generally more expensive than that in overseas markets because of consumption tax and import duties levied, prompting many to purchase luxuries overseas. Our experts advocate for reform on tax and import duties levied on luxury consumption.

## Online retailing continues astonishing growth; growing concerns over regulatory environment, logistics bottlenecks and credibility issues

In line with our experts' previous predictions, online retailing continues to be one of the brightest spots in China's commercial developments. More traditional commercial businesses in China have embarked on click-and-mortar strategy to lower operation costs and achieve wider customer reach. E-commerce is transforming China's commercial scene. Nonetheless, immature regulatory environment, infrastructure and logistics bottlenecks, and credibility issues remain major concerns.

## Hoping for return of glory days: China's numerous heritage brands are rejuvenated

China has thousands upon thousands of heritage brands long taking pride in their cultural roots and historical heritage. Many of these heritage brands have however struggled to survive over the past decades. But these years, some of them have also taken active moves to reinvent themselves. And with strong government support to protect and promote heritage brands, several heritage brands are now rejuvenated and set to make a comeback.

# Chapter 3 Implications for Foreign Investors

Against the backdrop of global financial crisis, China's total retail sales growth is expected to exceed 17% on a real basis in 2009, demonstrating strong fundamentals and potential of China's domestic market. Based on our highlights of the commercial sector in 2010, we are optimistic that China's consumer market will continue to deliver strong growth; this will bring tremendous business opportunities for foreign investors.

## Riding the uptrend of China's domestic market

### Policies to boost consumption set to continue

- Ongoing urbanization, improving household income, and better social security net, etc have laid strong fundamentals for retail sales growth in 2010. Besides, the government has made tremendous efforts to boost private consumption in China. Concrete measures are made or being studied and these have tremendous implications for businesses.
- Businesses should pay attention to the latest policy developments. China has long acknowledged that reducing reliance on exports and fixed assets investments is essential if it is to grow in a sustainable manner; the plunge in global demand over the past year has made this change more necessary. Boosting domestic consumption so as to rebalance its economic structure has become the top priority of China's economic policy.
- The government has restated this policy tone in the Central Economic Work Conference concluded in December 2009 and has decided to extend a number of consumption stimulus policies, bringing new thrusts to domestic sales. For example, the urban old-for-new subsidy on consumer electronics will be further extended beyond the original deadline of May 2010 and the coverage will be expanded; the extension of automobile stimulus package and growing middle-class will continue to boost sales of automobile in 2010.
- Areas under considerations such as easing the bottlenecks for export-oriented enterprises to engage in domestic sales and lowering tariffs and consumption taxes on luxuries should be watched as well. These will bring real impacts for foreign businesses on areas such as sourcing and product pricing.

### Luxury market is one of the bright spots

- The inflated asset price in property and stock markets has created tremendous wealth effect in China. The fast-growing middle-class who has more discretionary spending power is another strong driver. It is expected that luxury sales in China will reach 200 billion yuan and account for 32% of the global share in 2010. Luxury players with established brand names are best positioned to capitalize on these growth opportunities. As China's lower-tier cities are growingly affluent, businesses should not overlook their potential.

## The rural market offers tremendous potential

- In addition, increasing efforts devoted by the Chinese government in rural development is going to unleash huge potential in the vast rural market. Rural distribution landscape has improved a great deal after years of government efforts to build extensive rural retailing network and distribution facilities. Besides, projects such as the retailer direct-farm sourcing has cut the fat in China's rural supply chains and helped improve farmers' income. Taking the advantages of improving infrastructure, retailers can explore opportunities in rural regions. Nevertheless, it should be reminded that the purchasing power of the rural population is still lagging behind China's cities and it may take years for businesses to cultivate success.

## Exploring opportunities in online retail market

- We are positive on the long-term growth of e-commerce in China. Online platform is today an effective doorway to tap China's growing number of online shoppers at lower costs. Nevertheless, it still takes time for most e-tailers in China to profit. Retailers should also keep an eye on online security, logistics bottlenecks and regulatory environment.

- Pursuing a multi-channel strategy is a growing trend for retailers in China. On one hand, some traditional retailers are diversifying their marketing channels by going online; on the other hand, e-commerce companies are building their physical presence. Yet, an integrated and well-executed strategy is crucial for commercial enterprises to capture the full benefits of multi-channel retailing.

## Leveraging on export-oriented enterprises

- Hard hit by the financial crisis, many export-oriented enterprises have begun to target domestic sales. Made-to-export products, which are usually considered with higher quality, are well received among Chinese consumers. However, currently export-oriented enterprises have faced a number of obstacles in launching domestic sales such as high costs, lack of know-how and little investment in branding. Retail and distribution enterprises can play the role in offering stable distribution channels for these products. Retailers may also consider leveraging on export-oriented enterprises to develop private labels in China.

- It is noteworthy that the government has rolled out a series of supportive measures to facilitate export-oriented enterprises to sell domestically. Nevertheless, as there are signs that exports may bottom out, it is uncertain whether the supportive initiatives will continue in 2010. In this regard, retailers should closely watch the policy change.

## Enhancing competitiveness remains the key

- It is expected that retailer-supplier relationship will continue to receive attention in 2010. Instead of relying on rentals or entrance fees as major sources of income, more retailers should build expertise in managing merchandises to better cater to customers' changing needs and improve differentiation. This shall improve competitiveness of retailers in China.

- Businesses should also improve supply chain efficiency to stay ahead of the competition. Retailer direct-farm sourcing is a case in point.

- Brand building is of prime importance in China. The revival of some heritage brands is a vivid example that strengthening intangible assets can bring real economic benefits.

## Going green to bring sustainable growth

- China has promised to cut carbon dioxide emissions per unit of GDP by 40% to 45% by 2020 from the 2005 level. To meet this target, it is expected that the government will soon announce further policies to promote energy conservation such as the regulation on *Restricting Products with Excessive Packages (限制商品過度包裝條例)*. This can affect the costs of doing businesses in China; commercial enterprises should keep a pulse on changing rules and regulations.

- Indeed, China is stepping up efforts to develop a sustainable economy. Echoing the Energy Conservation Campaign in Retail Industry launched in 2007, a number of retailers have taken green initiatives to reduce cost and enhance corporate image. Heavy investments in energy-saving facilities are still a concern for many domestic retailers, however.

