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The Path to Success for Retailers and Consumer Brands in China

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Overview

China has proven to the world that it is a force with which to be reckoned. Its vast population of 1.3 billion represents a literal wealth of potential for opportunistic retailers. Interest in this vast market was renewed on December 11, 2004 when restrictions that had prevented foreign retailers from operating wholly-owned stores were eased in accordance with China's commitments to the World Trade Organization.

For many global retail or consumer products companies, however, success in China will not come easily or quickly. One of the most common mistakes is approaching China as a single, huge market when, in fact, China is a series of markets that vary widely by geographic location and population characteristics. To follow the path to success for retailers and consumer brands in China, foreign retailers must understand the unique characteristics of China's many consumer markets, the nuances of its retail market and the complexities of its ever-changing economy.

China's Changing Economy

Foreign retailers that wish to penetrate the Chinese consumer market must first understand China's complicated and changing economy, which accounted for one tenth¹ of the global economy's growth last year.

China's economy—the world's seventh²-largest—grew 9.5%³ in 2004 and grew 9.5%⁴ year-over-year in the first quarter of this year, according to the National Bureau of Statistics (NBS). Top Chinese academics from the Chinese Academy of Social Sciences (CASS) predict that the economy will slow but still



achieve an impressive 8.9%⁵ growth rate for the year, surpassing the 8.0%⁶ target set by the Chinese Central Government.

Calculations from the NBS suggest that retail sales accounted for 48%⁷ of the RMB3.1⁸ trillion (US\$379 billion) GDP in the first quarter of this year, up from 40%⁹ the year before. This rapid GDP growth has been attributed to increasing consumption levels and a trade surplus.

The Chinese economy, by far one of the strongest performers in an overall sluggish global economic environment, is showing no signs of slowdown. The Chinese Central Government is expected to continue to put measures in place to “cool the economy.” Measures such as reining in fixed asset investments, controlling interest rates and restricting real estate transactions will affect entry/expansion plans of foreign retailers in China.

Grasping China's Expanding Retail Sector

China's Ministry of Commerce anticipates that retail sales will be up 13%¹⁰ over last year to hit RMB5.2¹¹ trillion (US\$628 billion), and expects sales to climb more than 10%¹² this year.

All this takes place in a highly fragmented market as China's top six retailers account for only one-fifth¹³ of national consumption with the following provinces generating RMB929¹⁴ billion (US\$112.2 billion) of retail sales last year:

- Beijing (population 14.3 million)*
- Chongqing (population 31.1 million)*
- Guangzhou (population 9.9 million)*
- Shanghai (population 16.3 million)*
- Tianjin (population 10.1 million)*
- Wuhan (population 7.9 million)*

* National Bureau of Statistics, April 2005

| Top 30 Retail Companies in China for 2004 | | | |
|---|---|---|---------------|
| | | Consolidated Revenues (RMB Billions) | # of Stores |
| 1 | Bailian Group | 67.6 | 5,493 |
| 2 | Beijing Gome Electrical Home Appliance | 23.9 | 227 |
| 3 | Dalian Dashang Group | 23.1 | 120 |
| 4 | Suning Electrical Goods Chain Store Group | 22.1 | 193 |
| 5 | Carrefour (China) | 16.2 | 62 |
| 6 | Beijing Hualian Group | 16.0 | 70 |
| 7 | Suguo Supermarket | 13.9 | 1,345 |
| 8 | Nong Gong Shang Supermarkets | 13.7 | 1,232 |
| 9 | Beijing Wumart | 13.3 | 609 |
| 10 | Sanlian Commercial Company | 13.3 | 254 |
| 11 | Shanghai Yongle Electrical | 13.2 | 106 |
| 12 | Chongqing General Trading Group | 13.1 | 153 |
| 13 | Hao You Duo Guan Li Zhi | 12.0 | 88 |
| 14 | Parkson (China) Investment | 11.9 | 1,400 |
| 15 | China Resources Vanguard | 11.0 | 476 |
| 16 | Five Star Appliance | 9.4 | 120 |
| 17 | A.Best Supermarkets | 8.5 | 58 |
| 18 | Wuhan Wushang Group | 7.9 | 38 |
| 19 | Jiangsu Wenfeng Great World Chain Development Corp. | 7.6 | 506 |
| 20 | Wal-Mart (China) | 7.6 | 43 |
| 21 | Lotus Supermarkets | 7.4 | 41 |
| 22 | The Homeworld Group | 7.2 | 69 |
| 23 | Shanghai Jinjiang Metro | 6.4 | 23 |
| 24 | Ren Ren Le Chain Store | 6.2 | 32 |
| 25 | Wuhan Zhongbai Group | 6.1 | 330 |
| 26 | Beijing Wang Fu Jing Group | 5.9 | 15 |
| 27 | Beijing Jing Ke Long Supermarkets | 5.2 | 140 |
| 28 | Orient Home | 5.2 | 22 |
| 29 | Liquan Group | 5.1 | 512 |
| 30 | Wuhan Zhongnan Commercial Group | 4.6 | 24 |
| | Total | 384.6 | 13,801 |

