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Retail Food Sector

Report

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Report Highlights:
China's food retail sector continues to grow and develop as hypermarkets and convenience stores open across the country. Hypermarkets are now present in all major and most second-tier cities. The pace of development, however, varies widely from city to city.

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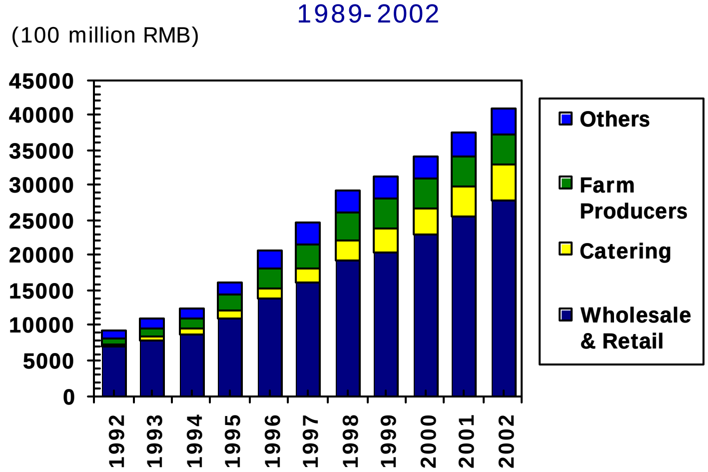
I. Market Summary

I.A Overview of the Retail Food Market in China

The transformation of China's food retail sector is continuing at a rapid pace, even as the sector as a whole grows. The pace of change varies widely, with the big three cities of Shanghai, Guangzhou and Beijing leading the way. The supermarket format is the most widespread, with chain stores commanding a presence even in small cities of the interior. In the larger cities, hypermarkets have become common, extending their reach beyond the wealthy coastal areas and into a number of large cities in the interior. Convenience store chains have extended their presence beyond Shanghai and Guangzhou, and are now gaining a foothold in Beijing and a number of second-tier cities in East and South China. Over the medium term, the focus of growth is likely to shift away from the top three cities and into second- and third-tier cities. Shanghai and Guangzhou are approaching saturation levels for both convenience stores and hypermarkets, and per-store profits are in decline. The pace of growth has been slower in Beijing, leaving more room for future expansion, particularly for convenience store chains. The SARS crisis proved to be a boon to both hypermarket and convenience store chains, which have a strong reputation for cleanliness and quality control. Although sales of seafood slumped, fruit and vegetable sales skyrocketed during the crisis.

CHINA: Retail Sales of Consumer-Oriented Goods 1989-2002

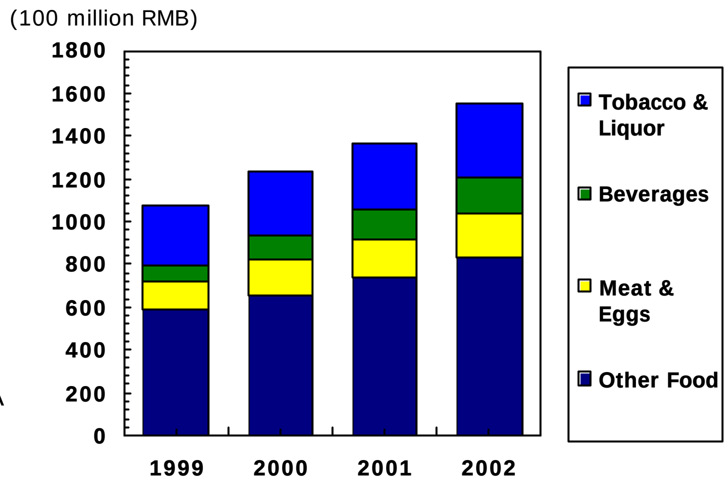


Source: China Statistical Yearbook, 2003, Table 16-1

Faced with intense competition, retailers are taking measures to control costs and increase revenues. Most now offer products such as ready-to-eat and heat-and-eat meals, while some are seeking to sell products with higher unit values—a positive development for high quality imported products. Another revenue-boosting measure has been for retailers to charge numerous different fees to suppliers in exchange for carrying their products, a tactic that has produced considerable friction with suppliers. This is also discouraging distributors from bringing in new products, as the cost of these fees places them under pressure to support only products that are guaranteed to succeed. Last Spring a group of dried nut packers launched a boycott of one major foreign-invested retailer in an effort to negotiate lower slotting fees for their products. The Chinese government has encouraged mergers among domestic chains, including one that joined together the nation's two largest food retail chains, Hualian and Lianhua. Other measures have included the development of private label products and increased vertical integration.

Supermarket chains remain the largest chain retail format, but are suffering from competition with hypermarkets and convenience stores. This sector is dominated almost exclusively by domestic chains, with Lianhua and Hualian by far the largest players, followed by Nonggongshang and Suguo. Only Lianhua and Hualian are true nationwide players, although Nonggongshang has expanded well beyond its base in East China. Both Lianhua and Hualian have continued to expand, both through opening new stores and through acquisitions. Although the two dominant chains were recently merged, both appear to be operating independently and continue to report revenues as separate entities. Competition is fierce and margins extremely thin. Most foreign retailers competing in this sector have been forced to either retrench and change to a different format or withdraw entirely. Management, purchasing, distribution systems, and layouts for supermarkets tend to be considerably less sophisticated than either hypermarket or convenience store chains. Penetration of imported products is extremely low, limited primarily to frozen vegetables and dried fruit and nuts. Most stores feature extensive frozen and refrigerated sections with a wide variety of products ranging from frozen dumplings to fresh dairy products. The quality of fresh vegetables and meat is variable, however, and many shoppers still prefer to buy these products at wet markets or from streetside vendors. Some supermarkets are attempting to boost traffic by offering more ready-to-cook products such as meat prepackaged with spices and cut vegetables.

CHINA: Sales by Size: Retailers (>5Million RMB) & Wholesalers (>20Million RMB), 1999 - 2002



Source: China Statistical Yearbook, 2003, Table 16-1

<u>Hypermarkets</u> are growing rapidly, particularly in second-tier cities. Foreign invested companies such as Carrefour and Metro pioneered the format in China, and these companies, along with Wal-Mart, Lotus and several others, remain among the strongest competitors in the market. These chains have established stores in cities as diverse as Kunming, Wuhan and Harbin. Foreign-invested hypermarkets are comparable to their overseas counterparts in terms of management and layout, with some adjustments for the Chinese market. A number of Chinese chains, most notably Lianhua and Nonggongshang, have responded to the competition by establishing hypermarkets of their own. In a number of smaller cities, local companies have also established hypermarkets, although these often operate as hybrid hypermarket/department stores. Imports are more common in hypermarkets than in any other retail format, particularly in the foreign invested chains. These chains are also more aggressive in pursuing promotions, though many levy exorbitant fees from suppliers in exchange for carrying new products or supporting promotions.

