

# China



**Area ('000 sq km)<sup>1</sup>:** 9,600  
(US 9,600 – EU25 3,981 – World 133,700)

**Capital<sup>2</sup>:** Beijing  
(Number of inhabitants: 14.9 million)

**Population (million):** 1,307  
(US 296 – EU25 459 – World 6,000)

**Median age<sup>3</sup>:** 33 years

**Nominal GDP (USD billion)<sup>3</sup>:** 2,224.9  
(US 12,487 – EU25 13,447 – World 44,183)

**Nominal GDP (USD billion at PPP):** 8,227  
(US 12,487 – EU25 12,657 – World 59,763)

**GDP per head (USD at PPP):** 6,292.4  
(US 42,129 – EU25 27,538 – World 9,962)

**Currency<sup>3</sup>:** Chinese Yuan Renminbi (RMB)  
(USD1 = RMB8.2)

**Languages<sup>3</sup>:** Standard Chinese or Mandarin, Yue (Cantonese), Wu (Shanghaiese), Minbei (Fuzhou), Minnan (Hokkien-Taiwanese), Xiang, Gan, Hakka dialects, minority languages

**Main religions<sup>3</sup>:** Taoist, Buddhist

**Government type<sup>3</sup>:** Communist state

Sources: ( ) Economic Intelligence Unit 2006 data,  
(<sup>1</sup>) World Bank 2005, (<sup>2</sup>) National Bureau of Statistics,  
(<sup>3</sup>) CIA Fact book



# China

## **ECONOMIC OVERVIEW**

*Accession to the 4<sup>th</sup> economic rank in the world*

**GDP AND CPI**  
*Strong economic  
development fuelled by  
rapid growth*

China's ongoing economic reforms in the last two decades have opened the economy to international trade and investment. The economy continues its robust surge upward, growing by a strong 9.9% in 2005, with a gross domestic product (GDP) of USD2,224 billion. The figures are more staggering in purchasing power disparity, estimated to be at USD8,227 billion or USD6,292 per capita.

China's economic development has been fuelled by the rapid growth of fixed asset investment, backed by a high domestic saving rate, huge inflows of foreign direct investment (FDI) and major efforts in infrastructure. Services and industry accounted for 39.8% and 53.1% respectively of the GDP in 2005.

China's implementation of the World Trade Organization (WTO) requirements is giving further impetus to investor interest, as is the continued liberalisation and deregulation in banking and finance, insurance, telecommunications, and wholesale and retail sectors. China is now the fourth largest economy in GDP terms, behind the US, Japan and Germany. The country is also the world's third largest trader, exporting USD752.2 billion worth of goods in 2005, while importing USD631.8 billion.

China's consumer price index (CPI) posted a moderate growth of 1.8% in 2005, 2.1 percentage point lower than that of the previous year.

### **GDP and CPI**

	2002	2003	2004	2005
GDP growth (%)	9.1	10.0	10.1	9.9
CPI (%)	-0.7	1.2	3.9	1.8

Source: EIU, July 2006



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## ECONOMIC FORECAST

*Maintaining steady economic development*

Despite the government's effort to slow down investment and prevent the economy from overheating, China's economy continued to surge forward with GDP growth estimated to be 9.6% for the whole year. Factors such as political and social stability, improvements in labour productivity due to increased opening and reform and technological advances are expected to sustain an economic growth rate of 8% to 9% annually over the next five to ten years.

Inflows of FDI are expected to stay steady in the next few years as China continues to implement WTO requirements. Government officials forecast that actual FDI will remain at USD100 billion annually throughout the 11<sup>th</sup> Five-Year Plan (2006 to 2010), the country's blueprint for economic policy.

The CPI for the first six months of 2006 is estimated to be 1.3% and is expected to remain at around 1.2% for the whole year. Rising prices for oil and raw materials may lead to consumer prices increase and stoke inflation fears. But experts find no evidence that China is facing inflation as supply of most products surpasses demand and there is little room for the CPI to pick up.

In a bid to continue maintaining a steady development of the economy, the Chinese central government aims to spur domestic consumption by increasing consumer purchasing power. Increasing residents' income, raising the personal income tax threshold, hiking the pension payment of the retired, abolishing all agricultural taxes and enhancing subsidies to farmers are among the measures the government has taken to boost disposal income. The central government has allocated more public funds for healthcare and education to ease the household burden. Fostering domestic demand has taken centre stage in the 11<sup>th</sup> Five-Year Plan.

Besides public policy to stimulate consumption, the change in population demographics is another strong driver for consumer spending in China. The generation of free-spending young Chinese would prop up the economy unlike their parents who are more prone to save.

### GDP and CPI forecast

	2006	2007	2008
GDP growth (%)	9.6	8.3	8.1
CPI (%)	1.2	2.1	2.5

Source: EIU, July 2006



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## CURRENCY REFORM

In July 2005, China changed its currency regime to a currency-basket model. The Renminbi was re-valued by 2.1% against the US dollar. The Renminbi has appreciated by a further 1.1% since then. This move, though modest, may signal the start of a shift towards a more flexible exchange rate regime, which will be essential if China were to move towards a market-oriented financial system.

## UNEMPLOYMENT

### *Challenging unemployment*

Despite strong economic growth, continued structural reform is creating challenges for China in terms of employment. The official unemployment rate for 2005 was 4.2% (9.4 million). However, EIU estimate puts urban unemployment, including workers laid off from state-owned enterprises, to be 9%.

#### Unemployment rate and forecast

	2002	2003	2004	2005	2006	2007	2008
%	9.7	10.3	9.9	9.0	9.3	9.2	9.1

Source: EIU, July 2006

China created some 9.7 million jobs in 2005 and is adopting measures, including offering technical training and providing small-scaled loans in 100 pioneer cities, to help people find work.

According to estimates by the country's National Development and Reform Commission, the average number of jobless will reach 12.3 million during the period between 2006 and 2010.



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## REGULATORY ENVIRONMENT

### *A challenging regulatory environment*

**FOREIGN DIRECT INVESTMENT**  
*A leading destination for FDI*

FDI in China occurs most commonly through foreign-invested enterprises (FIEs), which can be established wholly or partly within China, and the foreign investor must hold at least 25% ownership. FIEs are mainly in the form of:

- Equity joint ventures – limited liability companies with joint Chinese and foreign ownership set up for a specific purpose. The share of the results is determined by the equity contributions to the joint venture by the two parties.
- Cooperative joint ventures – similar to equity joint ventures but the obligations of the two parties are specified in a contract, in which the share of results is also stated.
- Wholly foreign-owned enterprises (WFOEs) – legal entities wholly owned by one or more foreign investors. Industries in which WFOEs are not allowed are set out in the government's Catalogue Guiding Foreign Investments, published in 1995 and amended in 2002 and 2004.

#### FDI

	2002	2003	2004	2005
FDI (RMB bn)	408.1	389.7	454.7	648.4
FDI (USD bn)	49.3	47.1	54.9	79.1

Source: EIU, July 2006

**RETAIL REGULATIONS**  
*A broad range of legislation*

In fulfilment of its WTO commitments, China has gradually opened many sectors in which foreign investment had previously been restricted, among which is the distribution sector. The key regulations implementing this revised policy are the Measures for the Administration of Foreign Investment in the Commercial Sector (Commercial Measures), effective from 1 June 2004, and the Circular on Issues Regarding the Delegation of Approval Authority for Foreign-invested Commercial Enterprises to the Local Authorities (Circular 94) of the Ministry of Commerce (MOFCOM), effective from 1 March 2006. These developments, together with other policy changes, have given foreign investors greater access to the country's distribution sector.



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### Foreign invested commercial enterprises

*A special legal entity for investors*

Under the Commercial Measures, foreign investors are allowed to engage in four forms of distribution activities, namely retailing, wholesaling, franchising and commission agents' services. A foreign investor must set up a foreign-invested commercial enterprise (FICE) in order to engage in these distribution activities. FICEs are also permitted to import and export products regardless of their origin. FICEs can engage in other relevant ancillary business activities such as warehousing, inventory management and delivery.

An FICE may be a Sino-foreign joint venture or a wholly foreign-owned enterprise. Under the Commercial Measures, market entry threshold on capital requirements are substantially reduced and geographical restrictions were abolished. An FICE may engage simultaneously in one or more of the business activities mentioned above and may authorise third parties to open franchises shops.

Under Circular 94, the approval of FICEs in general is delegated to MOFCOM at local provincial level and the Administration Committee of the Economic and Technological Zones (ETDZs) for FICEs to be set up in state-approved ETDZs. MOFCOM, however, remains the approval authority if the proposed FICE is involved in sales through television, telephone, mail order, internet, etc., or in the distribution of strategic raw materials.

### New store openings

*Local authorities approve in most cases*

The objective of Circular 94 is to simplify the approval procedures and improve efficiency in face of the growing number of FICE applications. Local MOFCOM authorities are authorised to approve new outlets if:

- The area of a single store does not exceed 5,000 square metres, the number of stores does not exceed three, and the total number of similar stores opened by the foreign investor in China via FICE does not exceed 30; or
- The area of a single store does not exceed 3,000 square metres, the number of stores does not exceed five, and the total number of similar stores opened by the foreign investor in China via FICE does not exceed 50; or
- The area of a single store does not exceed 300 square metres.