# Chapter 4 The Ten Highlights of China's Commercial Sector, 2009-2010

## 1. Retail sales set to reach new heights with huge government initiatives to boost consumption

### Retail sales in record growth

In the first 11 months of 2009, total retail sales of China totaled 11,273.3 billion yuan, up by 15.3% yoy on a nominal basis and by 17% on a real basis. Real growth had been the fastest since 1985, beating market expectations. It is expected that total retail sales will continue to grow in December 2009; and full-year growth of 2009 may exceed the historical record in 1985 (17.2%). Optimism is based on 4 reasons: 1) acceleration of China's economic growth in the fourth quarter of 2009; 2) continuous improvement in consumer confidence and personal income growth; 3) consumer price index (CPI) started turning into positive territory in November 2009, boosting headline retail sales; 4) low-base effect due to the financial crisis at the end of 2008.

It is noteworthy that consumption and retail sales growth has been highly stable throughout 2009. Monthly retail sales growth maintained at the level around 15% between March and September of 2009, with variance less than 1 percentage point. On the contrary, fluctuations in domestic investments and exports have been significant due to huge government stimulus measures and weakening global demand. Although the global financial turmoil has hurt a large number of companies home and abroad, China's commercial sector is fortunate enough to witness very few bankruptcy cases.

Record growth in retail and commercial sectors in the face of economic crisis is phenomenal since the establishment of the People's Republic of China 60 years ago. There are several reasons behind the impressive growth:

First among which is that rising economic power and capital accumulation over the past decades have greatly enhanced purchasing power. Government and corporate spending has played an important role in driving consumption with increasing share of both in the country's retail sales in 2009.

On the other hand, aggressive promotions by retailers also stimulate retail sales. Nonetheless, this has hurt players' gross margin. Despite increase in revenue, a lot of players witness declines in profit or even experience losses.

Policy-wise, a series of stimulus measures initiated by the government also boost domestic consumption. There is room for further improvement in these government-inspired measures, though.

## Government initiatives to boost consumption

In response to synchronized recession in developed economies, the government has put huge emphasis on boosting domestic demand. Government measures include offering subsidies to purchasing home appliances, automobiles and agricultural machinery, and expanding the “old for-new” (trade-in) subsidies for car and home appliance purchases, etc. These subsidy programs are more rural-inclined. Subsidies to rural population (25 billion yuan) far higher than that to urban population (7 billion yuan) in home appliances and automobiles purchases is a case in point. See Exhibit 1 for major government initiatives to encourage consumption.

### Exhibit 1: Major government initiatives to encourage domestic consumption

| Measures | Details |
|---|---|
| “Bring Home Electrical Appliances to the Countryside” program | Subsidizes rural households to purchase electrical appliances |
| “Bring Automobiles to the Countryside” program | Subsidizes rural households to purchase motorcycles and automobiles |
| Tax cut for buying vehicles | Vehicle purchase tax for low-emission automobiles is cut to 5% from 10% |
| “Old-for-new” (trade-in) subsidies for car | Provides subsidies between 5,000 yuan to 15,000 yuan for replacing old commercial cars in rural and urban regions |
| “Old-for-new” (trade-in) subsidies for home appliances | Home appliances (television, refrigerator, washing machine, air-conditioner or computer) buyers will receive a subsidy of up to 10% of the price of the new products |
| Agricultural machinery subsidy | Subsidizes rural households to purchase agricultural machinery |

*Source: respective government websites, compiled by the Li & Fung Research Centre*

## Evaluation of the government initiatives

Thanks to the subsidy measures, rural retail sales growth has been higher than that of urban regions by 2 percentage points in the first half of 2009, even though rural income growth was lower than that in the urban regions by 3.1 percentage points during the same period. Besides, domestic automobile sales has grown impressively which helps offset sluggish exports.

However, the “Bring Home Electrical Appliances to the Countryside” program is estimated to boost home appliances sales by just 60 to 70 billion yuan in 2009, below government expectation (some officials had hoped the program could generate new consumption of 920 billion yuan in 4 years, implying an average of 230 billion yuan of new consumption each year). Some experts, though, remain optimistic and believe that we should use longer time frame to evaluate the program. Home appliance consumption in rural areas is lagging behind that in urban areas by 10-15 years; it is not likely that the huge potential in the rural areas will be fully realized in just a year.

## What do our experts think?

- There is huge unfulfilled demand for a variety of products in China's rural areas. Besides, trading-up by urban consumers, say automobile purchase and replacement, shall underpin strong growth in China's retail and commercial sector in the coming years.

- The government will continue to subsidize the purchase of home appliances and automobiles in 2010. The amount of subsidy may be higher and product range coverage may be widened as well. Our experts hope that more flexibility will be granted in allocating the use of funding. They also suggest that the increase in subsidy rate in domestic sales of selected categories to be on par with the increase in export tax rebate rate, in order to show government's determination to boost domestic consumption.

- Government subsidies help boost domestic sales, at least in the short run. To sustain the growth in domestic consumption in the long run, the Chinese government has strived its best to fundamentally improve social security system and narrow income disparity. As highlighted in the Central Economic Work Conference in early December, efforts such as affordable housing projects, and further implementation of healthcare and education reforms will continue; we believe these moves will support China's long-term consumption growth.

- Looking forward in 2010, global economy will be on a recovery path; but growth is likely to be fragile. Unlike the past, we will have a "New Normal" as two major powers China and the United States strive to change their economic growth models.

  It is expected that China's exports will resume stronger growth; nevertheless, trade protectionism and anticipation of RMB appreciation will continue to cast clouds on export prospects. Government investment will continue to increase at a high speed but growth in private investment is less certain amid overcapacity concerns. Therefore, consumption shall play a growingly important role in driving economic growth as well as rebalancing the economic structure of China.

- It is hoped that the World Expo 2010 in Shanghai China will boost consumption sentiment as well.

- Inflation will be closely watched in 2010. Many of our experts anticipate that the CPI will start to pick up in the second half of 2010. For China, the acceptable CPI range would be 3-4%. Indeed, mild inflation could stimulate economic growth as well as consumption.