Faced with tougher competition, hypermarket chains are seeking various ways to reduce costs and increase revenues. Most now offer a variety of ready-to-eat or heat-and-eat products, as well as pre-packaged ready-to-cook meal sets. Many have also opened kiosks inside the store for independent contractors that offer various freshly made snacks. The most recent trend is for stores to stock house-brand items. This runs against the traditional preference of Chinese consumers for name-brand products as a guarantee of quality, instead relying on the reputation of the hypermarket chain to provide that guarantee, while it works with traditional consumer price sensitivity.

<u>Convenience store chains</u> continue to be dominated by Chinese companies, although U.S.-based 7- Eleven has announced plans to expand beyond its base in South China into the Beijing market. Nearly all of the Chinese-owned chains are affiliated with a larger food retail company: Quik is owned by Lianhua, Alldays is owned by Nonggongshang, Kedi is owned by Bright Dairy (which is owned by Nonggongshang), and Lawson's is a joint venture with Hualian. The pace of development for convenience stores is extremely uneven with Shanghai leading the way. Beijing, on the other hand, has only recently opened to convenience store chains, and the combination of local regulations and local consumer culture may prevent explosive, uncontrolled growth as seen in Shanghai. Stores connected to gas stations are gaining popularity, with the trend being most advanced in the Guangzhou area.

Convenience stores are the newest retail format: management, purchasing and distribution systems are very modern and heavily automated. Although the specific distribution systems vary, most chains use automated on-line systems to report sales and order products. Nearly all convenience stores include frozen and refrigerated food sections, along with microwave ovens and a variety of hot snacks. Apart from nuts and dried fruit, imported products are fairly rare. However, some chains are seeking to boost revenues by stocking more expensive items, and have expressed an interest in stocking more imports.

Nearly all convenience stores include refrigerator and freezer sections, as well as a variety of hot snacks, such as tea eggs and boiled dumplings. The emphasis in these stores is on impulse purchases of packaged foods and ready-to-eat items such as ice cream, dairy drinks and cigarettes. Where convenience stores are common, competition is extremely tough, driving down per-store profits. These chains are extremely sensitive to the demographics of the customer base, identifying them primarily as school kids and working parents. One director described his customers as ‘travellers,’ explaining that the ideal locations are at schools, bus stations, subways and other public facilities. Another strategy has been to collocate convenience stores with supermarkets owned by the same company. Rather than competing, the convenience store benefits from the foot traffic generated by the supermarket, then during off hours acts as a 24-hour window for the supermarket.

Traditional markets continue to be a presence throughout China, although many of the wet markets in big cities are being closed or consolidated. Local authorities in most cities view the wet markets as unsanitary, not to mention that tax revenues from these markets are small, relative to more well regulated markets. SARS accelerated the process by focusing more attention on sanitation and depressing demand for meat and seafood. In some areas, the authorities are attempting to move the markets indoors into a cleaner and better-regulated environment. Although some supermarkets are offering expanded produce sections, the quality, variety, freshness and pricing are often not up to consumers’ standards. It is not unusual to see street vendors selling vegetables outside of supermarkets, and in some cases the supermarkets actually seem to encourage them, as both benefit from the increased foot traffic.

Other traditional formats include the small variety store (called xiaomaibu) and fruit stands. Although challenged by convenience stores, xiaomaibus continue to dot every city in China, filling in the gaps left by supermarkets and convenience stores. Sourcing and supply are improvised, and these stores are highly unlikely to stock any imported products at all. Over the long term, this format is likely to decline as the extreme small scale makes them unprofitable, while expanding the size of the stores will put them into direct competition with convenience stores. Fruit stands are also common throughout China, appearing in a wide range of venues, including small open markets, kiosks and small storefront operations. Like the xiaomaibus, these are family-owned operations and extremely small in scale. These shops occasionally stock imported fruit, from Israeli tangerines to Washington State apples to Thai rambutans, but also include quite a large number of fakes and counterfeits.

I.B Major Food Retail Chains in China

Revenue, Lies and Statistics

Reliable statistics on the size of China's food retail sector are not publicly available. Although there are several sources for such numbers, all have serious shortcomings. None report income for foreign-invested joint ventures (JVs), instead listing them under the name of the Chinese JV partner, many of whom own food retail operations of their own. This can create considerable confusion in the case of JVs like Carrefour, which has different Chinese partners in different regions, including Lianhua. Thus it is difficult to determine how much of Lianhua's reported revenue derives from its JV with Carrefour. Metro, on the other hand, has a single, separately incorporated JV partner, making it easier to identify and track revenues.

The complex web of ownership in the domestic industry also adds to the confusion. For example, the Kedi convenience store chain is owned indirectly by Nonggongshang through it's Bright Dairy subsidiary, but is listed separately in most statistics. However, Nonggongshang's Alldays convenience store chain is not listed and it is unclear whether it is included in the total numbers for Nonggongshang. Likewise, Lianhua's Quik convenience store chain, the largest in China, is not listed separately, but is clearly not included in the number of stores reported for Lianhua (there are over 1,200 Quik outlets, and a total of only 1,883 stores reported for Lianhua, one of China's two largest supermarket chains). Whether the Quik revenues are also excluded from Lianhua's total revenues is unclear.

Keeping these shortcomings in mind, the following table provides some sense of the size of the retail food sector and the players involved. Data from several different sources is included.