In the case where an FICE is to be established by means of merger and acquisition by a foreign enterprise, and the foreign enterprise and target domestic enterprise are under the control of the same management or individual, approval from MOFCOM is still required.



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## CLOSER ECONOMIC PARTNERSHIP ARRANGEMENT

*Fluid relations with Hong  
Kong based companies*

On 29 June 2006, further trade liberalisation measures were announced under the fourth round of the Closer Economic Partnership Arrangement (CEPA), a WTO-compliant, free trade agreement which was first signed by the central government of China and the Hong Kong government and came into full effect from 1 January 2004. CEPA provides preferential access to the mainland market and reduces tariffs for the export of certain finished goods and services by qualified Hong Kong-based companies, whether locally or foreign owned.

The latest round of the CEPA benefits covers two broad areas:

- With effect from 1 January 2007, market access to 10 areas in the mainland already included in the CEPA will be relaxed further. The areas involved are: legal, construction, information technology, conventions and exhibitions, audiovisual, distribution, tourism, air transport, road transport and individually owned stores.
- Trade and investment facilitation measures will be extended to include the protection of intellectual property with immediate effect. One of the key means of improving cooperation in intellectual property protection will be the establishment of an Intellectual Property Protection Coordination Centre in Hong Kong. The Centre will facilitate the exchange of information relating to the formulation and implementation of intellectual property laws and regulations, and more.

Under the new measures, the maximum shareholding of qualified Hong Kong-based companies in retail businesses with over 30 stores in China will be raised – from currently not exceeding 51% to 65% from January 2007.

CEPA continues to have a positive impact on attracting investors to Hong Kong. About 23% of foreign companies establishing in Hong Kong in the first half of 2006 indicated that CEPA played an important role in their decision to invest in Hong Kong. Strategically CEPA opens a new chapter in cross-border trade and investment between Hong Kong and mainland China and reinforces Hong Kong's position as an ideal location to do business with China.

## DIRECT SELLING

*Permitted under WTO  
requirements*

Direct selling had been banned in China since 1998 after the sector was fraught with scandals and frauds. The Chinese government permitted only 10 foreign-invested direct selling companies to operate in China through retail outlets with employed sales representatives. As part of China's WTO commitments, market access for "wholesale or retail trade services away from a fixed location" has to be granted. On 2 September 2005, China issued



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two long-awaited new regulations governing the direct selling sector, namely Measures for the Administration of Direct Selling (Direct Selling Measures) by MOFCOM and the Anti Pyramid Promotional Scheme Regulations (Anti Pyramid Regulations) by the State Administration for Industry and Commerce.

Under the Direct Selling Measures, effective from 1 December 2005, companies applying to engage in direct selling must meet the following four requirements:

- They must have goodwill and have no record of serious irregularities in business practice in the preceding five years, and foreign investors must have at least three years of experience in direct selling in China;
- They must have a minimum paid-up registered capital of RMB80 million (USD10 million);
- They must pay a bond deposit of RMB20 to 100 million (USD2.5 to 12.5 million) to a designated bank; and
- They must establish an information reporting and disclosure system.

The Direct Selling Measures also impose various other requirements, including rules on operation mode, rate of commission, and recruitment and training of sales persons.

The Anti Pyramid Regulations, effective from 1 November 2005, aim at eliminating illegal pyramid schemes. Penalties for violating the Anti Pyramid Regulations are fines up to RMB2 million (USD0.25 million) per occurrence or criminal charges, depending on the seriousness of the violation.

The Measures for the Administration of Commercial Franchise Operations, effective from 1 February 2005, removed restrictions on market access and apply to all enterprises engaged in commercial franchise in China. A franchiser must have at least two directly owned outlets in China for at least one year before it may lawfully grant franchises. FIEs wishing to engage in commercial franchising must register and obtain approval of the relevant government authorities. They are also subject to a number of pre-sale and ongoing disclosure obligations.

In a bid to enhance protection of intellectual property, China has formulated an Action Plan on Intellectual Property Rights (IPR) Protection 2006. The action plan covers trademark, copyright, patent and import-export, and

### FRANCHISING

*Unrestricted market access*

### INTELLECTUAL PROPERTY RIGHTS

*Legislation is under active  
development*



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encompasses nine areas of protection, namely legislation, law enforcement, mechanism building, publicity, training and education, international exchange and cooperation, promotion of business self-discipline, provision of services to rights holders, and topical research.

Under the 2006 Action Plan, existing laws and regulations on trademark, copyright and patent will be revised while new administration measures and rules will be drafted to offer greater IPR protection. Enforcement actions will be stepped up in investigation, crackdown and supervision in the various areas of IPR protection.

In tandem with legislative and enforcement actions, China has also concentrated efforts on raising public awareness on the importance of respecting IPR. Various campaigns are launched across the country; for example, an IPR protection website, [www.ipr.gov.cn](http://www.ipr.gov.cn), was launched in April 2006 to introduce to domestic and overseas readers China's laws, rules, policies and measures concerning IPR protection.

The State Intellectual Property Office will join the National People's Congress Standing Committee in monitoring the enforcement of the Patent Law. Report centres will be established to handle IPR violation complaints as a means for building a mechanism with long-term effectiveness.

In terms of international exchange and cooperation, efforts will focus on legislation, copyright, patent and customs protection, with 19 projects being planned. Among these, seven are joint campaigns between China and the US.

China is making earnest efforts to address the issue of IPR protection, but as in all other countries, this issue will remain a constant major challenge for some time to come.

According to China's National Development and Reform Commission, the number of newly established foreign-invested real estate enterprises increased by 25.4% year-on-year in the first half of 2006. The amount of foreign capital actually utilised was up 27.9%, reaching RMB389.2 billion (USD48.8 billion).

In a bid to curb foreign capital from over-investing in the real estate sector and to control property speculation, the State Council approved on 11 July 2006 a guideline entitled Opinions on Regulating the Administration and Entry of Foreign Investment to the Real Estate Sector (Circular 171).

Under Circular 171, jointly drafted by six government authorities including the Ministry of Construction and the People's Bank of China, foreigners need to be resident in China for at least a year and foreign enterprises must have

## PROPERTY/REAL ESTATE SECTOR

*Restrictions on foreign ownership*



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### CONSUMPTION TAX

*Levied on "luxury" goods*

branches or representative offices in China before they can buy residential properties or office premises for their own use. If foreign institutions and individuals invest in domestic property not for their own use, they must apply to set up an FIE to engage in real estate investment, operations, and/or development. The ratio of registered capital should be no lower than 50% of any project with total investments of more than USD10 million.

Other rules and regulations have also been implemented to control property transactions among domestic residents, including the imposition of tax on sellers. The objective is to cool down the heated property sector and rein in rampant speculation.

Consumption tax was first introduced in China in January 1994 when the indirect tax system was reformed and also for the purpose of controlling excessive production and consumption of luxury products. Consumption tax affects mainly the producers and end-users of selected consumer goods such as cigarettes, beer, skin and hair-care products and gasoline. Different tax rates apply to different items.

New changes were introduced in 2006 and some of these changes affect consumer goods. Effective from 1 April 2006, consumption tax on skin care (except high-end products) and hair care products was eliminated, as these products are no longer regarded as luxuries but daily-use products. High-end skin products, however, are now taxed at the same rate as cosmetics at 30%. The new rates and definition of high-end skin care products are yet to be announced, but some high-end product players have already adjusted their price in stages to cushion the shock so as to retain their customers.

The category "motor cars" is reclassified into "passenger cars" and "commercial vehicles". For passenger cars, the former three levels of tax rates – 3%, 5% and 8% – have been replaced by six levels of tax rates, from 3% to 20%. Commercial vehicles are subject to a single rate of 5%. For motorcycles, the tax rate is reduced from 10% to 3% for motorcycles with cylinder capacity of 250ml or less and 10% for all others.

Consumption Tax, which ranges from 8% to 20% is also payable on certain imported consumer products.

### FOREIGN ENTERPRISE INCOME TAX

*Levied on all foreign-invested  
retail and wholesale activities*

The Foreign Enterprise Income Tax Law provides for a standard FEIT rate of 33%, consisting of a 30% state income tax and a 3% local tax. Currently, there is no specific tax incentive that is granted to foreign-invested retail and



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## VALUE-ADDED TAX

*Basic rate of 17%*

## CUSTOMS

*Many duty reductions following WTO membership*

wholesale companies. However, if these companies are registered and operate in those state-approved special investment zones, such as Shanghai Pudong New Area, a reduced FEIT rate (e.g. 15%) would apply. Nevertheless, reform of the China income tax system has been under discussion for some time. A new unified corporate income tax law may be promulgated soon as it is reported that the draft law will be laid before the State Council for review in October 2006. The FEIT rate as well as any preferential tax treatments currently available to foreign-invested enterprises will likely be changed.

In addition to FEIT, the importation and sale of tangible goods will be subject to VAT in general. The standard VAT rate is 17% while certain goods are taxed at the lower rate of 13% or are exempt from VAT. Exports are zero-rated and related input VAT, after absorbing certain non-creditable portion (depending on categories of goods) as cost, could be fully or partially refunded. VAT is levied on the basis of the value added to the taxable goods at each stage of a supply chain.

Import VAT, which is normally assessed at the rate of 17%, is also payable.

Customs or import duties are levied by the customs authority on goods imported into China based on predefined and published nomenclature, per the Harmonised System. Customs duty is levied based on the Cost, Insurance and Freight (CIF) Transaction Price of the imported goods at the rate of duty specified in the PRC Customs Tariff.