- There is not much doubt that GDP growth of China will hit the 8%-target in 2009; and our experts generally believe the economic growth will accelerate in 2010. If CPI range is 3-4% in 2010, we predict the total retail sales growth of China to exceed 20% in 2010, higher than that in 2009.

## 2. Export-oriented enterprises eyeing the domestic market; growing calls for accelerating integration of domestic and foreign trade

Owing to synchronized recession in developed economies, China's export orders from foreign buyers have contracted dramatically. To weather the challenges, many export-oriented manufacturers have turned their eyes to China's domestic market. Over the past year, the Chinese government, export-oriented manufacturers, retail and distribution enterprises and industry experts in China have made concerted efforts to help export-oriented enterprises embark on domestic sale.

### Some examples to facilitate export-oriented enterprises to sell domestically

With the support from the Ministry of Commerce and the Commerce and Economic Development Bureau of Hong Kong, the 105th Canton Fair which traditionally serves only overseas buyers staged business matching sessions targeting domestic sales. Representatives from 200 retail and distribution enterprises in China and 700 mainland and Hong Kong-invested enterprises attended the fair; transaction valued 466 million yuan was concluded in the sessions.

The Beijing Municipal Commission of Commerce has also launched the "Export-Products Flea Market", during which export-oriented enterprises could sell directly to the public and conduct businesses with retailers in China. The made-to-export products, which are usually with higher quality, are reportedly to be very well received. There are many similar projects across China.

Furthermore, the Guangdong government has organized the "Foreign-Invested Enterprises Commodities Fair" in Dongguan. It attracted more than 4,000 merchandising representatives from retailers in China including Wumart (物美), Chaoshifa (超市發), Wangfujing Department Store (王府井百貨), Wal-Mart and Carrefour. The Economic and Trade Commission of Guangdong Province and China's leading e-commerce player Alibaba have also jointly launched the first "Online Merchants Trade Fair" (網貨交易會) in a bid to help export-oriented enterprises sell their products domestically online. More than 400 small- and medium-sized enterprises from Guangdong and thousands of sellers from Taobao.com under the Alibaba Group attended the fair.

Some big retailers such as Wumart, Better Life Commercial Chain Store (湖南步步高) from Hunan and Shandong Liqun Group (山東利群集團) have also taken active initiatives in facilitating domestic sales of export products. Initiatives include buying factories' backlog, providing distribution channels for products of export-oriented enterprises with domestically registered trademarks and working with the enterprises to develop private labels.

As the world economy continues to rebalance, boosting domestic consumption will be a main engine for China's future economic growth. China shall reduce its reliance on foreign trade. China's retail and distribution enterprises shall enhance co-operation with export-oriented enterprises to facilitate domestic sales. Instead of relying solely on export markets, traditional export-oriented enterprises have to "walk on two legs" by exploring opportunities domestically.

## Obstacles encountered by export-oriented enterprises

Fostering integration between domestic and foreign trade could enable more efficient flow of resources and lower costs. Nevertheless, selling domestically is not easy for many export-oriented enterprises. Key problems they encountered are as follows:

- Government policies and taxation design. Although the government has reiterated the importance of both foreign and domestic trade, the former has long received more government support. For instance, enterprises can enjoy tax rebates for exports but no tax relief in domestic sales. Selling to foreign markets often grants enterprises more stable returns and involve fewer risks. Many manufacturers thus have little incentives to engage in selling domestically.

- Different requirements in domestic and foreign trades. The key for success in domestic sales lies in strong distribution channels, marketing and sales strategies and after-sale services. On the other hand, export-oriented enterprises mostly engage in original equipment manufacturing (OEM) and usually do not develop their own brands; effective cost control, good product quality and on-time delivery are key. It is difficult for export-oriented enterprises to enter domestic market if there is no change in business mindsets.

- Different industry practices home and abroad. The credit system in export markets is more developed. Settlement of export is facilitated by letter of credit and credit insurance of international standards; financial conditions of buyers could also be evaluated easily by credit rating reports. It is therefore easier for enterprises to control their transaction and financial risks. The situation is different in domestic market, where deferred payment is common and different types of entrance fees and levies are popular. Lack of transparency worries many manufacturers to tap the domestic potential.

- Brand building and IPR protection. Many export enterprises do not have their own brands and are weak in design capability, making them difficult to secure a place in domestic market. Also, since consumption preferences in domestic and foreign markets are different, selling made-to-export products domestically may not be easy. On the other hand, for enterprises that have developed their own brands, intellectual property right (IPR) infringement is a concern.

- Regional protectionism and underdeveloped logistics infrastructure. Both are obstacles for product distribution in China and will add to overall cost.

## What do our experts observe?

Obstacles encountered in selling domestically cannot be solved overnight; in fact, many export-oriented enterprises still place hope for recovery in exports and adopt a "wait-and-see" attitude in tapping the domestic potential. But the picture should gradually change with efforts from all sides. For instance, some retailers such as Yonghui Superstores (永輝超市) has taken steps to improve relationship with suppliers - it is willing to pay suppliers in cash for quality and popular products. Our experts hope that more retailers will take similar initiatives; they also hope that the government will launch further supportive initiatives to integrate foreign and domestic trade.

## 3. Great strides in improving China's rural commercial and distribution networks; continuous efforts still needed

To improve the livelihood of the vast rural population, the Mainland authorities have actively taken a series of initiatives to improve the rural distribution landscape over the past few years; of which the *Rural Retailing Network Project* (萬村千鄉工程) and the *Agricultural Produce Wholesale Market and Distribution Company Development Project* (雙百市場工程) are two major projects launched by the Ministry of Commerce (MOFCOM). And supports from governments are further strengthened in 2009.

### *Rural Retailing Network Project:* modernizing the rural commercial network

To modernize the retail networks in rural China, the MOFCOM launched the *Rural Retailing Network Project* in 2005. It is hoped that by 2010, a rural retailing network covering 90% of counties, 85% of townships and 65% of administrative villages in China will be built. Preferential treatments as well as financial and operational support are given to retail enterprises to encourage them to conduct chain operation in rural areas.

According to the MOFCOM, more than 416,000 retail stores have been set up or restructured in the countryside, covering 85% of the counties and 75% of townships in China by October 2009. Exhibit 1 demonstrates the progress of the *Rural Retailing Network Project*.