Source: Press Release: “Steady Growth Seen in China's Retail Industry Forerunners for Full Year 2004.” Ministry of Commerce, 6 February 2005.

Shanghai, with the highest per capita consumer income, is the leading consumer market in China. This prosperous city is widely acknowledged as a good testing ground for retailing in China because its population accounts for nearly 5%¹⁵ of the nation's consumer sales. Fast growth in consumer spending, a steady influx of immigrants and the ability to attract economic development adds to Shanghai's allure.

China's consumer products market also has started to warm up. According to statistics from NBS, China's total retail sales of consumer goods increased 13.7%¹⁶ year over year for the first quarter of this year or three percentage points higher than the same period the previous year.

The growth of China's domestic consumption resulted from the Chinese government successfully shifting the growth mode of the economy from investment driven to consumption-led. This consumer driven demand and potential growth provides a range of opportunities for both current and would-be retailers in China.

Time will tell if Shanghai and Beijing remain the leading consumer markets in China. There are several "up and coming" provinces with growing economies and incomes. These provinces include Fujian, Guangxi, Henan, Hubei and Tianjin.

| Potential Markets (Based on 2003 Data) | | | | | | | | | | | |
|--|---------------|------------|--------------|-------------------------|-------------------------------|---------------------|---------------|-------------------------|---------------|----------------------|---|
| Province | Area (Sq. Km) | Pop. (Mil) | GDP (RMB Bn) | Per Capita Income (RMB) | Per Capita Retail Sales (RMB) | Food Sales (RMB Bn) | % Total Sales | Non-Food Sales (RMB Bn) | % Total Sales | Total Sales (RMB Bn) | Comments |
| Fujian | 136,000 | 35 | 593 | 13,628 | 4,565 | 83.4 | 53% | 75.38 | 47% | 158.78 | Opportunities exist across all income levels, depending on location within the province. Province itself produces a wide variety of food and non-food consumer goods, and is therefore well endowed in terms of the supply of products. |
| Guangxi | 236,660 | 49 | 229 | 9,174 | 2,142 | 63 | 60% | 42.66 | 40% | 105.66 | Emergent economy in southern China, offers new potential opportunities. Topography and poverty in many areas may be unappealing for new retailers, but province includes many tourism linked opportunities. |
| Henan | 167,000 | 103 | 597 | 8,598 | 1,914 | 108.38 | 55% | 89.54 | 45% | 197.92 | Largest population of any Chinese province, represents fresh yet undeveloped market for major retailers. Strong potential to become key market for retailers wanting to move inland. |
| Hubei | 185,900 | 65 | 505 | 9,237 | 3,897 | 124.76 | 50% | 124.81 | 50% | 249.57 | Already becoming a major economy in central China due to location. Economic growth, especially in Wuhan, is expected to bring about further competition in the coming years. |
| Tianjin | 11,300 | 10 | 251 | 16,280 | 11,771 | 39.58 | 33% | 79.99 | 67% | 119.57 | Retail market has grown rapidly over recent years. Offers new development potential due to fast growth, though such opportunities may not last for long, given the speed at which new businesses have been moving into this market. |

Source: "Retailing in China 2004: A Market Analysis", May 2004, Access Asia Limited, Pages 68-175 (Section Title: Regional Retail Markets).