China has progressively reduced import duties in accordance with its WTO commitments. The average import duty rate is now 9.9% and this will be reduced marginally to approximately 9% in 2006. Import licensing, tariff quota and similar non-tariff barriers have also been substantially eliminated for most consumer products in recent years. Other non-tariff barriers, such as the Compulsory Certification Catalogue (CCC), may apply to certain consumer products.

Since China's WTO accession, foreign-invested companies may now acquire import/export rights direct without having to trade through a third party Import/Export Company, which was historically the normal practice. This should reduce the landed cost of imported goods and also simplify the import/export procedures and processes. China is also entering into preferential trading arrangements with other countries. Most notable is the ASEAN grouping that comprises key countries such as Thailand, Malaysia and Singapore. Under the ASEAN China FTA, trade between these countries can take place with lower (preferential) customs duties imposed. Free trade areas such as these can enable improved market access into China.



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## DEMOGRAPHICS AND CONSUMER BEHAVIOUR

*Increasing urban and rural incomes help to fuel a dynamic consumption but companies must remain wary of diverse cultures and spending habits in this vast and complex market*

China's population in 2005 is estimated to be slightly over 1.3 billion. Annual population growth rate has been relatively low, about 0.73% between 2000 and 2005. Over the next decade, the population is expected to increase at around 1% annually, reaching 1.4 billion by 2015.

In 2005, 934 million people were of working age (15 – 64 years). The United Nations estimate that by 2015, the economically active population in China will stand at 1005 million.

### Population

	2002	2003	2004	2005
Population (m)	1,284.5	1,292.3	1,299.9	1,307.4

Source: EIU, July 2006

More significant than the size increase is the change in age composition of the population. Between 2000 and 2005, the under-20 population declined by almost 27 million and is expected to drop by a further 72 million over the next decade by 2015. The main reasons for this decrease are delayed marriage and childbirth. The number of young adults (20 to 34 years) will increase by 77 million between 2005 and 2015. At the same time, by 2015, the number of older working population (50 to 64 years) will have increased steadily to almost 266 million, and so will the number of the over 65, reaching 105 million.

### Age profile

% of total population	1999	2004	2009 (f)	Trend
0-14 years	25.9	22.3	19.8	↓
15-64 years	67.4	70.3	72.1	↑
Over 65 years	6.7	7.5	8.1	↑

Source: EIU, July 2006

### POPULATION EVOLUTION

*Slowing population growth*

### POPULATION BY AGE GROUP

*Steadily ageing demographic pattern*



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The shift in age distribution of the population will directly impact on the consumer market in China. The drop in the number of children will mean less spending on child-related products such as toys, games and children clothing. At the same time, households with no children will have more money to spend on items such as home improvements, consumer electronics, travel and entertainment.

On the other hand, the increase in the ageing population implies that more demand will be generated on services and products in healthcare, pharmaceuticals, insurance and the like.

Official residence registrations show that China's rural population stands at 940 million or some 60% of the total population in 2005. The government, however, points out that the total of actual rural dwellers is about 750 million people as about 200 million people have migrated to work in cities and towns.

### Urban/Rural split

% of total population	1999	2004	2009 (f)
Urban	34.9	39.5	44.1
Rural	65.1	60.5	55.9

Source: EIU, July 2006

The urbanisation rate currently stands at 1.4%, which means that about 20 million rural dwellers become urban residents each year. Official statistics indicate that nearly 40% of rural dwellers' annual per capita income, about USD395, was earned in cities.

As part of the continuing effort to reduce income disparity and rural poverty, and to sustain urbanisation of the population, the Chinese central government announced in March 2006 a series of measures to build a "new socialist countryside" over the next five years. The aim of the new measures is to improve living standards and productivity levels in rural areas. Included among the measures are increasing rural infrastructure spending, removing agricultural taxes, increasing rural education expenditure and upgrading healthcare systems in rural areas.

## URBANISATION OF THE POPULATION

*Government efforts to bridge rural/urban income gaps*



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## INCOME/BUYING POWER

*Unequal regional distribution of growing prosperity*

Both urban and rural incomes have witnessed impressive growth since the introduction of structural and economic reforms in China. The annual per capita disposal income of urban households was RMB10,493 (USD1,280) in 2005, a real increase of 8.8% year-on-year. The annual per capita net income of rural households was RMB3,255 (USD397), a real increase of 6.2% year-on-year after deducting price factors.

Major coastal cities such as Shanghai, Beijing, Guangzhou and Shenzhen are more affluent than the other parts of China since these cities were the first to open their economy some two decades ago. Per capita household disposal incomes in these cities are in general higher than the national average. Sustained economic growth and the rapid expansion of modern retail format in recent years spread China's new-found wealth to other cities as well, in particular those in the Pearl River Delta and the Yangtze River Delta.

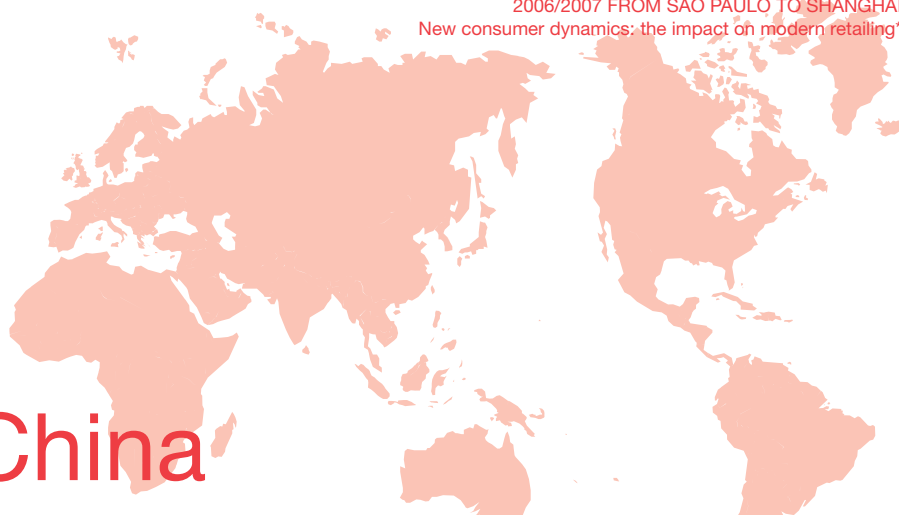
Rural dwellers also benefit from this boom in the economy, though to a far lesser extent. Migrant workers who work in the cities are sending back home their earned savings, which reached the substantial amount of RMB370 billion (USD44.7 billion) in 2003. Such income transfers are growing and are expected to boost the buying power of rural households. Indeed rural dwellers are changing their concept on consumption with this enhanced financial position.

Economic indicators of the 10 most prosperous provinces/municipalities, 2004

Province/Municipality	Major cities	Population (Million)	GDP per capita (RMB'000)	Household consumption (RMB'000)	
				Urban	Rural
Shanghai	N/A	17.4	46.3	20.9	9.1
Beijing	N/A	14.9	41.1	15.0	5.5
Tianjin	N/A	10.2	30.6	11.4	4.7
Zhejiang	Hangzhou, Ningbo	47.2	24.4	12.8	4.7
Guangdong	Guangzhou	83.0	20.9	11.4	3.4
Jiangsu	Nanjing	74.3	20.2	9.1	3.5



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Shandong	Qingdao, Jinan	91.8	20.0	8.5	3.3
Fujian	Fuzhou, Xiamen	35.1	16.5	9.7	4.8
Liaoning	Dalian, Shenyang	42.2	15.8	7.7	2.8
Inner Mongolia	Baotou	23.8	12.8	7.5	2.1

Source: National Bureau of Statistics

## AVERAGE HOUSEHOLD SPENDING PATTERN

*Expenditure on non-basic goods is on a steady upswing*

Increase in per capita income, improvement in living standard and the rapid spread of modern retail format have led to a change in the household consumption pattern. Urban residents are now spending more on discretionary items such as computers, mobile phones, consumer electronic products and healthcare services and products, as well as big-ticket items such as house purchase, cars and overseas travel.

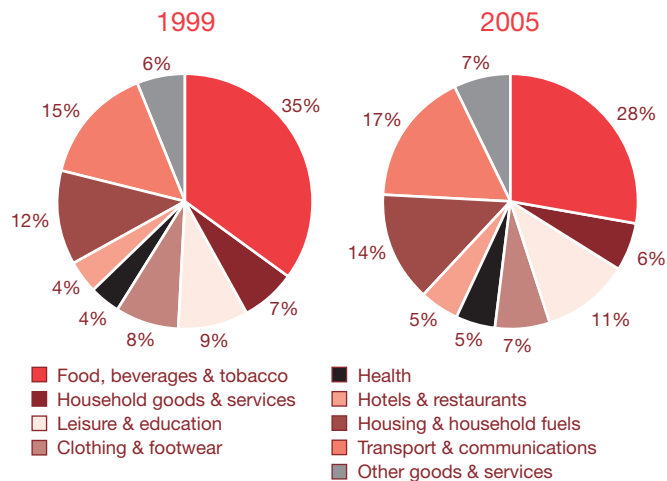
Rural consumers are also changing their concepts of consumption. Remittances sent home by migrant workers has enabled many rural dwellers to spend on items beyond the basics. Ownership of durable goods is on the rise and home improvements are more prevalent in certain parts of the rural regions now.