### Exhibit 1: Progress of the *Rural Retailing Network Project* (as of October 2009)

| | |
|---|---|
| **Retailing network** | |
| Accumulated number of retail outlets built or restructured | 416,000 |
| Accumulated number of distribution centers built or restructured | 1,467 |
| Coverage | 85% of counties, 75% of townships and 50% of administrative villages |
| **Economic benefits** | |
| Sales revenue achieved in the outlets | ~208.4 billion yuan |
| Investment driven | ~35 billion yuan |
| New employment created | 630,000 |

*Source: The MOFCOM*

### *Agricultural Produce Wholesale Market and Distribution Company Development Project:* constructing an efficient rural distribution network

Underdeveloped distribution and logistics infrastructure in rural areas has hampered the distribution of agricultural produce, posing great hurdles for farmers to improve their livelihood. Launched by the MOFCOM in 2006, the *Agricultural Produce Wholesale Market and Distribution Company Development Project* aims to facilitate the distribution of agricultural produce to markets through building or restructuring 200 large-scale modern agricultural produce wholesale markets. The MOFCOM hopes to modernize their operation through developing cold chain logistics and improving warehouse management, etc. It is believed that modern operation can help lower the distribution costs of agriculture produce and promote food safety. The project has achieved impressive progress.

## Improving rural distribution landscape will continue to top the government agenda in the next few years

Agriculture is the backbone of the Chinese economy; issues associated with agriculture have always been a major weighing factor in China's economic development and one of the greatest concerns of the Chinese government. Our experts observe that:

- Rural development has huge social, economic and political implications for China. Despite rapid industrialization and urbanization, the Chinese government will continue to place top priority on boosting the developments of the sector.
- With an 8-billion rural population, improving rural distribution landscape can help China unleash its vast consumption potential, which is key for the country to rebalance its economy.
- Improving rural distribution landscape remains a tough challenge. Continuous government support is undoubtedly welcomed and indeed much needed; but given the complexity of the vast interior, more participation of rural households and retail enterprises is essential for long-run success, through bringing in more in-depth local knowledge and experiences.

## What do our experts suggest?

The government-inspired measures are much appreciated. There are a few areas that may better the landscape in rural China

- Increasing use of information technology;
- Strengthening government fiscal supports in building distribution centers; extending their service coverage to traditional format retailers;
- Providing more vocational trainings for rural retail staff in areas such as modern operations concepts and techniques;
- Optimizing investment by better coordination among relevant government departments, such as the Ministry of Commerce, the Ministry of Agriculture and the State Post Bureau, etc., under the leadership of the central government;
- Facilitating the channel of agricultural produce to markets and movements of different factors of production;
- Improving public services such as healthcare, education and elderly services in rural area.

Improving China's rural distribution landscape is a no easy task. The key to success lies in effective coordination between the government and the market.

## 4. Retailer direct-farm sourcing will continue to grow

Retailer direct-farm sourcing is increasingly popular in China. First introduced in the country by Carrefour in 2007, many foreign retailers such as Wal-Mart, Tesco, Lotus and RT Mart soon embarked on similar initiatives; many domestic retailers have followed suit in recent years as well. With its many benefits, retailer direct-farm sourcing should continue to grow in the years to come.

### Retailer direct-farm sourcing in China

Although retailer direct-farm sourcing is popular in many developed markets, it is relatively new in China. Given the complexity of the Chinese market and the huge diversity of products involved, retailers are experimenting with different modes of cooperation. Some retailers directly invest in planting and production bases; some work with farmers' cooperatives and themselves responsible for transportation and logistics; some work with agricultural production and processing firms; some directly coordinate with rural households; some smaller players line up with others to source food products together, etc. All in all, retailers are shortening their agricultural products supply chains in China through direct-farm sourcing.

### Retailer direct-farm sourcing has significant implications in China

Retailer direct-farm sourcing has significant implications in China. It benefits farmers, retailers and consumers; and helps promote sustainable developments in the long run.

- ***Farmers can share better profits in the agricultural supply chains***

  China's agricultural development is lagging behind. Many small-scale farm producers have long relied on layers upon layers of middlemen to sell their products; distribution cost is high. According to a survey by the Ministry of Agriculture, there can be as many as 33 different types of charges and fees incurred for agricultural products to get into retailers' hand, hampering income growth of rural households.

  As the agricultural product supply chains are shortened, retailers can offer higher purchasing price to farmers than local dealers. Besides, establishing long-term stable contractual relationship with retailers helps farmers improve sales and facilitate future planning. Rural households sharing better profits will promote healthy developments of China's agricultural sector.

- ***Retailers lower costs; consumers enjoy better-quality products at lower prices***

  Direct-farm sourcing allows retailers to purchase cheaper yet fresher and better-quality products. Yonghui Group (福建永輝集團), the largest retail chain in Fujian province, has won consumers' hearts with price of its agricultural products 10-20% lower than average. RT Mart, one of the largest foreign retailers in China, also improves its margin with secured supplies of fresh vegetables and fruits directly from farms. Besides, many retailers see great opportunities in enhancing their image via the programs - apart from differentiating with others through better products, they also establish themselves as socially responsible companies benefiting the country's farmers.

The benefits to consumers are clear. They enjoy safer, fresher yet cheaper food products.

- ***Retailer direct-farm sourcing promotes sustainable developments***

  Retailer direct-farm sourcing requires solving many bottlenecks in China's retail supply chains; it also pushes forward the upgrade of China's logistics infrastructure through the introduction of cold chain logistics, modern processing and packaging methods, etc. Supply chain efficiency is greatly improved and waste from farm to table is reduced.

## Strong government support for retailer direct-farm sourcing

Retailer direct-farm sourcing has received strong government support. In a bid to modernize the country's agriculture sector, MOFCOM, the Ministry of Finance and the Ministry of Agriculture have jointly in 2009 issued the *Pilot Scheme Notice of Promoting Closer Cooperation Between Farmers and Supermarkets* (關於開展農超對接試點工作的通知) in 15 provinces where conditions for direct-farm sourcing are considered relatively mature. Government funding of 400 million yuan has been allocated to support 200 retailer direct-farm sourcing projects in areas such as improving cold chain logistics, distribution centers, quality surveillance and brand building. It is hoped that by 2012, participating retailers can directly source more than 50% of their agricultural products.

