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Retail Food Sector

All China Retail Annual Report

2006

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Report Highlights:
The retail food industry continues to grow and modernize as hypermarkets, supermarkets and convenience stores displace wet markets and other traditional outlets. Distribution systems have not kept pace however, and penetration of imported foods into the retail market remains relatively low.

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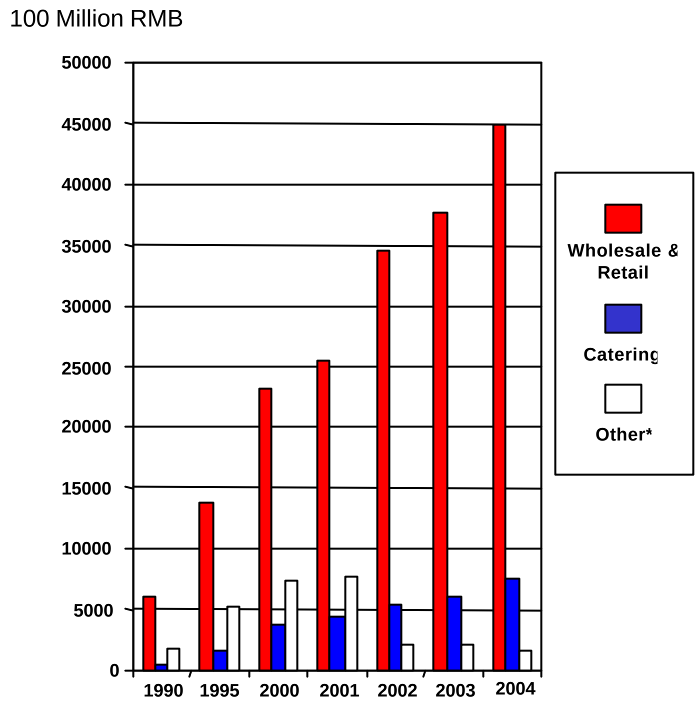
I. Market Summary

I.A. Overview of the Retail Food Market in China

Total retail sales in reached $674 billion in 2004, growing by 17.6% over the previous year. Expansion slowed slightly in the first half of 2005, with retail sales gaining by 13.2% over the same period in 2004. Retail Forward now ranks China as the world's 7th largest retail market, likely to move to 5th within the next five years. Although modern formats and chain retailers are spreading rapidly across the country, small-scale retail continues to dominate: in 2004 sales by chain stores accounted for slightly over 8% of the total. This number is deceptive in that market penetration of chain retail tends to be very high in the cities and very low in rural areas. Food sales constitute a large proportion of retail sales, with food accounting for over 1/3 of average Chinese urban household expenditures.

Figure 1: Retail Sales of Consumer Goods by Sector, 1990-2004

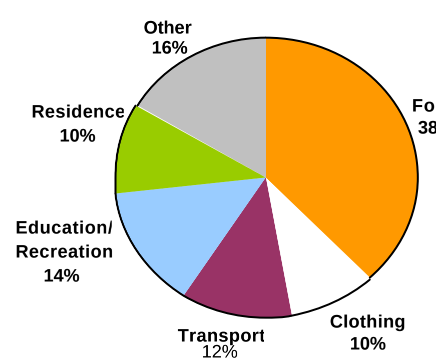


Source: China Statistical Yearbook, 2005, Table 17-3
*Beginning in 2002, direct sales of commodities by farmers were excluded from this figure.

Food retailing in China's urban areas is undergoing a rapid modernization, although the pace varies widely by geographic location. Major urban centers in Guangzhou and Shanghai lead the way, with Beijing following close behind. Most major cities now host multiple hypermarkets and one or more international retailers. With markets in Beijing, Shanghai and Guangzhou approaching saturation, many chains are expanding to second and even third tier cities. Development in retail distribution has not kept pace, and over 90% of the products for sale, even in international retailers, are locally sourced. Outside of the cities of Shanghai, Beijing and Guangzhou, penetration of imported foods is extremely low, typically constituting less than 1% of SKUs (this issue is discussed in detail below).

International retailers such as Carrefour, Wal-Mart and Metro have set the pace for retail development, and domestic and international competitors have entered these markets in large numbers, bringing the level of development close to international standards. Ferocious competition in these cities is leading the major retailers to push out into increasingly remote markets. China is an immense country however, and despite rapid growth and massive investment, all international retailers combined still account for only 3-4% of total grocery sales and 2.6% of all retail sales. At the same time, however, in a retail landscape populated by small shops

Figure 2: Urban Household Expenditures By Category, 2004



Source: China Statistical Yearbook, 2005 these international chains stand out: within the ranks of China's top 100 chain stores, they accounted for 23 percent of total sales in 2004 (as compared to only 16 percent the preceding year).