A word of caution is necessary however. China is a vast, complex market where huge regional differences exist. Such differences are not just about income or spending. The diversity in lifestyle, food preferences, custom and tradition, and business styles are just some of the points that foreign companies investing in China must take into account, not only in their choice of product and service mixes, but also in dealing with and managing their local enterprises.



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Composition of average household expenditure: 1999 vs 2005



Source: EIU, July 2006

## LIFESTYLE/ SHOPPING HABITS

*A middle-class lifestyle is strongly affirming itself*

According to the National Bureau of Statistics (NBS) of China, middle class household is defined as those with annual household income of RMB60,000 (USD7,322) to RMB500,000 (USD61,016). Currently, 5% of total households fall within this definition, but according to NBS forecast, by 2020 this percentage will increase to 45% of total households.

Indeed, the rising middle class is already a force that retail and consumer companies must reckon with. These middle class residents are avid consumers of a wide variety of durable goods such as high-end electrical and electronic appliances, upmarket fashion and upgraded home goods. They are also spending more on services such as entertainment and recreation, healthcare and fitness and financial and insurances. The growth in size, income and wealth accumulation as well as the changing consumption pattern of the middle class will play a major role in shaping the consumer market of China in future.

China's young population, those between 13 and 24 years old, is the first generation of the one-child policy to have a wide range of lifestyle choices. Like their counterparts in the West, friends and advertisements in magazines, televisions and the Internet about new trends and styles have the most influence on them.



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### BRAND/PRICE SENSITIVITY

*A complex attitude to  
brand value*

The attitudes towards brands among Chinese consumers seem to be ambivalent. For luxury goods, whether be it fashion or home goods, brands certainly matter as famous brand names and the fact that one can afford them are regarded as status symbol. However, when it comes to other products such as packaged goods or daily-use products for the home, consumers are less concerned about brands but more on price and product quality.

Though foreign brands are still regarded as more superior and speak louder as status symbols among the urban affluent consumers, the rapid emergence of domestic brands, particularly in consumer-packaged goods, is posing serious competition to foreign ones. However, the success of foreign consumer companies like Nestlé, Danone and Procter & Gamble in penetrating the Chinese market proves that it is product quality, localisation and offering that ultimately determines popularity among Chinese consumers.

Consumers' favour in brands varies from product to product. Where health and safety are issues of concern such as cosmetics and toiletries, foreign brands such as Unilever, Procter & Gamble, L'Oréal and Shiseido feature strongly. For daily-use products such as detergents and household care products, consumers make no distinction between foreign or domestic brands and tend to favour local brands, which are lower in price.



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### **RETAIL AND CONSUMER SECTOR PERFORMANCE**

*While growth is strong overall, segment performance is uneven due to regional and social differences in consumer demands as well as the varying quality of infrastructure across the market.*

#### **MAJOR CONSUMER GOODS PLAYERS**

*Increasing competition for consumer loyalty*

*Urban demand for convenience retail and ready-to-eat products*

*Opportunities for developing the rural market*

Over the past decade, China's fast moving consumer goods (FMCG) market has witnessed enormous growth, but at varying rates for different sectors because of consumer characteristics, product supply and distribution.

Well-off urban consumers in higher-tier cities are in general more receptive to and able to afford most FMCG products. The emergence of foreign FMCG products and their subsequent success in changing consumer habits has, however, resulted in widespread imitation from domestic companies. Consumers have many choices available and building brand loyalty is a challenge.

At present, imported packaged foods' market penetration is relatively low. They are popular among urban consumers in higher-tier cities as imported packaged foods are perceived to be of higher quality, safer and more stylish. More frequent travel overseas has also whet the appetite of many Chinese consumers for ethnic food and foreign cuisine.

Traditionally, fresh foods have been the staple of Chinese diet. However, urban consumers are changing their eating habits and shopping pattern in their quest for speed and convenience. The busy urban workers, in particular working women, find relief from cooking burden in packaged and convenience foods. The spread of supermarkets makes it easier to buy packaged and convenience foods. Total sales of packaged foods in 2004 reached almost RMB43 billion (USD5.2 billion), an increase of some 9%.

Rural residents, on the other hand, are much less receptive to packaged foods. Major reasons for this attitude include tradition, lower income level and low household penetration of refrigerators and microwave ovens. The underdeveloped retail network and distribution infrastructure results in higher retail price of packaged food and makes it less affordable among rural consumers.



# China

However, with the central government's initiative in building a national retail market in the rural regions, the development of the rural retail market will be accelerated and enhanced. Rural consumers will have easier access to wider product offerings at lower prices.

## Major consumer goods players in selected sectors

Sector	Brand (Global Brand Owner)	Company (National Brand Owner)	Market share %	
			2003	2004
Cosmetics and toiletries	Amway (Alicor Inc)	Amway (China) Co. Ltd	4.7	5.5
	Olay (Procter & Gamble)	P&G (Guangzhou) Ltd.	4.3	5.2
	Avon (Avon Products Inc)	Avon (China)	2.8	3.3
Household care products	Diao	Zhejiang Nice Daily Use Chemical Co. Ltd.	14.8	14.1
	Keon	Shanxi Nafine Chemicals Group Ltd.	7.1	7.1
	Liby	Guangzhou Liby Co. Ltd.	6.3	6.6
Packaged foods	Mr. Kon	Ting Hsin International Group	3.2	3.3
	Yili	Inner Mongolia Yili Industrial Group	2.3	2.9
	Mengniu	Inner Mongolia Mengniu Group	1.3	2.1

Source: Consumer China 2006, Euromonitor



# China

## MAJOR RETAIL PLAYERS

### Government initiatives

*Increasing regulation to homogenise development*

The breakneck pace of development of the retail sector has engendered market irregularities such as food safety problems, substandard products, unscrupulous business practices and bogus advertising. To better protect consumers and market players, and to ensure the healthier and more orderly development of the retail sector, the Chinese government has launched a series of regulations and policies in 2005. The following is a snapshot of the new rules:

- Measures for the Administration of Retailers' Sales Promotion – to regulate the sales promotion activities launched by retailers to protect the interest of consumers;
- Measures for the Administration of Transactions between Retailers and Suppliers – to regulate purchasing transactions between retailers and suppliers, with detailed provisions on the content of purchase contract, payment method, monitoring by local commercial authorities, establishing a risk warning mechanism;
- Measures for the Administration of Food Hygiene Licensing – to tighten the issue of licences and to promote good practices among food producers in order to regulate the food market and ensure food safety; and
- Anti Pyramid Regulations – to step up inspection to enforce the government's ban on pyramid schemes, particularly with the coming into effect of regulations on direct selling.

### Retail sales

*Continuing growth*

China's total retail sales reached USD797.4 billion in 2005, a growth of 13.7% over 2004. The combined sales of the China's top 100 chain enterprises amounted to RMB707.6 billion (USD86.3 billion), an increase of 42% year-on-year. The number of stores operated by the top 100 chain enterprises was 38,260, up 26% from the previous year.

#### Retail sales

	2003	2004	2005
Retail sales (USD m)	573,232	681,777	797,361
Retail sales growth (% p.a. in RMB)	11.2	14.5	13.7

Source: EIU, July 2006



## China

Between 11 December 2004 (when China fully opened its distribution sector) and the end of 2005, 1,027 foreign-invested retail enterprises were approved by MOFCOM, out of which 625 are wholly foreign-owned. In the top 100 retailers' list, 27 were foreign-invested, including Carrefour, METRO, Tesco, Tricon, Wal-Mart and Parkson. The combined sales of these foreign-invested retail operations totalled RMB261.9 billion (USD32 billion) in 2005, accounting for 37% of the total sales of the top 100 chain enterprises.

### Food retail channels

The rapid development of chain operation and the rise of modern retail formats are transforming the retail landscape in China. Supermarkets, hypermarkets and convenience stores are increasingly become the favoured venues for consumers shopping for their groceries and food.

#### Supermarkets *Dominated by domestic players*

The development and spread of the sector has been very impressive. The Shanghai-based Brilliance Group (formerly known as Bailian Group), the largest supermarket chain operator in China, added 845 stores in 2005, bringing the total number of stores to 6,345. Wumart Stores, Beijing's largest supermarket chain, also accelerated its expansion and has extended its retail network in Beijing, Tianjin and Hebei Province.

With the proliferation of supermarkets of all sizes and descriptions, intense competition is driving inefficient operators out of the market. At the same time, many retailers, including strong regional players, want to exit or sell out. Vanguard's purchase of Cikelong Supermarket and Tianjin Yuetan Supermarket and Beijing Hualian's acquisition of 51% of Guangxi Jieyong are recent examples. Larger players also try to forge strategic cooperation via alliances. For example, in December 2005, Brilliance Group and Dashang Group agreed to set up a third company together with the objective to strengthen the two companies' position in the retail sector.

In February 2006, Beijing Hualian announced its acquisition of the Singapore branch of Japan-based retail operator, Seiyu. This may mark the beginning of a trend for Chinese retailers to expand overseas via merger and acquisition.