Table 1. CHINA: Top Retail Chains in 2002

	Data Source					
	CCFA[1]		Business Information of Shanghai[2]		Purchasing Magazine[3]	
Retail Chain	Revenue (billion rmb)	Stores	Revenue (billion rmb)	Stores	Revenue (billion rmb)	Stores
Lianhua	18.33	1921	18.3	1921	18.0	1883
Hualian	15.07	1200	15.1	1200	12.5	1080
Dalian Dept. Store Grp.			12.8	51	10.0	51
Beijing Hualian	10.30	54	10.3	54	NA	NA
Nonggongshang	8.73	702	8.7	702	8.5	670
Huarun Wanjia	8.59	397	8.6	397	8.59	450
Suguo	7.02	940	7.0	940	7.02	940
Wuhan Wushang Group	NA	NA	5.9	20	NA	NA
Chongqing Shangshe	5.36	72	5.4	76	NA	NA
Jinjiang (Metro)	5.31	16	5.3	16	NA	NA
Beijing Wumei	5.07	355	NA	NA	NA	NA
Beijing Jingkelong	4.26	102	NA	NA	NA	NA
Shanghai Kedi[4]	1.1	706	NA	NA	NA	NA

1) CCFA statistics provide greater detail than other sources, but appear to be missing key players. CCFA may have separated the subsidiary companies, which would then have fallen further down in the list. 2) Business Information of Shanghai statistics are consistent with other sources, but conflict with other statistics in the same publication. 3) The Purchasing Magazine statistics are missing at least one major player and report consistently lower revenue and store numbers than other sources. They also suffer internal inconsistencies. 4) Kedi is included to show the impact of separating subsidiary companies. Nonggongshang indirectly owns it.

Because it excludes foreign JVs, the table above does not show the growing influence of foreign-invested retailers. These are listed in the following table, along with the number of stores and revenue estimates, where available. The difference between the 2002 number and the current (October, 2003) number gives an idea of the pace of growth. Note also that Metro has announced plans to add up to 10 stores per year over the next 10 years.

Table 2. CHINA: Major Foreign-Invested Hypermarket Companies

Retailer	Ownership	Number of Outlets 2002/current	Annual Sales (billion rmb)
Carrefour	Sino-French	32/41	12.9[1]
Wal-Mart	Sino-U.S.	25/31	NA[2]
Metro	Sino-German	16/18	5.3[3]
PriceMart	Sino-U.S.	26/NA	NA
Lotus	Sino-Thai	5/NA	NA
Trustmart	Sino-Taiwan	40/76	NA
RT Mart	Sino-Taiwan	14/NA	NA
1) ATO/Shanghai estimate; 3) CCFA statistics			

I.C Advantages and Challenges for U.S. Exporters in China

Table 3. CHINA: Strengths and Challenges for U.S. products in Retail Food Market

Advantages	Challenges
Chinese consumers generally regard U.S. products as being of high quality.	U.S. products are routinely counterfeited.
Chinese consumers spend over 1/3 of their income on food.	Consumers are extremely price sensitive, and are often unwilling to risk spending on products they are unfamiliar with.
U.S. brands are widely known and respected in China's urban markets.	Many U.S. companies have established plants in China, manufacturing their products using Chinese ingredients.
Incomes are growing rapidly in second-tier cities, creating a whole new range of opportunities.	Distribution and logistics remain underdeveloped, making distribution of imported products to interior cities extremely difficult.
Food is a central part of Chinese culture, and consumers enjoy trying new tastes.	Lack of knowledge about U.S. products and how to prepare them makes consumers more hesitant to buy.
China's entry into the WTO has reduced tariffs on many imported products.	Labeling and sanitary restrictions act as non-tariff barriers. Enforcement of these rules is haphazard, creating additional uncertainty.
The Agricultural Cooperation Agreement opened the Chinese ma rket to many U.S. products that were previously banned.	U.S. exporters that have relied on gray market channels in the past lack direct contact with Chinese buyers.
Rapid growth in retail food chains has created more opportunities for bulk purchasing.	Purchasing by most retail chains remains decentralized. Few purchase imports directly, so exporters must establish a relationship with a distributor.

I.D Regional Market Profiles

Guangzhou Region – Guangdong province, of which Guangzhou is the capital, is one of the wealthiest and most developed markets in China. It is also regarded as one of the centers of China's food culture, with an emphasis on the exotic. The influence of Hong Kong is also very strong in this region, with distributors more likely to rely on Hong Kong-based companies to transship products than in other parts of China.

Guangzhou has seen the establishment of a large number of **hypermarkets** in recent years, and competition has become fierce. Chinese retailers in this area appear to be slowing down their pace of expansion, and are now focusing on increased profitability for their existing stores. CRC Vanguard (Huarun Wanjian), one of the largest retailers in the region, recently announced that it will temporarily stop purchasing and merger activities to focus on profitability. Minrun, which recently purchased Daoneijia, has also announced that it will slow down its pace of expansion. Among the foreign-invested hypermarket chains, Hong Kong's Park n' Shop, Taiwan's Trust-Mart and the U.S.' Wal-Mart are currently the largest.

Despite tough competition, foreign-invested retailers have plans to expand in this area. Metro recently announced plans to open a new store in Dongguan, and 7-8 more stores in the Guangzhou area over the next 5 years. Nearby cities such as Dongguan offer fertile fields for future expansion, as do key emerging cities in neighboring Fujian province, such as Xiamen. Changsha in neighboring Hunan province is already home to Metro and Carrefour stores, as well as a major domestic hypermarket company, Hunan Apollo.

Table 4. CHINA: Hypermarkets in Guangzhou

Retailer	Ownership (Base)	Total Sales (RMB)	Number of stores (Dec 2002)	Relative sales efficiency per outlet (RMB)
CRC Vanguard	China (Shenzhen)	42.1 billion	450	9.35 million
Xin Yi Jia	China (Shenzhen)	15.6 billion	26	60 million
Park'n Shop	Hong Kong	897 million	8	112.1 million
Trust-Mart	Taiwan (Guangzhou)	827 million	11	75.2 million
Wal-Mart	U.S. (Shenzhen)	655 million	25 (nationwide)	26.2 million
Makro	Netherlands (Guangzhou)	362 million	3	120.7 million
Jusco	Japan (Guangzhou)	179 million	5	35.8 million
Homecity	China (Guangzhou)	109 million	25	4.54 million
Carrefour	France (Shanghai)	N/A	33 (nationwide)	N/A
Minrun/ Daoneijia	China (Shenzhen)	10.1 billion	21	48.1 million

Source: ATO/Guangzhou and Purchasing Magazine No. 6, 2003
All listed supermarkets and hypermarkets rely on agents and distributors.