## What do our experts think?

Our experts think that the government is guiding the use of funding of retailer direct-farm sourcing in a right direction. Nonetheless, they would appreciate if the government can launch further measures to encourage related services such as food processing and packaging to be conducted in rural areas, so that the rural population can enjoy better income opportunities. Besides, the government should rethink its current agriculture tax system – while the agriculture tax was scrapped several years ago, the government can consider launching further agriculture-friendly tax incentives, say lowering related value-added tax and business tax, etc. Last but not least, current applications for related tax rebates or exemptions are complicated and timely; the government should work and improve on this front.

## 5. Domestic and foreign retail chain operators seek to improve competitiveness in different ways, exerting growing pressures on smaller players

Intensifying competition is prompting retail chain operators in China to improve their competitiveness. Domestic and foreign retail chain operators are observed to have different priorities in their strategies in China - growing number of domestic players are paying attention to strengthening internal management; meanwhile, foreign retailers continue to accelerate expansion into second- and third-tier cities in general.

### Domestic players set to improve their internal management

Many domestic players have embarked on rapid store network expansion, without paying enough attention to internal management, in the past. This makes their capital chains vulnerable when the market slows down. Indeed, slowdown in sales in late 2008 has taught domestic retailers a major lesson on the importance of internal management, which is especially true as the overall costs are still trending north in China. It is estimated that China's labor and rental costs have been up by 15% and 10-20% respectively since late 2008.

Domestic retailers have sought a series of measures to control costs and reinvent their businesses.

- ***More cautious store expansion***

  Economic downturn has prompted domestic retailers to be more cautious towards capital expenditure and many have revised their expansion plans. In fact, rapid expansion over the past few years has resulted in heated competition, especially in the coastal cities. Retail cannibalization has hurt many retailers' profit margins. As a result, many have slowed down their store expansion and put more focus on enhancing same store sales performance, say revamping old stores and negotiating rental concessions with landlords.

  It is right to say that retailers are adopting more rational expansion approach, compared to what we have seen a few years ago. Instead of adopting aggressive national expansion, a number of domestic retailers are now more realistic and pay their attention to gaining foothold in respective regional markets.

- ***Improving supply chain efficiency***

  Domestic retailers increasingly view supply chain efficiency as a core factor for retail success. Improving supply chain efficiency through better use of information technology and strengthening relationship with suppliers is receiving attention. Recent successes include Suning (蘇寧電器) and Wumart (物美集團). Suning has partnered with IBM several years ago to develop its SAP/ERP systems to optimize its workflows. With its central system directly connected to stores and major suppliers, Suning now has easy access to check its sales and inventory level, reducing bullwhip effects through centralized ordering and saving costs for internal communications. Timely adjustment of merchandize mix also allows the firm to be more demand-driven. Since the adoption of the system for 3 years, Suning has reduced its warehouse areas by 50%, and inventory level by 20-50%. Improving inventory turnover enables the company to have better use of its capital.

- ***Transforming merchandising practices***

  Besides, some retailers have also sought to flatten their distribution system through direct sourcing. Direct sourcing for food and agricultural produce has gained particular attention from domestic players – they believe they have better understanding of local tastes; better local connection is another added advantage. For instance, Wuhan ZhongBai (武漢中百集團) have tried to cut the fat in the supply chains through sourcing agricultural produce directly from farmers. It is hoped that through direct sourcing, consumers can buy more unique and higher-quality products at competitive prices.

## Expansion into lower tiers cities remains the prime focus of major foreign retail chain operators

Already leading in internal management, foreign retail chain operators continue to view store network expansion in China as their prime focus, especially into second- and third-tier cities. There are 3 reasons: 1) market saturation in first-tier cities; 2) huge potential in second- and third-tier cities; 3) lower operating cost and less competition. Indeed, despite tightening credit environment, there were little signs international retail giants slowing their expansion in China. Major players such as Carrefour, RT-Mart and Wal-Mart continue to penetrate the market. Wal-Mart has accelerated its expansion speed and opened further 23 stores by the end of the first quarter in 2009, making its total number of stores in China to 140. Tesco, on the other hand, is also spearheading major expansion in China; it is hoped that its business in China will soon become bigger than its home country.

Our experts expect the trend to continue in 2010.

## Growing pressures felt by smaller retail players

As domestic and foreign retail chain operators seek to improve their competitiveness in different ways, it is axiomatic that smaller retail players, especially those in lower-tier cities, will face growing challenges.

Nonetheless, some smaller retail players have also sought to fight the competition. For instance, some residential communities retail players have tried to make good use of government fiscal support granted to the country's small-and-medium-sized enterprises; some also seek to line up with other players to improve performance in areas such as retail branding, purchasing, distribution.

Market competition is set to intensify in China. We believe the fittest will survive.

## 6. Growing calls to change retailers' profit structure and build win-win relationship with suppliers

In recent years, the profit structure of many retailers in China has changed significantly. Many retailers no longer derive their major profits from direct merchandise sales. Instead, cumbersome charges such as entrance fees, promotion and marketing fees, listing fees for new products, and rental income are now their predominant sources of revenue.

Some Chinese retailers claimed that there is nothing wrong with this profit model; in fact, they have learnt so from multinational retail players. Suppliers (mainly manufacturers) are undoubtedly discontented, believing that they are treated unfairly by retailers. Some experts also criticize that this profit model runs against the essence of retailing and would bring about problems such as lack of differentiation, proliferation of counterfeit goods and corruption. Indeed, retailers in China increasingly behave like landlords, which is unhealthy for the development of retail industry. To address this concern, the government has announced the *Management Rules on Fair Transaction between Retailers and Suppliers* (零售商供應商公平交易管理辦法)[1] in 2006, restricting retailers from levying cumbersome charges.

### Strained relationship between retailers and suppliers

A recent study has highlighted the strained relationship between retailers and suppliers along the supply chain. According to a survey by the China Suppliers Research Centre, 77.7% of suppliers said that retailers have an absolute advantage during price negotiation; 80% of suppliers have experiences of being forced by retailers to cut price; 52.7% of suppliers complained retailers for breach of contracts; there are many evidences that retailers often arbitrarily extend their payment terms. The study has taken Gome Electrical Appliances (國美電器) as example. According to the financial statements of Gome, operating profit in 2006 was 914 million yuan; meanwhile, numerous types of fees which include charges on suppliers had reached a stunning 888 million yuan. In 2007, the operating profit and levies on suppliers were 1.803 billion yuan and 1.843 billion yuan respectively - income from suppliers has exceeded income from business operations.