# China

## Key domestic food retailers (2005)

Company	Sales (USD bn)		Number of outlets	
	Total	Growth (%)	Total	Growth (%)
Brilliance Group	8.8	7.2	6,345	15.4
CR Vanguard	3.8	26.0	2,133	20.0
Dashang Group	3.7	30.5	130	8.3
Beijing Hualian	2.5	30.0	74	5.7
Wumart	2.3	43.6	659	8.4

Source: China Chain Store and Franchise Association

### Hypermarkets Development led by international retailers

The top 10 largest foreign operators have around 475 stores in total, with a combined turnover of RMB93.7 billion (USD11.43 billion) in 2005. The largest foreign hypermarket operators include Carrefour, Wal-Mart, Tesco, Auchan and Lotus.

With market saturation in first-tier cities, hypermarket operators are looking for expansion in lower-tier cities and the inland regions. For example, Carrefour, the top foreign retailer in China with sales of RMB17.4 billion (USD2.12 billion) in 2005, has plans to open around 20 new hypermarkets. The new store locations include Zhengzhou in Henan province, Urumiqi in Xinjiang and Kuming in west China, while Wal-Mart is focusing on smaller urban centres such as Foshan, Mianyang, Nanhai and Wuhu. Tesco is extending its market reach to Dalian, Hangzhou, Ningbo, Shenyang, Tianjin and Shanghai through acquisition of an established hypermarket operator, Hymall in China. Thailand-based Lotus has started to expand to mid-sized cities like Huaian and Kunshan in Jiangsu province and Jiangmen in Guangdong province.

With the removal of restriction on ownership, coupled with their localisation strategies, some foreign retailers are buying out their Chinese joint venture partners. For instance, Carrefour acquired the 35% holding of its joint venture partner, Kunming Department Store, in October 2005, in addition to establishing a WFOE in Shenzhen. Other global retailers such as METRO and Lotus are also contemplating buying out their local partners.

On the other hand, to remain competitive, innovation in product and service offerings is vital to attract consumers. Wal-Mart, for example, is offering more fresh produce and includes fast food counters to offer breakfast, lunch and dinner to busy shoppers.



# China

## Key foreign food retailers (2005)

Company	Home country	Sales (USD m)	Number of hypermarkets
Carrefour	France	2,127.7	70
RT-Mart	Taiwan	1,915.9	60
Trust Mart	Taiwan	1,610.8	105
Lotus	Thailand	1,227.6	61
Wal-Mart	USA	1,212.2	56
Tesco	UK	966.5	39
METRO	Germany	920.9	27
Auchan	France	610.2	13
Makro	The Netherlands	122.0	5

Source: China Chain Store and Franchise Association

**Convenience stores**  
 Concentrated demand in urban areas

Development of the format is most dynamic in Shanghai and Guangdong, but otherwise sporadic across China. The sector comprises mainly domestic chains, such as Quick of Lianhua and Alldays and Kedi of Nong Gong Shang. Foreign players include 7-Eleven, Lawson, FamilyMart and Circle K. Because of the proliferation of convenience stores, competition is intense and net margins are squeezed.

Some global retailers are starting to adopt a multi-format strategy and include convenience stores in their operation in a bid to capitalise on the growing demand for convenience from urban consumers.

**Discount stores**  
 A nascent segment in major cities

The discount store first appeared in China in 2003, as introduced by Carrefour under its fascia, DIA. In a joint venture with leading domestic retailer, Shanghai Lianhua Supermarket, Carrefour has opened some 250 DIA stores in Shanghai. Goods sold through these discount stores are mostly private label merchandise and are priced more competitively than in hypermarkets. This format is still in the development stage in China and is confined to Tier I cities.



# China

## Non-food retail channels

Department stores  
*Evolving to stay competitive*

Once a popular retail format in China, department stores are being marginalised by modern retail formats. To survive and stay competitive, many established department stores in major cities such as Beijing and Shanghai have to reinvent themselves in various ways, such as focusing on mid and high-end customers or incorporating different kinds of retail formats like supermarket and specialty counters in the store.

Department stores that have made the Top 100 Chain Enterprises list include Parkson (Malaysia), Hefei Department Store, Beijing Wanfujing Department Stores and Shenzhen Tunglowan Department Store. Other foreign operators include Pacific Department Store (Taiwan), Robinson (Philippines) and JUSCO (Japan).

The MOFCOM announced in May 2006 that department stores would be rated into three levels, namely Gold, Silver and Bronze according to scores based on retail space, product mix, shopping environment, management, service, credibility and other criteria. The rating scheme would first be tried out in the nine cities of Beijing, Tianjin, Shanghai, Chongqing, Dalian, Nanjin, Changsha, Qingdao and Xian. It is believed that MOFCOM's move is an attempt to revive the appeal of department stores to woo customers that are drifting away to other modern retail formats.

### Key department stores (2005)

Store brand	Sales (USD m)	Growth (%)	Number of stores	Growth (%)
Parkson Department Store	1,342.4	49	36	20
Hefei Department Store	1,281.3	44	54	29
Wanfujing Department Store	790.0	22	14	8

Source: China Chain Store and Franchise Association

Specialty stores remain popular

Specialty stores specialising in one type of product or service continue to flourish in China. For example, in 2005, specialty stores included in China's Top 30 Chain Enterprises recorded annual sales revenue growth of 60.7% year-on-year and saw the number of stores increased by 50.8%.



# China

**Consumer electronics and appliances**  
*In demand from middle-class consumers*

The top retailers in the sector are domestic players, namely Gome, Suning, Yongle, Five Stars and Sanlian. Foreign investment in this domestically dominated sector is very low. Consumer electronics sales are projected to grow by more than 10% annually for the next decade, reaching USD100 billion in 2010.

Best Buy of USA eventually confirmed its first move into the Chinese market in May 2006. Best Buy agreed to purchase a controlling stake in China's fourth largest electronics and appliances retailer, Five Stars. The acquisition would give Best Buy access to 136 stores in eight provinces.

Gome is the market leader, with 426 stores in 88 cities. Listed in Hong Kong, Gome also operates six stores there. To expand its retail network, in particular in new regions, Gome is on the acquisition trail in 2005 – Black Swan Appliance in Heilongjiang, E-home Chain Store in Shenzhen and Wuhan Zhongshang Commercial Group in Hebei. Gome's latest acquisition in mid-2006 is its third largest rival in the sector, Yongle, thereby bringing the number of stores to over 625 and consolidating its market leader position further.

### Key consumer electronics and appliance retailers (2005)

Company	Sales (USD bn)		Number of stores	
	2005	2004	2005	2004
Gome	6.08	2.90	426	227
Suning	4.85	2.67	363	193
Yongle	1.85	1.32	199	108
Five Stars	1.78	1.14	193	120
Sanlian	1.61	1.61	274	254

Source: China Chain Store and Franchise Association

**Home goods and furnishings**  
*Home ownership has increased market*

Even though the sector is still fragmented and is made up of independent stores each offering a particular product such as kitchen fixtures and baths, a number of foreign and domestic home goods retailers have opened stores to target the middle class and educated professionals.

B&Q has been in China since 1999. In April 2005, it acquired the 13 stores of OBI, another foreign home improvement retailer that had exited the Chinese market because of problems with its local partner. B&Q also opened stores in Chongqing, Dalian, Dongguan, Xian and Xiamen. The total number of stores rose to 48, and B&Q plans to have 100 outlets in China by 2010.



# China

IKEA, on the other hand, is expanding its presence in China more gradually. It has two outlets in Shanghai and Beijing, with another store under construction in Wangjing, a new residential district in northern Beijing. Another store is planned to be set up in Kunming. IKEA revealed that China is the top purchasing choice for the company, with 18% of its purchasing fund allocated to China.

US-based Home Depot gained Chinese government approval in 2005 to invest USD15.5 million in opening stores in the country. It is reported that the company is planning to set up a wholly owned company, rather than using acquisition to establish itself in China.

### Key home goods and furnishing retailers (2005)

Store brand	Sales (USD m)	Growth (%)	Number of stores	Growth (%)
Home World	1,124.8	28	82	30
Orient Home	735.2	15	27	23
B&Q	629.7	156	48	129

Source: China Chain Store and Franchise Association

### Clothing and apparel Sales continue to grow

The total sales of clothing in China in 2004 exceeded RMB562 billion (USD67.9 billion) and the figure is expected to grow further with increasing per capita income and rising consumer aspiration. Despite being the manufacturing base for many of the world's biggest and most famous apparel brands, China has yet to come up with any major brands of its own. Li Ning (sports wear), Daphne (footwear), Boton (leisure wear) and Gujin (underwear) are the handful of domestic brands that have national market reach in their respective categories.

Early foreign entrants to this sector are mainly from Hong Kong, with brands like Esprit, Giordano, Bossini, Baleno and Glorious Sun. These brands are considered foreign brands, upscale and yet not luxury, and therefore have a strong appeal to middle-market consumers.

Prior to the liberalisation of the distribution sector in December 2004, medium-sized foreign apparel chains, except for a few foreign premium fashion brands, were restricted in entry to China's massive apparel market because of stringent requirements. The post-liberalisation scenario has attracted many middle-market apparel brands to China, including Zara and Mango from Spain, Etam and Kookai from France, UNIQLO from Japan, La Senza from Canada and Tommy Hilfiger and Jockey from the US.



## China

### Luxury goods A strong segment

Amid this influx of stronger foreign players (from a fashion point of view), the stronghold of the early entrants from Hong Kong, which focus almost entirely on casual wear, is being challenged. In response, Giordano has gone upmarket with the launch of Giordano Ladies in order to seek a market niche. Esprit, on the other hand, has been offering the same merchandise in China as what is offered globally, with strong European tilt, and therefore has managed to keep its appeal among young, professional class consumers.