The **convenience store** format is also well developed in the Guangzhou area, though not at the level of Shanghai, leaving room for future growth. Foreign-invested chains are common here, and actually hold a dominant market share. The key foreign-invested chains are 7-Eleven (operated through a Taiwanese joint venture) and BP Service Station Convenience Stores. As the last indicates, the service-station format for convenience stores is much better developed than in Shanghai, where it is just now getting started. Domestic convenience giants Quik and Kedi are only now establishing a foothold in the area, but are likely to expand quickly. Kedi has established a regional logistics center, and Quik has included a number of mini-marts in Guangzhou as part of its deal with Sinopec to open stores at Sinopec gas stations.

The convenience store industry in this region appears to be expanding quickly into niche-oriented stores. Apart from the gas-station stores, 7-Eleven has signed deals to open stores in the subway systems in Guangzhou and Shenzhen. The expansion into these niche markets involves some differentiation, as the customer base is quite different. Gas station stores cater primarily to truck drivers, who typically purchase soft drinks and packaged products, while more typical convenience store customers tend to purchase ready-to-eat foods, snacks and newspapers. Subway stores are expected to offer a narrow range of products including ready-to-eat breakfast foods, batteries and newspapers.

Table 5. CHINA: Company Profiles: Convenience Stores in Guangzhou

Retailer	Ownership	No. of Outlets
7-Eleven	President/Tianwan (franchise holder)	126, another 25 stores in subway stations
Kedi	Dairy Farm/Hong Kong	13
Quik	Lianhua/Chinese	65
BP Service Station Convenience Stores	BP/PetrolChina	140+ (30+ in and near Guangzhou, others are on major expressways)
OK	Ya Li Group/Hong Kong	4
Sources: ATO Guangzhou Field Research		

Shanghai Region – Shanghai and nearby parts of Zhejiang and Jiangsu provinces form one of the most vibrant centers of commerce in China. Shanghai has made massive investments in import and distribution infrastructure, with the expressed goal of becoming China's biggest port and the gateway to the entire Yangtze River basin. The area is also home to a number of relatively unknown but massive cities. Imports generally enter directly through the port of Shanghai. Transshipment through Hong Kong, once commonplace, is fast becoming a rarity.

The **hypermarket** and supermarket sector is similarly well developed compared to Guangzhou, although the players are different. In general, foreign-invested hypermarkets are receptive to promotions and have well-established procedures, while domestically owned hypermarkets are traditionally less interested in them. Although many chains have centralized purchasing for some products, a large number of items continue to be sourced by individual stores or small groups of stores. The scale of stores in the city of Shanghai tends to be small. Hence what are commonly called supermarkets are often little larger than grocery stores, while many hypermarkets are actually somewhere between a supermarket and a hypermarket in size. Competition is fierce, and retailers are seeking innovative ways to attract customers, including promotions and by offering more and more ready-to-eat, heat-and-eat and similar 'meal solutions,' as well as snacks.

Unsurprisingly, the Shanghai-based supermarket and hypermarket giants Lianhua, Hualian and Nonggongshang dominate the supermarket scene, and are significant players among the hypermarkets. However, foreign-owned hypermarkets have a substantial share of the business (keep in mind that Lianhua's revenues include those earned from its joint venture with Carrefour). Among foreign-invested retailers, Carrefour is the most successful in this area, although Metro, Trust-Mart, Lotus, Auchon and other are present. Wal-Mart is still absent from Shanghai proper, but is rumored to have plans to open as many as five stores in 2005, after China opens the retail business to wholly foreign-owned enterprises. Wal-Mart has also recently made forays into other cities in the region, most recently including Nanchang, the capital of the interior province of Jiangxi. Carrefour has recently opened Dia discount stores in Shanghai. These small stores offer a limited range of house-brand products at deep discounts. In 2003, food and agriculture powerhouse New Hope Group, China's largest private company, announced plans to open a series of NextMart hypermarkets in malls owned by its Nextmall Group.

Despite these plans, future development in the Shanghai area is likely to focus the numerous large cities nearby. Suzhou, Hangzhou and Wuxi are cities of well over 1 million people with incomes well above the national average, within 2 hours drive of Shanghai. Further afield, a number of other cities have attracted substantial investment from foreign retailers. Kunming in particular (in Yunnan province) has become a hotbed of activity and is now home to three Wal-Mart, two Carrefour, two PriceSmart, two Trust-Mart and one Parkson hypermarket. Other inland cities in the region have attracted foreign-invested hypermarkets, including Nanjing, Wuhan, Ningbo, Mianyang, Chengdu, Chongqing, and Nantong. Even the city of Nanchang in Jiangxi province is home to both Wal-Mart and Nonggongshang hypermarkets.

Table 6. CHINA: Major Supermarket and Hypermarkets in Shanghai

Company Name	Ownership	Business Line	Stores in Shanghai	Revenue (billion rmb) (nationwide)
Lianhua	China	supermarket, hypermarket	NA	18.3
Hualian	China	supermarket, hypermarket	NA	15.1
Nonggongshang	China	supermarket, hypermarket	NA	8.7
Carrefour*	France JV	Hypermarket	5	NA
Metro	German JV	Hypermarket	2	5.3
Lotus	Thai JV	Supermarket, hypermarket	2	2.4
Hualian (Jiemaisheng)	China	Hypermarket	NA	2.2
Jiadeli	China	Supermarket	NA	1.2
Jieqiang	China	Supermarket	NA	.88
Auchon	France JV	Hypermarket	4	.82
Hymall (Qibao)	China	Hypermarket	NA	.50
Hymall (Kangren)	China	Hypermarket	NA	.40

Source: Business Information of Shanghai; ATO/Shanghai research
Note: Store numbers for supermarkets chains were unavailable, and numbers for most supermarket/hypermarket chains combine both types of stores, making them less useful.

With roughly half of all the **convenience stores** in China, Shanghai is oversaturated. Key locations (near schools, subways and bus or train stations) often see three or four stores from competing chains on the same block. This competition has driven per-store profits down, and the chains are aggressively seeking ways to bring profits back up. In Shanghai, this sector is overwhelmingly dominated by domestically owned companies, with the relatively small chains Lawson's and C-Store being the only foreign-invested chains. Most chains have deep-pockets owners. Supermarket chains, particularly Lianhua, have realized that convenience store operations complement rather than compete with supermarkets, and often pair the two together, with the convenience store acting as a 24-hour window for the supermarket at night.