Moreover, the survey demonstrated that retailers have passed a large part of their costs to suppliers (on average account for 10% of their total sales); and 40% of suppliers reported having a gross margin of less than 10%; 50% of suppliers were forced to trim labors' welfare or downsize due to squeezing margins. As more than half of suppliers were from the food industry, this implies that interests of farmers are likely to be hurt.

1 The rule is applicable to retailers with annual sales over 10 million yuan. Retailers could not charge suppliers additional fees unless agreed by parties in concern and specified in the contracts. Moreover, retailers should also pay for all ordered items, even if they are not sold; and the payment must be made no later than 60 days upon receipt of goods. On the other hand, there are provisions to protect retailers' interests; for instance, suppliers are prohibited from practicing tie-in selling.

## What do our experts think?

- The current profit structure of retailers is not sustainable in the long run. Retailers should build their core competence in order to win consumers, or they risk failing to meet the challenges in economic downturn.

- Instead of relying on rentals or entrance fees as major sources of revenue, retailers should build expertise in managing merchandises to better cater to customers' changing needs.

- Reliance on entrance fees may lead to poor differentiation. As retailers fail to offer added value, they cannot but rely on price competition.

- Strained relationship between retailers and suppliers may force the latter to build their own distribution channels. It may lower the efficiency of the whole supply chains. For example, renowned food manufacturer Shineway Group (雙匯集團) has extensively built its retail chain stores due to heavy distribution costs.

- The current profit model of retailers will bring about malpractices or even fraudulent activities. Consequently, the business environment will be negatively impacted.

- The government can play a bigger role in fostering sustainable relationship between retailers and suppliers. Indeed, based on the *Management Rules on Fair Transaction between Retailers and Suppliers* launched in 2006, the Ministry of Commerce is studying to formulate regulatory measures with greater legal bindings.

- The China Chain Store and Franchise Association and IBM have co-launched a report *Cooperation between Industrial and Commercial Enterprises* in 2009. The study indicated that there are recent signs of improvements. Retailers were paying increasing attention to helping fast-moving-consumer-goods manufacturers improve their profitability. Gome has planned to scrap entrance fees in 50 of its flagship stores; Wumart has agreed to settle suppliers' payment on time and follow the regulatory rules strictly; Wal-Mart has also prohibited unreasonable charges on suppliers and strengthened cooperation with suppliers.

- More retailers and suppliers are beginning to recognize the importance of collaboration along the supply chain. However, the problems are deeply rooted and involve many vested interests, which cannot be solved overnight. Concerted efforts between the government, industry associations and enterprises must be made to further improving the business environment. We expect retailer-supplier relationship will get even better attention in 2010.

## 7. Going green to enhance profitability as well as to improve corporate image is catching real attention

Going green has been catching commercial businesses' real attention in recent years. The Ministry of Commerce (MOFCOM) launched the *Energy Conservation Campaign in Retail Industry* in 2007[1], since then large retailers in China have been paying increasing efforts to adopt green initiatives.

### Foreign retailers leading in environmental-friendly initiatives

As we observed, foreign retailers are more proactive than their domestic counterparts in energy saving and environmental protection. For example, Wal-Mart has invested 250 million yuan to retrofit a number of its stores in China in the first half of 2009 to improve energy efficiency. As part of its energy conservation efforts, a control center has been set up in Shanghai to centrally monitor the efficient use of air conditioning, refrigerators and lighting in stores. Meanwhile, Tesco has opened 21 "Green Stores" which account for one-third of its total stores in China. It also plans to introduce energy conservation standards in each of its new stores. These measures are expected to save power consumption of refrigerators and lighting system by 18% and 6% respectively. Carrefour (China) has also launched its "Energy Efficient Plan" since 2008, committing to reduce energy consumption by 20% for its new stores and 15% for its existing stores. The project will help Carrefour save 1 million yuan for each shop annually.

On the other hand, some large domestic retailers have gradually increased their investment in energy-saving facilities as well. Nevertheless, efforts are mostly piecemeal. There is a lack of comprehensive and systematic planning on energy saving. The major reason is that most domestic retailers have rented their retail properties; this reduces incentives to engage in long-term investment.

### Benefits of green stores are two-fold

The benefits of green stores are two-fold. First, green stores help save costs by cutting energy bills and enhancing efficiency. According to China Chain Store and Franchise Association, green stores could help reduce average energy consumption by 20% to 30%. Second, they help build a socially responsible corporate image. For instance, among the 660 cities in China, more than 400 cities are experiencing water shortage currently. Of which, 114 cities are facing serious water shortage. Water saving measures in the retail industry could ease part of the problem. Besides, conservation of electricity and gas could also reduce the emissions of carbon dioxide, in line with China's "low-carbon" development strategy.

1 The Ministry of Commerce has issued a circular to promote energy saving in the retail industry in 2007. It required supermarkets, department stores and franchisee stores covering an area of over 10,000 sq. m, to take the lead in energy conservation and emission reduction.

We believe that foreign retailers will continue to accelerate their pace for adopting green initiatives in China. Based on previous experiences, the maximum payback period of investment in energy saving measures is 3 years. It is expected the foreign retailers will start to recover some of its costs from 2010 onwards, releasing capital for a new round of energy-saving investments.

### What do our experts suggest?

Based on the level in 2005, the MOFCOM targeted to reduce energy consumption by 20% for every 10, 000 yuan of revenue generated by the retail industry by 2010. Following this direction, our experts proposed the following initiatives:

- Introduction of incentive schemes. As energy saving is beneficial to the whole society, the government should induce incentives of retailers by introducing reward scheme which requires allocations of financial resources as well as introduction of more detailed assessment methods.

- Expansion of energy saving measures. Energy saving is more than just water or electricity conservation. Retailers should broaden their participation in other areas such as banning over-packaging. The regulation on *Restricting Products with Excessive Packages* (限制商品過度包裝條例) will be announced soon; it may serve as one of indicators for assessing energy efficiency of retailers.