China's luxury goods market currently generated more than USD2 billion in sales a year. It is expected to grow 20% annually until 2008 and then 10% annually until 2010, with sales exceeding USD11.5 billion.

The promising market prospect is highlighted by the premium brands that have established a presence and are expanding, not only in first-tier cities but also venturing into lesser known ones. For example:

- Louis Vuitton – has more than 10 stores across China, including second-tier cities such as Xian, Xiamen and Qingdao; China accounts for 10% of its worldwide sales
- Cartier – has 12 stores in nine cities across China. By 2010, this will have increased to almost 30 and China will have overtaken Japan as its second biggest market in the world
- Giorgio Armani – rolled out its flagship store in Shanghai in 2004 and plans to open 30 stores in major cities by 2008
- Gucci – has seven stores and plans to add another 10 over the next three years
- Montblanc – has four boutiques and over 80 point of sale in 40 cities across China
- Prada – with 22 outlets, is building a flagship store in Shanghai

Industry analysts estimate that Chinese consumers, including residents of Hong Kong, now represent the third biggest luxury goods market worldwide, accounting for about 12% of global sales, and predict that the Chinese could overtake the Japanese as the world's top consumer in 10 years' time.



## China

### Alternative retail channels

#### Franchising

*A means for regional penetration*

China has 1,900 franchise systems, with 822,000 outlets and is growing at 40% annually. Franchise brands number about 2000, covering a diversity of products and services. At present, franchising business accounts for only 3% of China's total retail sales and has huge potential for further growth. Foreign franchisers in China include KFC, McDonald's, 7-Eleven, Pizza Hut, Athlete's Foot, Häagen-Dazs, etc.

#### Direct selling

*Potential for further growth*

Despite the fact that significant questions remain, the introduction of the direct selling rules in 2005 has provided the legal framework for direct selling operators to tap into China's retail market. Foreign companies now maintaining substantial market presence in China include Amway (personal care), Mary Kay (cosmetics), Avon (cosmetics), Nu Skin (personal care) and Sunrider (herbal products, vitamins). The potential of direct selling is believed to be bright; for example, Avon predicted 60% annual growth through 2007.

#### Online retailing

*A new route to consumers*

In China, there are 119 million Internet users, 916 Internet service providers and 14,000 content providers in 2006. The transaction volume of B2C shopping in 2004 was RMB4.2 billion (USD507.4million) and in 2005 the figure increased to RMB5.6 billion (USD683 million), a growth of 33%. It is reported that there are more than 20 million online shoppers in the country, and more than half of them use online payment.

It is forecast that the number of Internet users will increase to 178 million by the end of 2007. With the maturing payment and credit system and the rising computer-savvy young population, online retailing presents a viable alternative route to reach China's consumers.



## China

### **RETAIL AND CONSUMER CHALLENGES, OPPORTUNITIES AND EMERGING TRENDS**

#### CHALLENGES

##### Sourcing – buyers beware

Global retailers' sourcing from China is one of the factors driving the rapid growth of China's export of consumer products. Wal-Mart, Carrefour, METRO and Auchan, the top four foreign retailing giants in China, together have purchased over USD27 billion worth of goods from China in 2005.

However, the evolving international trade situation sometimes may throw up unexpected surprises that create risks in sourcing. For instance, the turn of events after the end of textile quotas in 2005 had caught a number of companies, including C&A, Liz Claiborne and Wal-Mart, that sourced apparel from China off guard and highlighted the need for global retailers and suppliers to take into account of risks such as these and have ready alternatives in their sourcing. Hong Kong is one of the options that companies should consider as Hong Kong-based apparel producers with production plants in China are eligible for "outward processing arrangement" that is not subject to quota restriction on China.

Another lesson learnt is that retailers and suppliers must choose their third-party sourcing agent with care. Li & Fung, the industry's largest agent and heavily involved in textile sourcing in China, came through the incident without any effect on their performance as the company had foreseen the likely scenario and was well prepared ahead. This is the kind of standard that global retailers and suppliers must look for in their sourcing agents.

#### Supply chain

Despite vast improvement, China's underdeveloped distribution infrastructure and fragmented retail markets pose huge challenges to FMCG companies trying to penetrate lower-tier cities. With the liberalisation of the distribution sector and the aggressive expansion of leading foreign retailers, FMCG companies will find it easier to ride on the back of these developments to gain access to lower-tier markets. Companies such as Coca-Cola and Nestlé are investing in their own distribution systems and bringing in new technology and management know-how as a solution.

Another major constraint in distribution efficiency is the lack of cold storage warehousing, limited refrigerator carriers and efficient methods of food preservation and packaging.



## China

In most parts of China, distribution infrastructure remains underdeveloped. Despite government efforts in upgrading and extending the country's infrastructure, supply chain-related costs remain higher than elsewhere: about 20% of product price compared with 10% in the US, as US Commerce Department points out.

Inefficient supply chains will create additional hurdles and strain on the system for retailers and suppliers in their expansion beyond the first-tier cities. The serious shortage of logistics professionals and the lack of qualified distributors further exacerbate the problem.

The opening of the logistics sector under the WTO liberalisation measures as well as under CEPA will alleviate the situation to a certain extent. As such, it is estimated that the market share for third-party logistics service providers would grow from the current 3% to 20% by 2010, with a market value of USD30 billion. However, for the near term, infrastructure and logistics constraints will remain very real issues and can only be addressed over time.

### Currency revaluation

Under international trade pressure, China is expected to continue building the mechanism needed to float the Renminbi which will be re-valued upwards further. However, the currency appreciation will be gradual to avert drastic impact of the country's import and export. For retailers and suppliers buying from China, this will mean high prices for their sourced merchandise and this must be factored in any sourcing budget. Yet, looking at it from a positive angle, currency appreciation would make Chinese consumers richer and able to purchase more products from the West.

### EMERGING TRENDS AND OPPORTUNITIES

#### Moving to secondary cities

Foreign retailers are following close on the heels of rising economic prosperity in the lower-tier cities and are opening new stores in places such as Chengdu, Chongqing and Shenyang.

For example, Carrefour has relocated its regional headquarters for central and western China to Chengdu as part of its strategy to secure a foothold in China's western region. Wal-Mart is reported to be in negotiation with 10 second-tier cities, including Jinhua in Zhejiang and Wuhu in Anhui, about setting up new stores in these cities. METRO, on the other hand, is focusing on Dalian, Shenyang Harbin and Changchun in China's northeast.



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Opportunities also abound in the smaller cities in the Pearl River Delta (PRD) and Yangtze River Delta (YRD). Foreign retailers are well advised not to lose sight of these economically vibrant cities. Take the example of Foshan and Dongguan, two of the most prosperous cities alongside Guangzhou and Shenzhen in the PRD. Per capita GDP in each was over RMB40,000 (USD4,833) in 2003. In 2004, GDP of Foshan was RMB165.3 billion (USD20 billion) and Dongguan RMB115.5 billion (USD13.95 billion). A similarly robust picture is presented by cities such as Kunshan, Suzhou, Wuxi and Tongling in the YRD.

### Mergers and acquisitions

M&A activities are expected to continue in the coming few years. For foreign retailers, M&A can be a fast means of gaining market entry as in the case of Tesco, or penetrate new markets and extend network in other regions as in the case of B&Q. In June 2006, Belgian brewer InBev completed its acquisition of Fujian Sedrin Brewery in China and a wholly-foreign-owned enterprise, InBev Sedrin, has been established. This RMB5,886 million (USD717.8 million) acquisition, combined with InBev's existing operations in China, positions InBev as one of the largest brewers in the country.

Recently, France's SEB, the maker of Tefal non-stick saucepans, announced the proposed acquisition of majority shareholding in Zhejiang Supor Cookware Co. Ltd., China's biggest company in the field. Italy-based appliance maker Candy Group had signed an agreement to acquire 75% of Jinling Electrical Co. Ltd., a washing machine manufacturer that is the third ranking brand in the China market. Even though, at the time of writing this report, these deals are still subject to approval by the Chinese government, they represent a growing trend in foreign acquisition of Chinese companies as a fast track to market entry and expanded activities.

For domestic players, market consolidation will be achieved through M&A. Stronger players may use this to buy out smaller retailers in regions where they want to extend their presence. Domestic retailers may also make use of M&A in other countries, such as the example of Beijing Hualian's acquisition of Seiyu in Singapore, as a way to breach into overseas markets.

Following the announcement of a new set of supplementary rules by MOFCOM in July 2006, the permitted scope of foreign investment in China is further extended. Foreign-funded investment companies are now permitted to undertake service outsourcing activities for offshore companies and their exports are eligible for export tax rebate. The supplementary rules also encourage foreign investors to undertake M&A of domestic enterprises.



## China

### Strategic alliances and voluntary chains

In future, more retailers are also likely to collaborate with companies providing retail-related ancillary services such as logistics and warehousing as a means of better managing the supply chain.

Forming strategic alliances among retailers to establish long-term strategic expansion and leverage on each other's strengths is expected to be more common in the coming years. The recent alliance and cooperation between Brilliance and Dashang may set the trend.