In Shanghai, convenience stores act as service centers, providing services to pay utility bills, purchase phone cards, etc. The stores claim to make little or no money from these services, nor from sales of cigarettes and dairy products, but are compelled to offer them as a means of generating foot traffic. The top profit-making items in this market are beverages and household items. To increase profits, stores are offering a wider range of ready-to-eat products. As elsewhere, penetration of imported products is minimal, limited primarily to nuts and dried fruit, although some chains have recently featured U.S. fruit nectars and potato products. Several chains have expressed a growing interest in carrying more imported products as a means of increasing sales values.

Tough competition and falling profit margins have led many observers to expect a wave of mergers and acquisitions, but this has yet to materialize. If anything, some chains are expanding by moving into niche venues. Hualian's joint venture, Lawson's, has announced plans to open stores in shopping malls, while Lianhua's chain of Quik stores announced a deal with a subsidiary of the Sinopec petroleum group to open stores in gas stations. Two large chains, 21 Convenience and Liangyou, saw changes in management, but will both continue to operate independently. Quik, Kedi and C-Store have sought greener pastures in nearby cities such as Suzhou and Wuxi. Despite the ferocious competition, rumors continue to swirl that 7-11 will enter the market. Some industry observers attribute the continued expansion of smaller local chains to this rumor, as the owners are hopeful that a foreign chain will buy them out as a means of establishing an instant presence in Shanghai.

Table 7. CHINA: Major Convenience Stores in Shanghai Area

Retailer	Ownership	Annual sales million rmb (latest or estimated)	Number of outlets/cities	Principal locations
Lianhua/Quik*	China	18,300	1,200/50+	Coastal China
Kedi	China	1,094	700+/9+	East, South China
NGS/Alldays*	China	8,700	800+/1	Shanghai
Liangyou	China	890	470/1	Shanghai
21 Century	China	160	516/NA	Shanghai
Lawson/Hualian	Japan JV	185	78/1	Shanghai
Mei	China	234	270/1	Shanghai
C-Store	Taiwan JV	NA	NA/2	Shanghai, Jiangsu
Source: ATO/Shanghai research				

Beijing Region – Although Beijing is an extremely wealthy and well-developed city, retail development lags slightly behind Shanghai and Guangzhou. There are various explanations for this, but many sources cite Beijing's generally conservative regulatory climate. While this has slowed the pace of development for retail, it has also left Beijing with more room for future development than the other two leading cities. Imports do reasonably well in Beijing, but distributors complain of difficulties shipping through the nearest port, Tianjin. Officials at this port have a reputation for aggressive pursuit of taxes and fees, and stringent interpretation of China's loosely worded import, quarantine and labeling regulations. As a result, some distributors prefer to bypass Tianjin and bring products in through Dalian, Qinghuangdao, Shanghai, and even Guangzhou.

Unlike Guangzhou and Shanghai, Beijing does not have a brace of large satellite cities nearby. Whereas Guangdong province (where Guangzhou is located) and Zhejiang and Jiangsu provinces (near Shanghai) are both hotbeds of commercial development with dozens of wealthy and growing satellite cities, neighboring Hubei province remains primarily an agricultural region. The exception is the port of Tianjin, which is a major city in its own right and has household incomes well above the urban average. Further afield, this region offers a number of massive and dynamic cities that are already attracting the interest of foreign-invested hypermarket chains. Harbin (Heilongjiang), Dalian (Liaoning) and Qingdao (Shandong) are all thriving cities that have attracted the attention of retailers like Carrefour, Wal-Mart and Metro. Shandong province deserves special mention: in addition to the coastal resort city of Qingdao, the provincial capital of Jinan shows great potential. The southern part of the province is also dotted with often overlooked and thriving commercial centers.

Hypermarkets are a major presence in Beijing. Foreign-invested hypermarkets include Carrefour, Metro and Wal-Mart, while a number of Chinese companies including Hualian, Nonggongshang and Wu-Mart also have operations in the city. The supermarket sector is also well developed, and the city is home to several major chains such as Jingkelong (ranked 12^{th} among national chains by CCFA). The Beijing government has been aggressive in relocating, merging and shutting down wet markets, which has helped to drive customers toward the fast-growing supermarket and hypermarket sector.

Development has been slowest for **convenience stores**. Industry observers attribute this to the conservative regulatory climate, which has likely been fueled by a desire to avoid the uncontrolled growth seen in Shanghai (not to mention protecting Beijing's hordes of family-owned variety stores). This suspicion is borne out by the slow pace in approving permits for convenience store chains to operate in Beijing. Several permits have been granted over the past year or so, most notably to Lianhua's Quik chain, and a number of Quik stores have appeared in the city.

II. Road Map for Market Entry

Ground Rules

China is not a single amorphous market, but a myriad of small markets separated by geography, culture, cuisine, demographics and local dialects. As such, there is no single formula for entry into this market: the best approach to marketing a product will vary depending on the product and the specific market being targeted. Nonetheless, there are some basic guidelines that apply in all cases.

☞ **Get to know the market**

China is very different from other places. Tastes, customs, culture, business rules and government regulation are all different. Visiting China gives exporters the opportunity to assess the market and establish relationships. Experience in other markets will not necessarily help you in China. Chinese buyers are often unfamiliar with U.S. product sources, quality standards and contract practices, while many U.S. exporters are not familiar with China's sales practices, distribution channels and customer preferences. Visiting China gives exporters the opportunity to assess the market and establish relationships.

☞ **Invest (wisely) in market research**

From the perspective of an outsider, Chinese tastes can seem fickle. Tastes poorly received in the U.S. may be successful in China, while products targeted to one market niche may find their best sales in an entirely different one. To avoid unpleasant surprises (and take advantage of the pleasant ones), exporters with a long-term interest in China are advised to research the market and ultimately to test their products directly. Due to the absence of reliable government data and restrictions on public polling, the quality of research by most international market research firms is only marginally better than that of much lower-priced local counterparts.

☞ **Find a local partner and/or distributor**

An exporter's success in China often hinges on his local partner, distributor or representative. Business in China is based on relationships and regular contact with buyers, distributors, consumers and government officials is crucial to success. For larger companies and companies with a long-term commitment to China, establishing a representative office or a joint venture partnership may be worthwhile. Others, however, are likely to rely on a local importer/distributor to handle marketing and regulatory issues, making the choice of a good partner absolutely critical. Hastily made partnerships are perhaps the most common cause of business failure in China.

☞ **Find your market segment or niche and focus on it**

China is an impossibly big place. A common mistake is for exporters to spread themselves too thin by trying to cater to the entire market spectrum. Exporters with limited resources are well advised to identify the best market niche for their product (e.g., wealthy gourmands, new mothers, middle-class teens, etc.), and serve it faithfully and consistently until they are sure of their success.