A Collection of Markets, Not a Single Market

Many retail and consumer products companies recognize the potential of 1.3 billion consumers but underestimate the complexities of Chinese consumers. There are two distinctly different types of consumer markets in China:

- An increasing number of major cities with high demand for the latest in electronic gadgetry (digital cameras, laptop computers, etc.) and brand-name products such as Shiseido® cosmetics and Louis Vuitton® bags.
- Small towns and rural areas where people are still considering the purchase of their first washing machine or color television.

Official statistics show that the income of urban and rural Chinese enjoyed relatively rapid growth in the first quarter of 2005. During the January–March period of this year, the per capita disposable income of urban residents was RMB 2,938¹⁷ (US\$355), a year-over-year increase of 11.3%¹⁸; the per capita cash income of rural residents reached RMB 967¹⁹ (US\$117), an increase of 15.9%²⁰.

These growth rates underscore the ability of Chinese consumers to demand and consume more. Consumers moving up to higher grade and luxury products, coupled with the increase in farmers' incomes, should drive the domestic consumer market. Huge demand is expected for cars, home furnishings, luxury furniture and energy-efficient home electric appliances.

Strong Domestic Brand Loyalty

Branding is a critical aspect of retailing—for both domestic and foreign retailers—in the Chinese market. Chinese consumers are unusually brand conscious and brand loyal. Moreover, they exhibit a strong preference for domestic brands for the following reasons:

- **Trust** – Home grown brands such as cosmetics brand Yue Sai (羽西) and sports retailer Li Ning (李宁) strike a familiar and comfortable chord with consumers.
- **Cost** – Domestic brands tend to have lower price points due to simpler packaging and lower advertising costs, making them more affordable for local consumers.
- **Patriotism** – There is a small segment of consumers who are strongly nationalistic and loyal to home-grown Chinese

products. This became apparent during recent Sino-Japanese tensions when consumers made a conscious choice to purchase domestic brands over Japanese products.

Retailers should be prepared to spend effort, time and possibly large sums of money to establish their brands with Chinese consumers. Simply marketing “Made in China” products will not substantially help build brand value. The overarching challenge will be for companies to build a level of awareness among Chinese consumers that will establish their brand as “home grown,” while maintaining the cachet of technological innovation and quality attributed to foreign companies.

Awareness of China's Financial Restrictions

China still maintains a relatively strong control over its financial institutions, which may affect or limit retailers' operations.

Under current regulations, foreign firms may repatriate profits drawn from their foreign exchange (forex) accounts by converting domestically earned RMB at designated forex banks without seeking approval from regulators. Other regulations, however, put in place to regulate China's currency flow can add layers of complexity to managing cash flow. For example, foreign-invested enterprises are required to maintain three separate hard-currency accounts:

- a base account, for trade and other current-account transactions;
- a capital account, for injections and repatriation of capital;
- a loan account, for the receipt and repayment of hard-currency loans.

Bank loans are relatively accessible assuming there are no major impediments such as bad credit. Chinese banks often regard foreign companies, and especially those backed by a Fortune 500-type company, as high-quality clients and will extend loans either in RMB or foreign currencies.

However, lines of credit are often limited to an amount that ranges between the company's total investment and its registered capital balance and requires a guarantee from the company's headquarters. There are no restrictions on credit loans, but foreign currency loans may no longer be translated into RMB loans.

Identifying and Managing Risks

Risks abound in any business but perhaps more so in a complex retail environment such as China.

One of the macroeconomic risks that is often overlooked by businesses entering China is the rapid social evolution. China's many State-Owned Enterprises (SOEs), which historically provided substantial employment opportunities, were recently restructured, eliminating many jobs. Without this safety net, many previously employed people have begun seeking employment in the private sector.

Increasing income gaps between urban and rural populations also are straining the fabric of Chinese society. Populations of tier one cities such as Beijing and Shanghai have experienced significant growth in income compared with the modest growth of rural farming cities. This has caused a rural-urban migration trend that has prompted many cities to limit the number of resident passes issued to rural immigrants. Without the passes, immigrants are unable to legitimately seek employment, further aggravating the frustrations among the rural population.

Consider Local Partner Cooperation

Although foreign companies can “go it alone,” partnering with a local player may be advantageous—though such partnerships must be cautiously structured. Domestic partners understand the local economy and consumer market and have relationships within the industry. Local players also have experience dealing with complex government agencies—a critical success factor for retailing in China.