Small and medium-sized domestic retailers have started to form voluntary chain operations to counter the intensified competition through enlarged bargaining power, pooling of resources, enhanced sourcing capabilities and sharing of logistics facilities and information. International chain operators, SPAR and IGA moved in to China in 2005.

SPAR is focusing on second-tier cities in Shandong, Henan, Hubei and Anhui in central eastern China. The first SPAR hypermarket with local partner Jia Jia Yue Supermarket in Weihai, Shandong was opened in 2005 and proved to be hugely successful. SPAR has plans for 15 SPAR hypermarkets in Shandong in three years.

IGA also made its debut in China in 2005 and has five members so far, namely Shenzhen Yourong and Ningbo Sanjiang in south China, Hunan Bubugao and Hubei Zhongbai in central China, and Heilongjiang Qikelong in the northeast. IGA encourages members to continue using their own brands while providing management and operation know-how to members.

The concept of voluntary chain operation has received official government support and generated immense interest among independent domestic retail operators. Further expansion of this business model is likely in the future.

### Rural market – a land of opportunity

The central government's ambitious programme announced in February 2005 to build a national rural retail network covering 70% of all villages within three years will open up huge opportunities for retail chain operators. The promised distribution infrastructure improvement, preferential treatment and support from local governments will pave the way for retailers to the hitherto untapped rural market. The programme, however, is not aiming at encouraging the opening of new stores in the rural market, but rather to entice participating retailers to take over or cooperate with existing rural stores by means of



## China

### Brand building

franchising or voluntary chain operation. In a way, this will help to reduce set-up cost and minimise conflict with local retail operators and consumers for the participating retailers. If successful, the programme would see around 250,000 supermarkets and convenience stores chains in the counties and major towns and villages by 2008.

Despite its robust retail and consumer market development, China has only a handful of international and national brands. Haier and Lenovo (consumer electronics and appliances) and Qingdao (beer) are the better known ones. The central government is keen to aid large domestic companies to build up their brands, but the emergence of extensive national brands will still be some time in the future.

However, given the Chinese consumers' strong preference for foreign brands and that this preference is attracting a host of brands to the market, foreign retail and consumer companies must be vigilant in brand building to keep from being smothered.

Brand building launches will call for effective and innovative marketing in order to succeed. Eastman Kodak, one of the official sponsors of the 2008 Olympic Games, launched an innovative marketing campaign by giving away free cameras to people in remote regions such as Gansu. This has the benefits of not only being a high-profile marketing stint but also presenting an enthusiastic response to the government's call for enterprises to go west.

### Private Labels

Developing private label, in conjunction with localisation of products, has been adopted by a number of foreign retail and consumer companies. For instance, Carrefour has launched 435 private label products in its stores across 23 Chinese cities last year. The Hong Kong-based chain, AS Watson, offers over 1,000 private label products in China, about 20% of its total product offerings. These lower-priced products are in general well-received by the price-conscious Chinese consumers.

With the expansion of the global retailers and the increasing brand-building capabilities of domestic retailers, private label products offering is expected to grow further in the coming years.



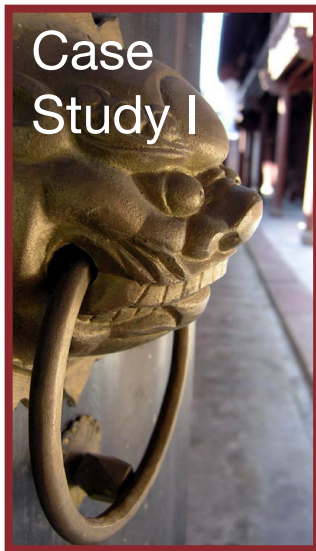
## China

### Research and development centres

Global retailers and suppliers are increasingly establishing R&D centres in China. For instance, Johnson & Johnson recently set up a consumer goods R&D and innovation centre in Shanghai, which is the company's largest R&D centre in the Asia-Pacific region. Estée Lauder opened a research centre in Shanghai in 2005 primarily to research on Chinese medicine, but it is believed that the company would also like to make use of the facility to study Chinese consumer behaviour. As a part of its strategy for expansion, Danone has recently opened a research centre for fresh dairy products in Shanghai. It has three others, one of which is dedicated to the biscuits business and the remaining two to beverages.

R&D centres were established by foreign investors in China in as early as 1980s, but these operations were focused mostly on product localisation. However, since the 1990s, multinational companies have invested over USD4 billion into some 750 R&D centres. A survey on the world's top 300 R&D spenders by the United Nation Commission on Trade and Development reported that over 61% of the respondents indicated that China would be their R&D destination in the coming years.

In addition to product localisation, nowadays these R&D centres increasingly are also generating innovative products with global application. The growing pool of university graduates in science and engineering in China and the government's keen support on high-tech R&D through tax concession and other incentives are some of the reasons driving the R&D trend.



## Case Study I

# Li & Fung Limited: From traditional Asian trading company to global supply chain manager

## KEY DRIVERS

Li & Fung Limited, set up in China 100 years ago and now headquartered in Hong Kong, is a leading global consumer goods sourcing company managing the supply chain for retailers and brands world wide through a network of over 70 sourcing offices in over 40 countries and territories. How has a family business succeeded in changing to become a global player with a lead position on the market?

### Background

Victor and William Fung, grandsons of the founder, now head the company and both had studied at the Harvard Business School. The Fung brothers are instrumental in transforming a family business into a global conglomerate while retaining some dimensions of Eastern traditional value in the operation of the company. In the words of the Fung brothers, Li & Fung is a Chinese company with Western characteristics – Western in management and business model and Eastern in attaching great value in relationships and entrepreneurship.

Garments make up a large part of the Li & Fung's business, which also covers the sourcing of hard goods such as fashion accessories, toys, gifts, home goods, promotional merchandise and others. Turnover of the company for the year 2005 was HK\$55.6 billion (USD7.2 billion), an increase of 18% over the previous year and profit attributable to shareholders was HKD1.79 billion (USD230 million). The company owns no production facilities but instead an internally vetted global network of 7,500 suppliers worldwide that are quality-conscious and cost-effective to ensure on-time delivery to its customers.

### Transforming the company

In the early years of the company, Li & Fung was principally a broker, charging a fee for putting sellers and buyers together. In the late 1970s, the company developed into a regional sourcing agent and set up offices in Taiwan, Korea and Singapore, leveraging its knowledge of the region, such as textile quotas and the strengths of each country in terms of product quality, to increase value for customers.

In the second stage of development in the 1980s, Li & Fung extended its sourcing agent strategy further and began to manage and deliver manufacturing programmes. For instance, based on customer-provided apparel designs, the company would create an entire programme with prototypes with the right fabric and in the right colours for the whole season, specifying the product

mix and schedule. The company also monitored and supervised the production in factories to ensure quality and on-time delivery.

The emergence of the Asian tigers in the early 1990s propelled Li & Fung to another stage in its development. Hong Kong then had become too expensive to be competitive in manufacturing. Fortunately, China began to open up to trade, thus enabling many Hong Kong manufacturers to shift the labour-intensive part in their production to southern China to address the cost problem. Li & Fung adopted what itself described as “virtual manufacturing” in that the value chain was broken up: the labour-intensive middle part of value chain was carried out in southern China, while the headquarter and its major sourcing and marketing offices handled the front end such as product design and production planning and back end, such as quality control and shipping.

Since then, Li & Fung has developed into a leading supply chain manager for many global retailers, extending its geographical reach and service offerings. The success factors in Li & Fung's evolution from traditional agency business into a global supply chain manager lie in the company's focused strategy in positioning itself as a supply chain manager, the integration of operational strategy with its organisational strategies, customer-centric organisational structure, information technology initiatives and globalisation efforts.

### Supply chain manager positioning

#### Dispersed manufacturing

Li & Fung instituted the innovative process of breaking up the supply chain into various stages of manufacturing and choosing the factories, locations and countries assigned for each stage according to their best competitive advantages. For example, an order of shirts from a retailer in the US may be disaggregated such that the yarn would be sourced from one country and then dyed and woven in some other factories in a second country. The tailoring of the shirts may be carried out in other factories in a third country. The factors that determine the location and

client's needs, timing, capacity, technology requirements, labour and required skills. Li & Fung would undertake quality control and testing at the back end of the value chain. By the time the finished products reached the retailer in the US, they would look as if they all come from the same factory, when in fact a number of factories in three countries have been involved in the value chain.

### Total Value-Added Package

For each customer order, Li & Fung would have a customised value chain and provide a one-stop shop service for the customer through a total value-added package and bring the retailers and manufacturers closer in collaboration.

Take the typical order of shirts again. Li & Fung would offer front end services in product design and development and production planning, preparing prototypes of the product in the process. Upon customer feedback, the company would move upstream to organise the production for the customer. In this middle part of the supply chain, Li & Fung would add value by taking charge of the whole production process, from raw material sourcing, selecting the manufacturer to providing management expertise and technical know-how.

The company helps the customer to buy "closer to the market" by virtue of its extensive network of global suppliers and the trust built between the company and the suppliers. Retailers of time-sensitive products such as fashion can wait until they are more certain of the fashion trend before they commit themselves to any order, while in the meantime Li & Fung has already had the required material for the season sourced and the producers of the final product standing by and ready to deliver. This would shorten the customer's buying cycle considerably, in turn translating it into better inventory management and lower markdown in stores.