☞ **Adapt your product to the Chinese market**

Exporters should be prepared to adapt their products to the demands of their Chinese customers. This includes flavors, packaging, prices and labeling. Small changes to flavors or packaging, based on market research, may make the product more viable in China. For example, Chinese consumers are often unwilling to buy products they can't see, so including a transparent window in the box can help sales. Labeling is another major issue, as China has detailed regulations on food labeling.

☞ **Pursue gradual but sustainable growth**

Another common pitfall is the temptation to pursue explosive growth (especially in geographic distribution and store penetration) in the first year or two, either to amass market share or impress investors. This may produce good results if long-term demand for the product exists, but more often than not exporters end up surfing the edge of a fad only to find themselves overextended and unable to focus on the requirements of local markets. In such cases, a sudden weakening in demand or the appearance of competition can prove fatal. The go-slow approach gives exporters time to accumulate customer feedback and fine-tune their products, marketing campaigns and distribution.

☞ **Invest in market promotion**

Once in the market, an exporter's product will be competing with tens, if not hundreds, of similar products. Domestically made products will have advantages on price, familiarity and brand recognition, while imports can be aided by aggressive promotion campaigns. Lacking the massive marketing budgets of multinationals like Nestle or Kraft, most exporters must design and implement their marketing campaigns carefully. Attending only quality trade shows and trade shows focused on your particular market segment is a good way to start. In-store promotions are also a cost-effective way to support your product while building your relationship with distributors and retailers. Above-the-line media advertising should be carefully planned, as TV and radio time is expensive and has limited reach. Exporters are advised to explore joint marketing opportunities with local Agricultural Trade Offices or with a State and Regional Trade Group (such as NASDA, WUSATA, MIATCO, SUSTA or EUSAFEC).

Market Structure

Distribution and logistics channels vary significantly within China and across all sectors, but have certain features in common.

- China is still subject to import licensing requirements and currency exchange restrictions. All imported products must, at least nominally, pass through the hands of a licensed importer. Few distributors or traders hold import licenses and very few licensed importers act as distributors, so the licensed importer is little more than a legal convention, adding paperwork (and fees) to the process. Import licensing requirements are being loosened, and are scheduled to end in 2005. Licensed importers typically also handle the formalities of currency exchange, which also requires special rights. Even if payment is made on delivery, the entire process can take several weeks from the time the goods arrive to the time that the foreign exchange transaction is completed.

- The most important task for an exporter is to identify a distributor they can work with. This company must be able to handle all the import formalities (including finding a licensed importer, customs clearance, logistics, quarantine and inspection), and have a network of retail customers. Finding a good distributor is critical to success.

- Indirect sales through Hong Kong still take place, but are declining in importance. In this case, exporters sell to an agent in Hong Kong, who then resells the product into China, in many ways taking on the same role that the distributor plays in direct transactions. Exporters lacking the time or resources to become directly involved in China often take this route, as business practices in Hong Kong are more familiar and language barriers less of a problem. In doing so, however, exporters lose contact with their ultimate customers and lose control over their products.

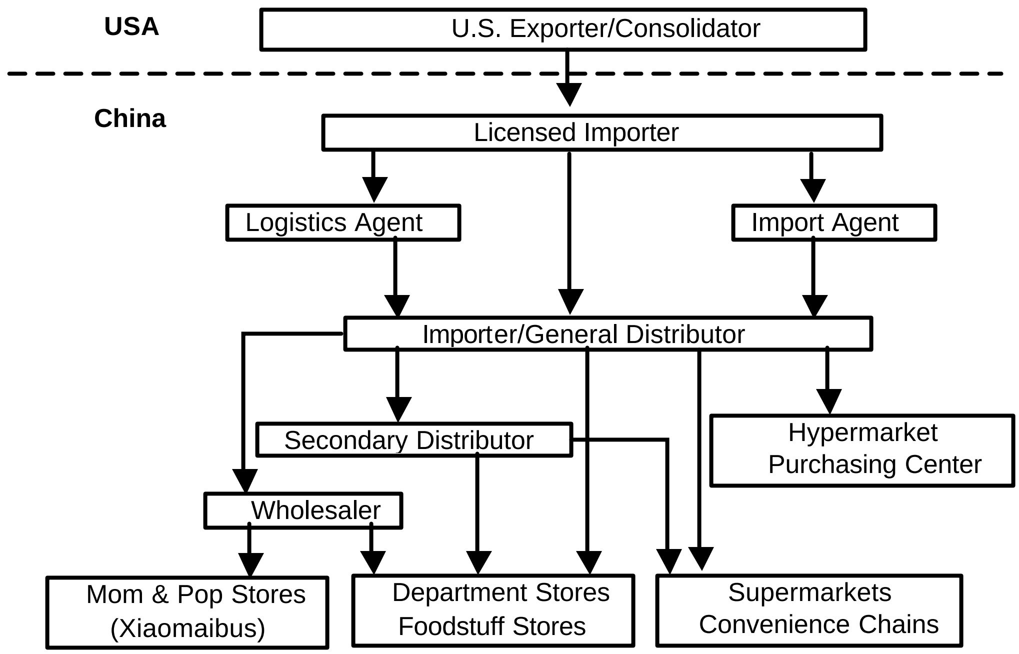
- Gray market channels, an extralegal version of indirect sales, also persist, though their importance has declined in recent years. Once necessary to move banned products into the mainland, these channels are notoriously opaque and increasingly subject to crackdowns. Declining tariffs and increased openness in the mainland market are likely to result in further decline of this channel.

- Once a product clears customs, it is usually stored in a warehouse rented by the distributor, with the storage costs borne by the exporter. As a result, most shipments arrive as consolidated containerloads ordered by one or more retailers. Most major ports in China include free trade zones with bonded warehousing.

- To enter the retail market, food products must meet a number of licensing requirements. All foods must receive a hygiene certificate from the local government where the store they are listing in is located. Food products also must be labeled in accordance with the latest labeling regulations. Functional or health foods must obtain a health-food certificate, and foods containing GMO ingredients may be subject to additional labeling requirements. Many of these regulations are vaguely worded, and enforcement tends to be arbitrary and opaque.