Domestic retailers are developing quickly. State-owned giants Lianhua and Hualian, both based in Shanghai, remain by far the largest food retailers in China. At last count, Lianhua operated 3,377 stores, mostly small supermarkets, across China, with plans to open another 600 stores in 2006 and a final goal of 8,000 by 2008. Although Lianhua and Hualian were merged two years ago to form Bailian, both chains continue to operate as separate entities. Much of their expansion has been fueled by acquisition of smaller chains. While this has extended their reach, it is also creating management problems. Lianhua is establishing stores in Europe, with the intention of sourcing and selling in both markets. Another state-owned giant, Shanghai Nonggongshang, has begun to expand into cities throughout East China.

Table 1. Anatomy of a Giant

Lianhua is the largest food retailer in China. Following are the basic statistics on this giant.

Lianhua At a Glance				
Division	Stores 03	Stores 04	2003 Revenue	2004 Revenue
Hypermarket	24	49	3,375	4,717
Supermarket	1,099	1,340	4,930	4,953
Convenience	NA	1,734	900	1,120
Source: Lianhua (revenue in million RMB).				

Privately-owned domestic chains are growing even more quickly. Key players include Wu-Mart in Beijing, Jiadeli in Shanghai and Suguo in Jiangsu province. Relatively small size and narrower geographic focus makes these chains quicker and more responsive to market conditions. All are expanding: Wu-Mart recently acquired rival MerryMart; Jiadeli is rumored to be in talks with a U.S. fund manager to raise funds for a nationwide expansion; and Suguo received a boost when CRE Vanguard, a major player in South China, raised its stake to 80%. CRE is also rumored to have hired away a number of managers from international retailers as they beef up their management capabilities. All of the major domestic retailers are hedging their bets by fielding a variety of different store formats. Lianhua, Hualian and Nonggongshang have developed special, branded hypermarket companies to compete with international hypermarkets. All three also own convenience store chains.

The pace of development among international retailers is extraordinary. Major new players have already entered the market, starting with Tesco's purchase of a 50% stake in HyMall, which overnight gave it 32 stores in China. Hong Kong's Sincere also announced plans to enter Shanghai's crowded convenience store sector, and SPAR has received permission to establish a wholly-owned foreign enterprise in China, having already established a joint venture with the Jiejieqiang chain in Shandong. Their voluntary chain model is likely to appeal to smaller chains looking for a competitive advantage. SPAR plans to open 15 stores in Shandong over the next three years. Another voluntary chain, IGA, has signed an agreement with Sanjiang Shopping Club in Ningbo, Zhejiang province. The most recent rumor involves the sale of Taiwan-based Trust-Mart, which, with 90 stores, could create a powerful new competitor overnight, depending on the buyer.