### Tackling the "soft cost"

Li & Fung reckons that manufacturing costs typically comprise just about 25 per cent of a product's price, while "soft costs", such as transportation and warehousing, make up the remaining 75 per cent. To tackle the soft costs, Li & Fung would adopt relatively unconventional steps in logistics and distribution, making savings as the ultimate goal.

## Operational and organisational strategy integration

### Geographical spread with operating agility

Given the spread of operations in so many countries, Li & Fung's organisational structure is such that the product group managers who are located in different locations are responsible for the day-to-day operations. These managers meet twice a year to discuss on strategic business issues. In addition to this, a policy committee, formed by these managers and the top management meet face-to-face regularly to discuss and agree on policies such as compliance and social responsibilities.

The committee then translates the policies into operating procedures and the product group managers will be the vehicles for implementing these procedures in their respective locations.

### Flexible client-servicing units

To maintain flexibility and prevent the company becoming bureaucratic, the basic operating unit of Li & Fung is the division, which consists of small team of staff dedicated to handle one customer or a number of smaller customers with similar needs. To encourage entrepreneurial spirit, each division head is given extensive autonomy and considerable operating freedom in running the division, in a manner similar to running his or her own business. As motivation, the compensation of the division head is tied to the profitability of the division.

### Central financial control

Financial controls and operating procedures, however, are managed and controlled centrally, and so are working capital and cash flow. The Fung brothers admit that this approach is much more conservative in contrast to the company's aggressive merchandising.

## Customer-centric organisational structure

### One customer, one division

Li & Fung structures its organisation around the customer. One division is deployed for one customer or a group of smaller customers with similar needs. Each division has its own sourcing teams in various countries, depending on the needs of its customer. These country-based sourcing teams work in branch offices of the company but report to the division head.

### Specialised teams

Staff in a division is organised into specialised teams in areas such as technical support, merchandising, material sourcing, quality control and shipping, in other words, a customised value chain for each customer order. Each division effectively becomes the product development, procurement and logistics arm of the retailer, thus saving time and cost for the customer.

### Customer relationship

Li & Fung retains a traditional dimension in its customer relationships. The Fung brothers endeavour to remain well informed of the company's customers and keep a personal touch with them, in the tradition of their grandfather and father. At the same time, relationship with suppliers is also built on trust and the company's long-standing record of honouring commitments.

## Embracing information technology

- Li & Fung sees the importance of information technology (IT) as it provides connectivity to its extensive supply chain network and provides customised, quality support for customers and their time-sensitive needs.
- The company has a standardised, computerised operating system for executing and tracking orders and all employees in the company have access to the system
- Each staff member in a client-servicing division has a direct software link to the customer that the division serves, thus enabling efficient connectivity, communication and compatibility with the customer.
- Li & Fung also tracks supplier relationship in a database so that the performance record of any particular supplier is at the fingertips of the staff.

## Globalisation and diversification

### Acquisitions

Throughout the years, one of the key strategies of Li & Fung has been to carry out a series of smaller acquisitions to augment capabilities in sectors that the company would like to see expansion or coverage. For example, in 2005 the company acquired a corporate promotional products supply company in Europe, an apparel company with 40 character brand licences in the US, an apparel company focused on supplying private labels to mass-market retailers and a furniture sourcing agency business in Indonesia.

Acquisition and integration of various businesses in different parts of the world have enabled Li & Fung to expand its presence and enlarge its diversity in product mix, geographical coverage and customer base.

### Diversification

The company's diversification strategy enables it to open up new customer segments and opportunities. For example, in 2003, the company started to build a brand business in the US as an extension of its role in the supply chain. Since then, its brand licensing business has extended to include some of the world's largest brands, such as Levi Strauss, Royal Velvet and Disney.

Among other new business ventures is the building of an onshore US business in private labels, licensed brands and proprietary brands. For example, in mid 2006, the company acquired two women's apparel and handbags business, Oxford Womenswear Group and Rosetti Handbags and Accessories, which license and sell private labels for major US retailers. The company leverages its core competency on the direct offshore sourcing model to service retailers preferring to conduct business on an on-shore basis. The licensed brands business developed in 2003/2004 would provide the basis for supplying branded goods to suppliers. Leveraging its capabilities in private labels and licensed brands areas, the company would be able to extend its coverage to proprietary brands, building exclusive lines of merchandise on nationally known brands for retailers.

## Key takeaways

In essence, innovation, differentiation, diversification and customisation are the key factors in the success of Li & Fung in maintaining its leadership position in the domestic market while emerging as a global player.

## Case Study II

# Procter & Gamble – Growing through innovation and collaboration



## KEY DRIVERS

Unlike retail and distribution, the Fast Moving Consumer Goods industry in China has been open since the end of the 1980s when a host of leading global companies entered the market. P&G was one of these early entrants. P&G established its first joint venture in Guangzhou in 1988. At present, P&G has operations in multiple locations including Guangzhou, Beijing, Chengdu and Tianjin, with cumulative investment over USD1 billion. P&G also has plants, distribution centres and sales branch offices in major cities in China, while its product selling covers more than 500 cities in the country. How has the company built its position as a market leader over the past 18 years?

## Background

Since its entry in 1988, P&G has brought to China such brands as Crest, Rejoice, Head & Shoulders, Safeguard, Olay, Whisper, Pampers, Ariel and Tide. P&G's rapid business growth in China has been achieved through focused product portfolio, innovation and local adaptation, and supplier/retailer collaboration.

## Focused product portfolio

When P&G entered the Chinese market, it began with a sole focus on establishing its shampoo market, backed up with massive advertising efforts. Faced with little domestic competition, P&G, and other foreign FMCG companies, found it relatively easy to sell their products. Despite this, P&G was careful to ensure that it had firmly established its market position in shampoo before broadening its portfolio of products into personal and household care sectors. With this focused strategy, P&G was able to apply the lessons learnt in launching its shampoo to other product lines as it brought them to the market.

However, as Chinese FMCG companies caught up on manufacturing in shampoo and many other FMCG products, market overcapacity changed foreign companies' hold on the market. Domestic shampoo brands were much lower in price and soon were snatching market share from foreign ones. In order to maintain a successful hold on the shampoo market share, P&G strove to obtain a clearer understanding of the market and a more defined identification of consumer segments by collecting consumer data. As a result, P&G created four strong brands and spent heavily on advertising to establish separate identities for each shampoo product range – Vidal Sasson for fashion, Pantene for healthy hair, Rejoice for soft and beauty, and Head & Shoulder for dandruff. These efforts on clear differentiation enabled P&G to claim market share.

As the market is saturated with a proliferation of brands, P&G regarded brand building as vital to differentiate its products. The company spent heavily on advertising to foster among its target consumer groups a desire for using P&G's product lines.

## Product innovation and local adaptation

P&G sees innovation as the driver of organic growth. P&G on average introduces one new brand of product in the Chinese market every six months. P&G's approach to innovation is to have a clear differentiation between its customers so that the company is able to ensure that it does not overspend on innovation at the low end and can more accurately meet the needs of the various tiers of consumer in its markets.

P&G adopts an open innovation model called "Connect and Develop" which taps into the creative thinking of not only its own researchers but also the ideas of a wide spectrum of individuals outside the company as well. Based on this model, P&G collaborates with organisations around the world, "systematically searching for proven technologies, packages and products that P&G can improve, scale up, and market", says P&G's Vice-President for innovation and knowledge.

P&G researchers' innovative ideas are not all confined within the walls of its company. Very often, observation starts the researchers on the path of discovery. For example, noticing Chinese women washing laundry and hanging it from apartment window to dry, R&D staff in China came to realise that though many households had washing machines, women were reluctant to use them because of costs of water and electricity involved. To address this market need, P&G created two further version of its top-tier laundry detergent – Tide Triple Action, launched in 2001 and aimed at the middle-tier

low-income consumers, and Tide Clean White to target the bottom tier consumers. Such response to consumer needs helped to boost sales of its detergents.

### Supplier/retailer collaboration

P&G endeavours to build superior relationships with external stakeholders to create a favourable external environment, which is supportive of its business goals. P&G sees retailers as its customers and attributes its success partly to its healthy cooperation with retailers.

P&G was the first manufacturing company to set up an Efficient Consumer Response (ECR) system in China. Its firm commitment in the power of this mechanism in smoothing relationship of supply chain related parties had led to the establishment of the ECR China in 2001, with the company as the manufacturer representative convenor and Shanghai Lianhua Supermarket as the retailer representative. P&G's active engagement of industry counterparts in ECR not only had promoted the development of ECR in China, but also enhanced P&G's image in the industry.

P&G embraces information technology as a means to forge closer ties and streamline the supply chain to deliver higher value to customers. For instance, the strategic collaboration between P&G and Lianhua in China has helped to optimise the supply chain and enhance procurement efficiency, thereby achieving enlarged market share, brand influence and competitiveness for both parties. Both P&G and Lianhua believe that information technology is the core technology for optimising the supply chain system and they collaborate closely on data collection, data analysis and information sharing. By adopting a consumer-driven supply and replenishment approach, inventory reduction, higher order satisfaction level, inventory turnover improvement and supply chain efficiency enhancement are achieved. The P&G/Lianhua collaboration illustrates the power of collaboration in value creation.

### Key takeaways

Knowledge of consumer tastes, focused product portfolio and brand-building as well as collaboration with partners in the extended supply chain are important success factors in market entry and sustainability, as illustrated in P&G's case.



# China

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