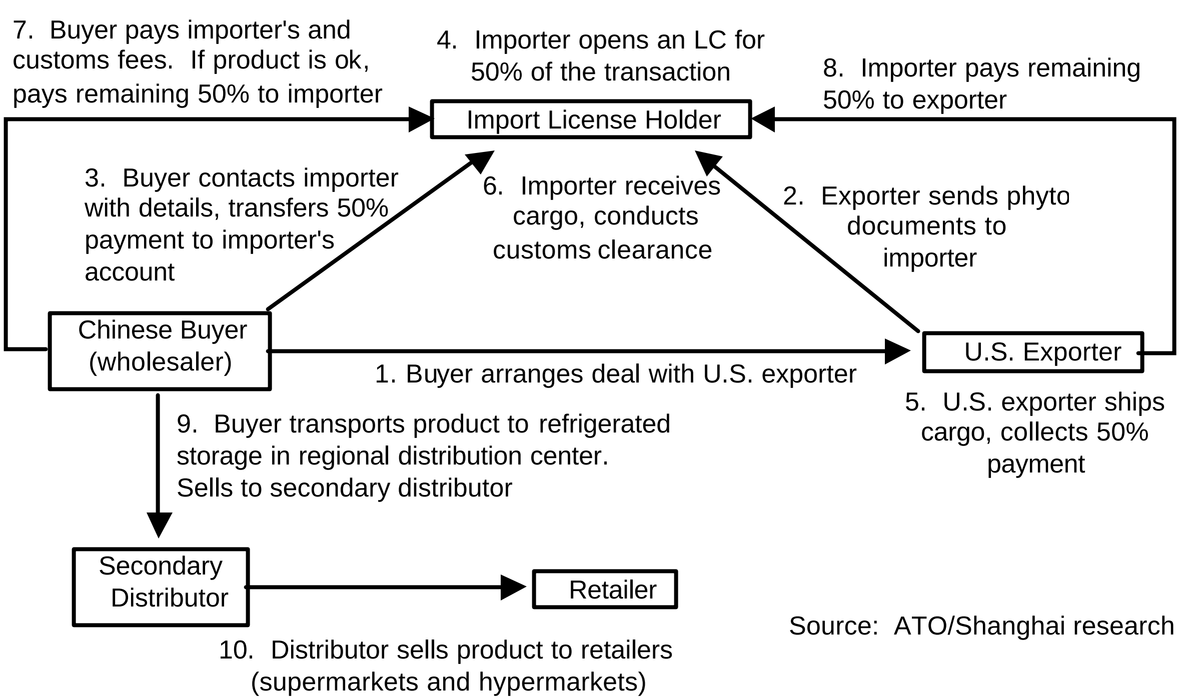
- In recent years a number of service-oriented logistics companies with foreign participation and/or management, have been established in port areas and near free-trade zones. These companies offer a one-stop solution for companies interested in exporting to or importing from China, including customs clearance; shipment, handling and storage; bonded warehousing and foreign exchange clearance for imports. They are also able to dispatch products on demand and maintain transparent, international-standard accounting for their customers. The following chart provides a simplified overview of the flow of goods from a U.S. supplier to a Chinese retail outlet.

Chart 1. CHINA: Imported Goods Marketing Chain



Source: ATO/Shanghai research

Import licensing and currency exchange restrictions complicate transactions more than are apparent from the above chart. The following chart follows the sequence of transactions involved in exporting celery from the U.S. to China.



Source: ATO/Shanghai research

Exporters working with a good distributor can avoid getting involved in these details. Nonetheless, knowing how the transaction works is important. Note that this is not a model for all transactions: details differ for different products and buyers. For example, payment of 50% on shipment is not typical of sales to retailers: most retail buyers do not pay until after they receive the shipment, and many will insist on 90-180 days credit. Also, first shipments of new products will require additional paperwork for approving the labels, etc. Nonetheless, it provides an idea of how the process works.

II.A Hypermarkets, Supermarkets and Warehouse Outlets

Hypermarkets and warehouse outlets provide the best opportunity for U.S. exporters. Dominated by chain stores, this sector has more centralized purchasing and higher volumes than most others, and foreign companies that are more familiar with and receptive to imported products often manage hypermarkets. Leading hypermarket chains such as Carrefour and Wal-Mart owe part of their success to the fact that they have managed to bypass China's inefficient wholesale system and are ordering some products directly from suppliers and manufacturers. Although these buyers still often rely on domestic distributors for logistics and import formalities, the distributor is much less involved in marketing the products. Supermarket chains are more difficult to work with, as management is often poor and purchasing and distribution systems are not usually centralized. Nonetheless, their sheer size and nationwide reach makes them tempting targets.

Exporters interested in this market segment are advised to familiarize themselves with their prospective buyers, as purchasing practices vary between different chains. Since most of these chains rely on distributors to some extent, it is also useful to become familiar with them. In some cases, the more aggressive distributors will act to market a new product to retailers. Support from the distributor can make a tremendous difference, as hypermarket chains frequently charge exorbitant slotting fees for new products. Since the supplier (i.e., the distributor) usually pays these fees, many distributors are hesitant to carry new products unless test marketing has shown good potential. On the positive side, both hypermarkets and distributors are generally very open to the sort of promotions that can prove the potential for new products. Be warned, however, that hypermarket chains may add strings to such promotions, such as a guarantee that the supplier will take back any product that has not sold by the end of the promotion.

II.B Convenience Stores

The convenience store industry is still relatively new to China. Unlike hypermarkets and supermarkets, which appear across the country, convenience chains are still geographically concentrated, with most located in East China, a significant number in South China and relatively few in North and Northeast China. Penetration by imports is limited primarily to dried fruit and nuts: chains tend to be conservative in product choice, and like to stick to well-known brand names. Purchasing is centralized, providing a single point of contact for companies wishing to introduce their products. Most chains rely on distributors for food products other than dairy, so suppliers hoping to crack this market must also establish a relationship with the distributor. Promotions are common in these chains, but are typically restricted to lucky-draw or two-for-one type deals and POP displays.

Brutal competition in some areas is causing chains to re-evaluate their strategies. Many have expressed a growing interest in increasing per-sales values by stocking more expensive products, including imports. At least one chain has already conducted a limited promotion of ready-to-eat U.S. potato products in Shanghai. Other strategies to raise profits include stocking more box lunches and focusing on niche markets, such as gas stations, subways and shopping malls.