## 8. Luxury sales demonstrate strong growth momentum; lowering consumption tax and import duties on luxuries can boost domestic sales further

### China is now the world's second largest luxury market

Hit by the global financial turmoil, sales of luxury goods has dropped worldwide since late 2008. Bain Company estimated that the global sales of luxury goods to fall by 15-20% year-on-year (yoy) in 1H09, and would fall by 8% for FY09 to reach EURO 153 billion. Currently, there is no official statistics on China's luxury sales; but industry players reflected that global financial downturn appears to have caused only a temporary dip in China's luxury retail sales. Performance of luxury sales was hit the hardest in the end of 2008; as China's economic sentiment improves, China's appetite for luxury goods has regained its strong momentum in recent months.

Indeed, luxury retail sales in China held up relatively well compared with other countries. Wealthy Chinese consumers still have a strong appetite for luxury goods. A report by Bain Company in November 2009 estimated that luxury sales growth in China would reach 12% yoy in 2009; China would become the world's fastest-growing luxury market, while sales in Europe, the United States and Japan market are expected to decline by 8%, 16% and 14% yoy respectively.

According to the World Luxury Association (WLA) in December 2009, Chinese consumers have lavished a total of USD 9.4 billion on luxury goods during the period between January and December 2009, surpassing the United States to come in second behind Japan in consumption of luxury goods and accounting for 25% of the global share. It is expected that luxury sales in China will reach 200 billion yuan and account for 32% of the global share in 2010.

### A lot of Chinese shop overseas for luxuries as a result of consumption tax and import duties in China

However, luxury products in mainland are generally more expensive than that in overseas markets because of consumption tax and import duties levied on luxury products such as watches, fragrances, cosmetics and leather goods etc. With increasing income, Renminbi appreciation against US dollar and easing travel restrictions, many Chinese consumers shop for luxuries abroad. The growth of luxury sales in mainland is lagging far behind the growth of Chinese consumption on luxuries overseas.

For instance, it is reported that annual sales value of Swiss-made luxury watches in China is approximately 20 billion yuan currently; but cross-border consumption of Swiss-made luxury watches in markets such as Hong Kong, Japan and Singapore by Chinese consumers totals over 50 billion yuan. Indeed, imported watches priced at 100,000 yuan in the mainland may be sold at just 80,000 yuan or less in Hong Kong. It is also reported that cosmetics in Europe or the States are priced just around 65% of the same product in Beijing.

In fact, overseas luxury consumption by Chinese consumers is staggering. According to media sources and industry experts, 80% of the customers in watch boutiques in Hong Kong are from the Chinese mainland; 75% of these Chinese customers purchase watches that are above HKD 30,000. Furthermore, 95% of premium watches were sold to Chinese tourists in Hong Kong.

Europe and the United States are the favorite destinations for Chinese tourists to purchase luxury products. 59% and 53% of Chinese tourists to Europe and the United States have purchased luxury products during their travel. In 2008, Chinese tourists on average spent USD 900 overseas on luxuries.

### What do our experts think?

Consumption tax and import duties on luxuries have deterred many Chinese consumers from purchasing luxuries domestically; this has undoubtedly hindered the growth of domestic retail sales. Our experts advocate for reform on consumption tax and import duties levied on luxuries. The benefits are many. First of all, there is growing demand for luxuries as Chinese consumers trade up; lowering consumption tax and import duties will benefit consumers and boost domestic consumption. This also encourages imports and helps reduce trade surplus. Besides, the government may also increase its revenue from other taxes such as value-added tax and business tax as domestic luxury sales is boosted.

## 9. Online retailing continues astonishing growth; growing concerns over regulatory environment, logistics bottlenecks and credibility issues

In line with our experts' predictions in 2008, online retailing has recorded explosive growth in 2009. According to iResearch estimates, the transaction value of online shopping[1] will jump by around 80% yoy to 230 billion yuan in 2009 (Exhibit 1). Its share in China's total retail sales of consumer goods will increase from 1.1% in 2008 to more than 1.8% in 2009.

**Exhibit 1: Transaction value of online shopping, 2001 – 2009***


**Estimated value*
*Source: iResearch Inc.*

There are several characteristics of online retailing in 2009:

- Taobao.com remains the dominant player. In the first half of 2009, Taobao.com recorded a total transaction value of 80.9 billion yuan, which was 81% of its full-year transaction value in 2008 and it accounted for 1.4% of the China's total retail sales (up by 0.4 percentage point from the same period last year). Taobao.com has 145 million registered users, accounting for 43% of the Internet population in China.

- Growing varieties and huge price competitiveness. Online retailing platforms in China are expanding from traditional categories such as electronics and telecommunications gadgets, household appliances, books and magazines to cover foodstuff, apparel and entertainment products. And most of the products are sold at a price much lower than pure-bricks retail stores. Even though many traditional pure-bricks retail stores have launched aggressive promotion

1 Including Business to Customer (B2C) and Customer to Customer (C2C) transactions

activities in the past year, online retailers are able to follow the price cuts and maintain their price competitiveness. For example, the price of electronic accessories from renowned 360buy.com (京東網上商城) is lower than that of pure-bricks stores by 8-15%.

- Online retailers are garnering market share from traditional retail stores. More retailers embark on multi-channel strategy and are scaling down expansion plans of physical stores. Online jewellery sales is an obvious example. As rentals, sales rebates, distribution and inventory cost are reduced or even scrapped, jewellery sold on e-commerce platforms is, on average, 50% cheaper than that in physical stores. It is reported that for the same platinum ring, the price is 4,860 yuan in physical stores but only 2,290 yuan in online shopping platforms such as Di.ONLY (戴歐妮網上珠寶) and zbird.com (鑽石小鳥). Taking advantages of low operating cost and wide customer reach of online channels, LUFOOK.com (六福典雅珠寶公司) has closed down about 500 of its 1,000 physical sales points. Today, the company derives 70% of its sales online and considered the physical presences mainly for product showcasing and confidence building purposes.

  Not limited to the retailers, some wholesalers also adopt multi-channel strategy. For instance, a childrenswear wholesale market in Zhejiang has established an online trading platform for nearly 200 of its tenants. Merchandisers could conduct business negotiation and transaction conveniently through the platform.