Significant rules and regulations often are issued as administrative notices rather than laws passed by legislatures. Moreover, these notices frequently are first distributed through various government agency channels before being published in the state-run media. This process can take many months or even years and the information that is published is often incomplete.

This lack of transparency is compounded by China's complex government structure, which spans numerous municipalities, cities and provinces. This often results in varying interpretation and enforcement of laws. Foreign firms are not always able to clearly understand the rules and regulations affecting them or be assured of consistent and equitable treatment by the agencies.

Recently, a large European retailer sold its entire operation in China to its rival, following a bitter dispute with its mainland joint-venture partner. The joint venture was established in 2002 with ambitious plans for expansion across China. When growth did not come quickly, both parties became impatient and made management decisions without joint consent. The mainland company decided to withdraw from the joint venture and grow the market on its own.

Conflicts such as these with local joint venture partners can be tricky to manage and painful to resolve. Although partnerships with domestic players can ease the transition for new market entrants, it also may complicate operations when goals and interests between partners begin to divert.

Conclusions

- China is a series of markets that vary widely by geographic location and population characteristics.
- There are two distinct markets in China; the wealthier consumers in the major cities demanding luxury goods, and those in small towns and rural markets with low incomes still focused on basic necessities.
- Chinese consumers are brand conscious and brand loyal. This is a challenge for companies entering the market as they must establish their brand as “home grown” while maintaining the cachet of technological innovation and quality.
- As China still maintains a relatively strong control over its financial institutions, there are limitations to foreign financing activities.
- China has a complex government structure, which spans numerous municipalities, cities and provinces. This often results in varying interpretation and enforcement of laws. Partnering with local firms more familiar with this environment can be beneficial.

Ernst & Young Can Help

Ernst & Young has operated in China since 1981. We have worked extensively with leaders in Chinese government and business and have played a role in assimilating Western companies and technologies into the Chinese economy. These

seasoned relationships enable us to expedite time consuming procedures and reduce uncertainty for our clients. Ernst & Young is a valuable knowledge resource for client decision makers as they:

- Assess the competitive landscape for retail and consumer product companies from both a national and regional perspective.
- Assess the opportunities and risks China represents for their business models.
- Deliberate on and establish the optimal business model in China.
- Select the best location in which to do business in China.
- Apply for new, or change existing, licenses and permits to commence operations.
- Conduct negotiations with Chinese governmental authorities.
- Conduct negotiations with joint venture or business alliance partner(s).

Auditing, Tax and Transaction Support—Ernst & Young can assist clients with auditing, tax and transaction issues as they:

- Contemplate wholly owned foreign enterprise (WOFE), joint ventures, or other ownership structures.
- Conduct financial and tax due diligence reviews of acquisition or joint venture targets.
- Determine a business-appropriate and tax-efficient organizational structure.
- Review the effects of China’s post-WTO changes to accounting, auditing, and tax regulations on foreign-owned businesses in China.
- Quantify and evaluate merits of various tax holidays, rebates, refunds, and other investment incentives offered by Chinese authorities as part of the site-selection process.
- Devise tax structures and transfer pricing plans.

Footnotes

¹ “Opening retail market up for grabs”, China Business Weekly, 13 January 2005.

² “China’s Opening and a Win-for-All World”, Address at the Fortune Global Forum, Bo Xilai, Minister of Commerce of China, May 18th, 2005

³ “China 2004 GDP growth unrevised at 9.5 pct – NBS”, Xinhua Financial Network, 28 February 2005.

⁴ “一季度国内生产总值达31355亿 同比增长 9.5%”, National Bureau of Statistics, 20 April 2005.

⁵ “China 2005 GDP expected to rise to 8.9 pct yr-on-yr – CASS”, Xinhua Financial Network, 25 April 2005.

⁶ “China sets targets for economic, social development in 2005”, Xinhua News Agency, 7 March 2005

⁷ “China attributes Q1 fast GDP growth to trade surplus, retail sales”, Xinhua Financial Network, 20 April 2005.

⁸ “Five problems perplex Chinese economy despite satisfying performance in Q1”, Xinhua’s China Economic Information Service, 20 April 2005.