There are several additional facts that exporters should keep in mind in targeting these chains. They are very sensitive to customer demographics: they will be more receptive to promotions and products that target school kids and working parents. Products will have to be adapted to suit impulse buyers: single-serving portions will do best. Customers at these stores are brand conscious, but also price sensitive. Key price points are 1 and 10 RMB/unit. At least one importer has found success by repacking U.S. products in very small, single-serving packages that are sold to school kids for 1 rmb apeice. Chains are also very sensitive to their own standards and store layouts: promotions will have to be closely coordinated with management.

II.C Traditional Markets, Wet Markets and "Mom and Pop" (Xiaomaibu) Stores

Wet markets are on the decline in China, but continue to dominate smaller cities, and remain a presence even in the largest cities. These outlets are unlikely to disappear entirely, as they remain the preferred venue for low-cost fresh vegetables and meat. Freshness and price are the chief concerns for Chinese consumers, to the extent that they often prefer to buy poultry and fish live, to be butchered on the spot. Supermarket chains tend to fall short in pricing, freshness and variety for meat and vegetables, while Hypermarkets are generally located too far away for daily shopping. Local governments, in an effort to improve both sanitation and tax revenues, are closing and consolidating the wet markets. Many governments are attempting to transform at least some of the wet markets into supermarket–style venues where multiple vendors can operate in a cleaner environment. SARS dealt a serious blow to wet markets, as sanitary concerns became a major concern. Wet markets are also the primary venue for sales of exotic meats, which were widely blamed for the SARS outbreak.

Likewise, the traditional variety store, the xiaomaibu, continues to persist even in convenience store-saturated Shanghai. Considerably smaller than even convenience stores, these family-owned shops offer an eclectic mix of drinks, snacks, household items, hardware, bicycle parts and whatever else the owner thinks to stock. Since convenience stores are heavily concentrated in the high traffic areas near subways, schools, bus stations and rail stations, xiaomaibus tend to fill in the spaces in between, often serving as the corner store for a particular apartment block or office building. The fact that these shops have complete flexibility in what they stock also allows them to serve extremely localized (even unique) market niches.

In all cases, management and distribution of product in these traditional venues is heavily improvised. Although imported products (particularly fruit) do, occasionally make their way in, by the time they reach the retail level, their identity as imports is lost. Counterfeiting is also routine, and strange and unusual products like Sunkist apples are not uncommon. These markets are driven almost exclusively by price. As a result, these venues are an extremely poor prospect for promotions.

III. Competition

The most serious competition for U.S. food exporters is local or joint venture producers and processors. While supermarkets are often stocked famous foreign brands such as Bugles, Coca-Cola, and M&Ms, close inspection reveals that most of these products are actually manufactured in China. The quality and variety of domestically produced foods has improved quickly, and many are now able to compete with imports with the added advantage of being specifically formulated to suit the local market. Domestically manufactured products have completely cornered the market in several categories, including beer, soft drinks, processed meat and low-end confections. Competition is also growing in other areas, such as wine and fresh fruit. Chinese products have traditionally competed on price alone, but improvements in quality and efforts to develop identifiable brands have made these products increasingly competitive in these areas as well.

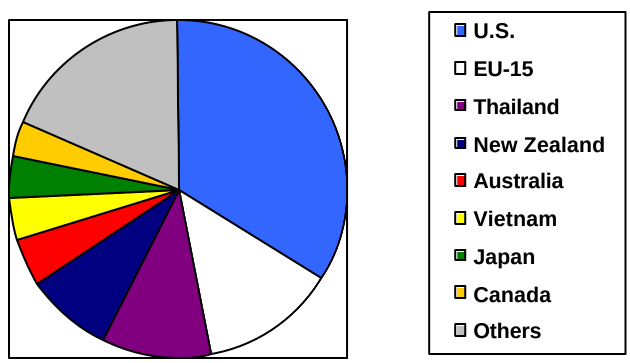
In the categories where imports are prominent, the competition tends to be strongest with Pacific Rim neighbors such as Thailand, Australia, New Zealand, and the Philippines. Competition from European countries tends to be strongest in high-end niches such as wine, cheese and premium chocolates. For certain commodities, specific countries have managed to maintain a consistent market presence:

- Fresh fruit: Thailand, U.S., South Africa, New Zealand, Australia, Philippines, South Africa
- Beef: U.S., Australia
- Breakfast cereal: U.S.
- Cheese: Australia, France, and U.S.
- Frozen potatoes: U.S., Canada
- Butter: New Zealand
- Poultry: U.S., Brazil
- Tree nuts: U.S. (almonds, pistachios), Iran (pistachios), Turkey (hazelnuts)
- Premium chocolate: Switzerland, Belgium, Italy, France
- Premium ice cream: U.S.
- Seafood: Norway, Russia, Canada, Australia, U.S.
- Variety meats/offals: U.S., New Zealand, Canada
- Wine: France, Spain, Italy, Chile
- Ginseng: Korea, U.S., Canada

Table 8. CHINA: Top Imports of Consumer Foods in 2002, By Type

Product	Value ($million)
Poultry Meat	426
Dairy (excl. cheese)	281
Fresh Fruit	276
Process Fruit & Veg.	260
Red Meat	200
Wine and Beer	76
Infant Foods (190110)	74
Food Prep. NES (210690)	74
Snack Foods (excl. nuts)	70
Tree Nuts	61
Source: UN Data	

Chart 2. CHINA: Direct Imports of Consumer-Oriented Agricultural Products
(by country of origin)
2002 Total Imports: $2.256 Billion



Although the U.S. is the dominant player in this market with a 20-percent share, other countries are pursuing it as well. A number of countries have set up trade promotion offices which are active in conducting trade promotions, including Australia, Canada, France, Great Britain, Italy, the Netherlands, New Zealand, Thailand, Malaysia and the Philippines. Vietnam has increased its share of imports very rapidly over the past few years, and is now an important player in the market.

IV. Best Product Prospects

IV.A Products Present in the Market Which Have Good Sales Potential

- Nuts and dried fruit
- Seafood

- Poultry meat
- Red meat
- Frozen vegetables
- Breakfast cereals
- Infant formula
- Pet foods
- Fruit juice
- Baby food
- Dried fruit
- Dairy products
- Frozen potato products

IV.B Products Not Present in Significant Quantities, Which Have Good Sales Potential

- Premium Ice Cream
- Ready-to-cook and ready-to-eat foods
- Non-native berry products
- Ingredients and flavorings
- Mexican food
- Functional foods

V. Post Contact and Additional Resources

FAS has four offices in China:

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