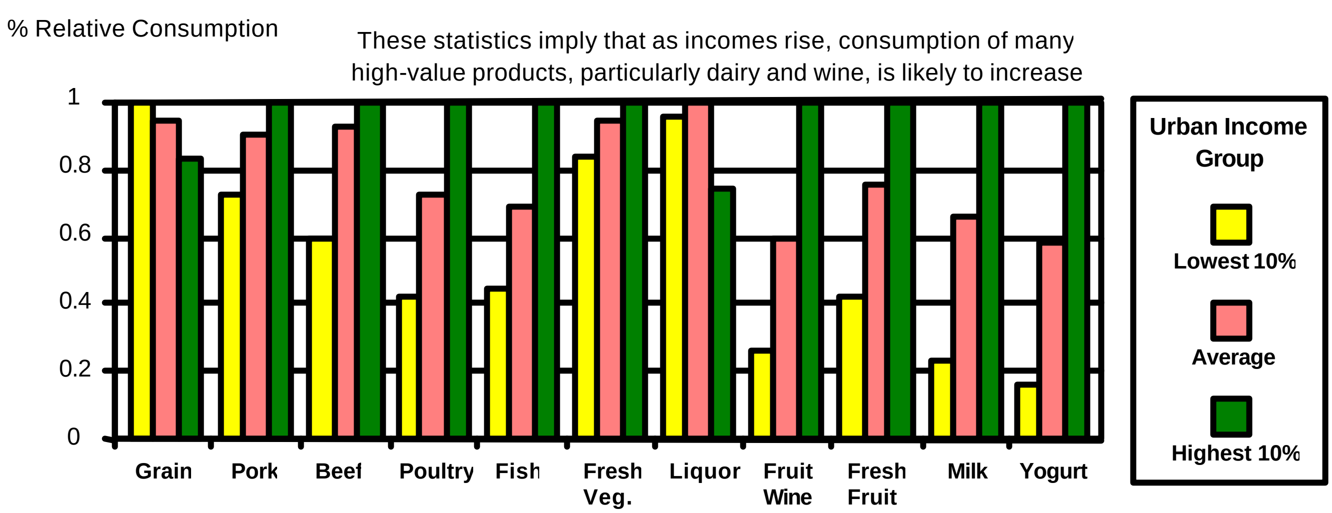
Many international retailers who have been present in the market for a number of years are also gearing up for expansion. The most notable is Lotus, which has quickly but quietly built up to over 78 Supercenter stores (as of February, 2006), with a target of 100 by the end of 2006. Lotus' efforts are focused on East China, with 20 stores in Shanghai alone. Its parent company, CP Group of Thailand, has diversified investments in agricultural processing across the country, which it may be able to leverage in the future. Ito Yokado has announced plans to double the number of high-end stores it is operating in Beijing to 10 (Ito also has two stores in Chengdu).

Liberalization of China's foreign ownership regulations has added to the ferment. Prior to 2004, all international retailers were required to enter into joint ventures with local companies. As a result, most international retailers were left with joint ventures with partners they may not have wanted. Carrefour Shanghai, for example, is a joint venture with it's biggest local competitor: Lianhua. In the wake of the reform, international retailers have either increased their stake or bought out their partners altogether. In the past year, Lotus has bought out money losing stores in Beijing and Tianjin, Carrefour has bought out partners in Changsha and Kunming, and Metro has increased it's stake from 60% to 90%. Wal-Mart, however, has announced that it does not intend to follow this trend, regarding the joint ventures as important to its relations with the local community.

Increased competition is forcing retailers, both domestic and international, to adapt. The strategies they are pursuing vary widely. Some (Carrefour, Wal-Mart and Metro) are resolving geographic imbalances by opening new stores in areas where they lack a presence. In Fall, 2005, Wal-Mart opened it's first store in Shanghai, while in the same year Carrefour opened it's first stores in Fujian (Fuzhou and Xiamen), and Metro opened it's first store in Guangzhou. Another strategy, followed successfully by Taiwanese retailers Trust-Mart and RT-Mart is to invest in less well-known but fast-developing cities, avoiding the most competitive markets. (Trust-Mart and RT-Mart have also cashed in on their strong knowledge of Chinese culture and products to attract customers in cities less familiar with foreign trends). Wal-Mart appears to be following a similar strategy. While it has no stores in Guangzhou, it has 10 in neighboring Shenzhen, and a list of locations that includes Guiyang and Taiyuan, the capitals of the mountainous inland provinces of Guizhou and Shanxi, as well as a very successful venture in Nanchang (Jiangxi province).

The opposite strategy, focusing on a narrower geographic market, has proved successful for other chains, particularly domestic retailers such as Wu-Mart, Suguo and Chengdu's Hongqi. This approach allows retailers to build greater volume and build stronger distribution chains, and is particularly favored by supermarket and convenience store chains. Lotus and E-Mart appear to be following this strategy as well, focusing most of their effort on Shanghai and the neighboring cities. Metro has focused on a niche of a different sort, having tailored its cash-

Figure 3. Relative Consumption of Selected Food Products By Income Group, 2003 (volume basis)



Note that percentages are calculated on a volume, not value basis.

and-carry membership model to become a supplier to China's hordes of small family-owned restaurants and cafeterias. Ito Yokado appears to be following both a geographic and demographic niche market strategy by targeting high-end consumer in Beijing.

Retail Distribution Development

Retail distribution channels have not grown to match the number and quality of retail outlets. With some notable exceptions, distribution is handled on a store-by-store or city-by-city basis, with stores receiving most imports through a local distributor, often even when alternatives exist. Because of their relative size, stores are able to negotiate highly favorable terms that include free return of unsold products, high listing fees for new products, and credit terms, effectively passing all market risk onto the distributor. This gives store managers a powerful incentive to favor the local distributor over alternatives that offer less generous terms. In at least one case, an international retailer's effort to establish single-desk distribution of imports failed when their own stores refused to work with the selected distributor. A second reason for reliance on local distributors is the tendency of international retailers to expand rapidly nationwide rather than focusing on a single city or region, creating large numbers of isolated stores that lack the volume to support a dedicated distribution network. A final reason has to do with the role of relationships in Chinese business: local distributors can provide a store with a network of business and government contacts that are useful in resolving problems with minimal fuss.