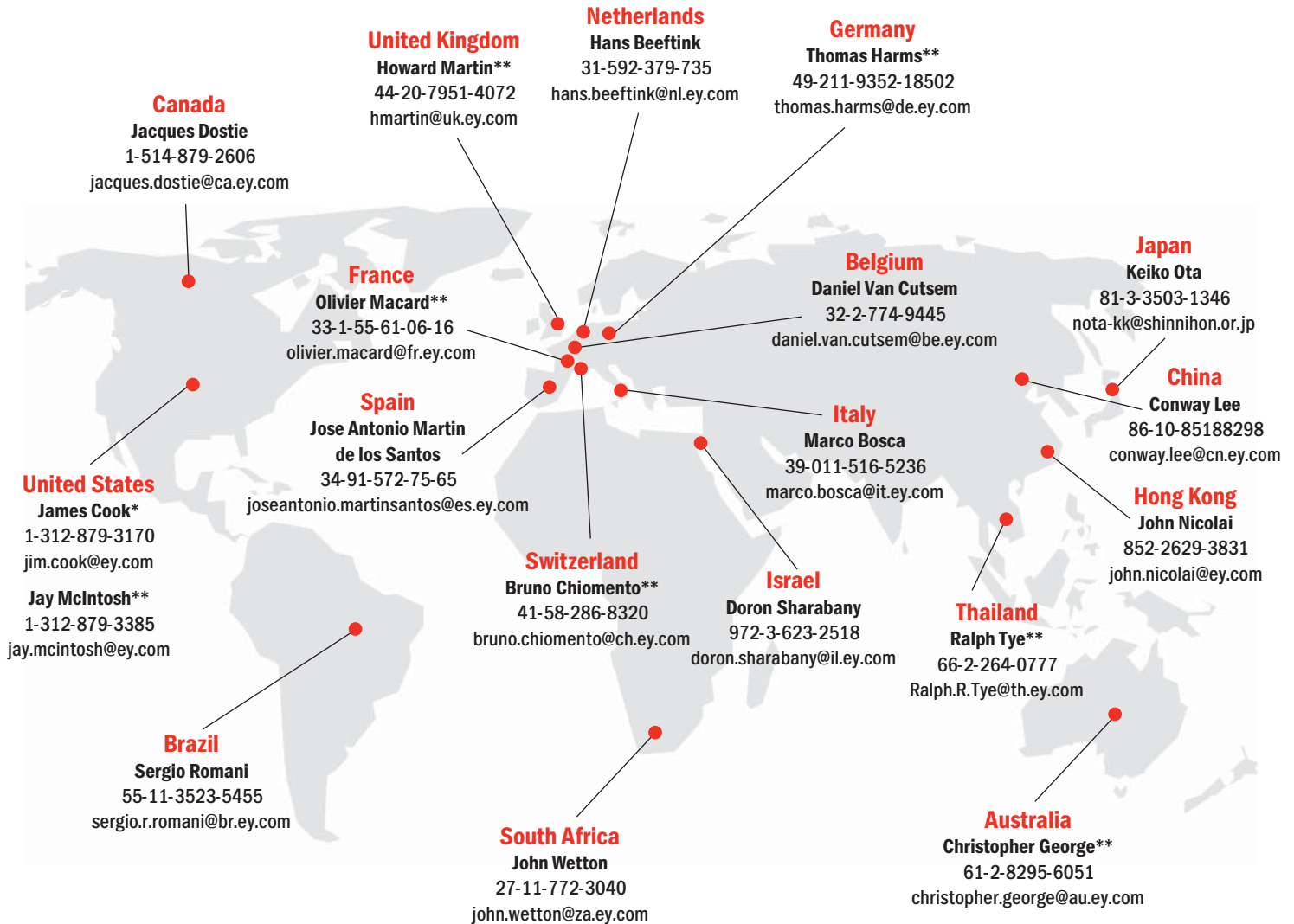
⁹ “China attributes Q1 fast GDP growth to trade surplus, retail sales”, Xinhua Financial Network, 20 April 2005.

^{10–12} “Opening retail market up for grabs”, China Business Weekly, 13 January 2005.

^{13–15} “China’s Top 6 Cities Take Up 17.5% of Total Consumption Market”, Asia Pulse, 18 February 2005.

^{16–20} “Analysis-China’s consumer market warms up”, Xinhua’s China Economic Information Service, 22 April 2005.

Global RCP Leadership



* Global Leader
 ** Area Leader

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