- E-commerce boosts employment. There were 570,000 online stores registered in Taobao.com in 2008, equal to the total new job openings in Shanghai in a year. According to the IDC, Taobao.com has indirectly created 1.25 million of new employment. Besides, e-commerce has significantly boosted China's third-party logistics industry – newly created demand from millions of online transactions daily is estimated to help generate more than 100,000 jobs in that field. According to a survey by the Yiwu Industrial and Commercial College (義烏工商學院), 43.7% of its students has launched C2C businesses on Taobao.com. Some of them have derived a monthly income of 3,000 yuan from their businesses. More noteworthy is that among the online business owners, 25% are previously unemployed, according to a study by China IntelliConsulting (正望諮詢研究). From this perspective, online retailing also promotes social equality by opening up new opportunities to weaker social groups.

## What do our experts concern?

Online retailing is quickly transforming the commercial landscape in China, bringing huge opportunities as well as challenges for different commercial players.

The major challenges include: 1) immature regulatory environment; 2) infrastructure and logistics bottlenecks; 3) lack of trust due to high number of online frauds. Many consumers reflected that they have bought counterfeit goods or have been cheated online. In view of the growing popularity of online shopping in China, improving credibility of the e-commerce industry is crucial.

Last but not least, our experts believe online retailing will continue its impressive growth in 2010. More and more retailers will embrace the "click-and-mortar" model.

## 10. Hoping for return of glory days: China's numerous heritage brands are rejuvenated

China has thousands upon thousands of heritage brands long taking pride in their cultural roots and historical heritage. Many of these heritage brands, also widely known as "lao zi hao" or "China's Time-Honored Brands" (中華商業老字號), have however struggled to survive over the past decades. But these years, some of them have also taken active moves to reinvent themselves; several rejuvenated heritage brands are now set to make a comeback.

### Heritage brands facing huge challenges over the past two decades

Many of China's heritage brands are small-and-medium-sized. They face a number of challenges over the past years, which include declining service qualities, fierce competition from local and foreign brands, lack of management expertise, aging image, increasing costs and insufficient capital, etc.

Excepting those in the catering sector, many heritage brands did not fare well in the past two decades. Indeed, according to a study of the China General Chamber of Commerce in 2005, 70 percent of heritage brands in China were barely able to maintain operations, while another 20 percent were on the verge of bankruptcy.

### Government supports heritage brands; heightened efforts to protect intellectual properties in 2009

The Chinese government has also taken a series of initiatives to protect and promote heritage brands of its own. For instance, in China's many historical tourist spots, heritage brands are marketed to tourists as "local specialties", adding more cultural elements to the whole traveling experiences.

Meanwhile, there are also some more concrete supportive measures to nurture heritage big names. In 2006, the Ministry of Commerce (MOFCOM) officially granted batches of Chinese enterprises the title of "China's Time-Honored Brand", supporting these enterprises to revitalize their brands. Traditional Chinese firms may also be able to receive government financial support to invest more in branding and ongoing operations if needed.

China is lagging behind in intellectual property protection and this has hurt the developments of heritage brands. For instance, some companies have their brand names registered by others in different industries to take advantage of the fame of the original brands. As many of these companies could not guarantee quality in their products, this greatly tarnishes the reputation of the whole heritage brands industry. Recognizing the importance of intellectual properties for healthy branding developments in the long run, the MOFCOM has launched further policies to support heritage brands in areas of intellectual property rights protection and operational improvements in 2009. Pilot schemes have been launched in 9 regions such as Beijing, Shanghai and Tianjin where businesses of heritage brands are most concentrated. Enterprises participating in the schemes can receive subsidies up to 50% on relevant expenditure. Financial support of a maximum of 40,000 yuan and 500,000 yuan might be granted to enterprises for trademark registrations and investment in operational upgrade and innovations respectively.

### Efforts for heritage brands to reinvent themselves starts to bear fruits

While many of the heritage brands are phased out of the market, some of them have also successfully revitalized their businesses through initiatives such as chain operation, revamping images and designs, online retailing and developing new markets. For instance, heritage brand players in Beijing have launched an online portal (http://www.lzheshop.cn/) selling over 3,000 merchandises in 7 product categories; Tianjin plans to follow suit as well.

According to industry statistics, sales and profits of over 20 major heritage brands in Beijing grew by 15.2% and 12.8% respectively in the first half of 2009. Exhibit 1 demonstrates some renowned heritage brands in China and their recent highlights.

### Exhibit 1: Selected heritage brands in China

| Brand Name | Established in | Categories | Remarks |
|---|---|---|---|
| Donglaishun 東來順 | 1903 | Catering | |
| Hongdu 紅都 | 1956 | Tailor-made clothing | |
| Daoxiangcun 稻香村 | 1773 | Catering | 2008: 2 billion yuan in sales value, up by 32% yoy |
| Neiliansheng 內聯升 | 1853 | Shoes | Sales value up by over 20% in recent years |
| Quanjude 全聚德 | 1864 | Catering | 1H 2009: revenue up by 14.5% |
| Wanglaoji 王老吉 | 1828 | Herbal medicine products | 2008: 10.5 billion yuan in sales value |
| Rongbaozhai 榮寶齋 | 1672 | Calligraphy and collectibles | |
| Ruifuxiang 瑞蚨祥 | 1893 | Silk and Chinese clothing | 1H 2009: profit grew by 146% yoy |
| Tongrentang 同仁堂 | 1669 | Medicine | 1H 2009: 5.41 billion yuan in revenue; 536 million yuan in profit |
| Wangzhihe 王致和 | 1669 | Food | 2008: 729 million yuan in sales value |
| Wuyutai 吳裕泰 | 1887 | Tea | |
| Yueshengzhai 月盛齋 | 1775 | Food | |
| Zhangyiyuan 張一元 | 1900 | Tea | 2008: 440 million yuan in sales value |

*Source: respective websites, compiled by Li & Fung Research Centre*

Our experts suggest further actions to safeguard traditional craft techniques developed by heritage brands. For example, facilitating patent registration and inscribing qualified heritage brands into the list of Intangible Cultural Heritage of China (中國非物質文化遺產). With continuous efforts by both government and enterprises, our experts are optimistic towards the development of heritage brands in China.