Because of the high level of risk they are expected to absorb, distributors tend to be extremely conservative about new products, particularly imports. As a result, penetration of imported foods into the retail sector is low. Even in relatively affluent cities, international retailers typically carry less than 1% imported SKUs. Notable exceptions include stores in Shanghai, Beijing, Guangzhou and nearby boomtowns, which are home to both large expatriate communities and to a large number of Chinese with overseas experience. Further inland, distribution problems are further complicated by China's heavily fragmented logistics systems, which make it difficult to transport products directly from the coast to deep inland cities. One survey in Chengdu found that temperature sensitive items, such as imported poultry and meat, changed ownership as many as five times before reaching the final user.

Fragmentation among suppliers of locally sourced products, particularly of vegetables and meat, helps to perpetuate the dominant role of the local distributor. One regional chain, Suguo, made repeated attempts to source produce directly from producers or wholesale markets. The sheer volume of transactions required to meet their demand was overwhelming, however, forcing them to give up the effort. Eventually Suguo came to rely on distributors not just for sourcing, but for most aspects of marketing—essentially granting the distributor space in the store to market their products. This is changing slowly, as farmers' professional associations become more common, giving producers the ability to supply larger quantities from a single source and at a more consistent level of quality.

Exceptions to these conditions also exist. Some retailers (e.g. Metro) have centralized distribution for many imported products, and a few large distributors have negotiated more favorable terms with retail chains at the national level, in some cases waiving listing fees. As chains grow larger and handle increasing volumes, and as Chinese and foreign suppliers become more organized, the role of the local distributor in handling imports is likely to decline in the long run. Nonetheless, for now, distribution remains the key obstacle to sales of imported processed food in China's retail sector.

I.B. Sectoral Overview

Supermarkets – This is the oldest modern retail format, and remains the most common in urban China. The sector is dominated by state-owned domestic retailers, the largest being the Shanghai-based companies Lianhua and Hualian. A number of strong, privately owned and regionally focused competitors have appeared in recent years, however, exemplified by Beijing's Wu-Mart. Although the supermarket format is losing market share to hypermarkets and convenience stores, the actual number of stores continues to grow. The durability of the supermarket model is rooted in the demographics and buying habits of Chinese shoppers. Small apartment sizes, small refrigerators, relatively low rates of car ownership makes long trips inconvenient, and limits the amount of food that can be kept at home. At the same time, Chinese consumers are extremely sensitive to the freshness and quality of the food that they buy. As a result, most Chinese prefer to make smaller shopping trips on a daily basis, rather than going on weekly or monthly shopping expeditions to a distant superstore.

The key weakness of China's supermarkets lies in the poor selection and quality of produce, an item in high demand with daily shoppers. This mismatch between supply and demand has not gone unnoticed, and it is common in many Chinese cities to see impromptu wet markets form outside of some supermarkets to take advantage. Several supermarket chains are expanding their line of fresh produce in an effort to capture this business, but face steep obstacles in sourcing the quantity and quality of produce they need. They are receiving support in this effort from local officials, who tend to regard wet markets as unsightly and unsafe, not to mention a source of untaxed commerce. The movement of supermarkets into fresh produce may prove a boon to fruit exporters, as fruit is one of the few imports that have been able to penetrate into the local wholesale markets that supply these stores.

Supermarkets have the poorest penetration of imported products of all the modern retail formats, even in major cities. The only U.S. imports routinely found in these stores are frozen corn and mixed vegetables, frozen potatoes, and occasionally fresh oranges, apples and wine. This is the result of both customer base and distribution systems. Chinese supermarkets cater primarily to middle-market daily shoppers, who are extremely price sensitive. By contrast, hypermarkets and convenience stores are less price sensitive, with hypermarkets appealing more to upscale shoppers (particularly those who own cars), while convenience stores make an open tradeoff between time and money. The other obstacle to imports lies in the weak distribution systems for supermarkets, who tend to rely on small-scale local distributors or local wholesale markets, or to buy directly from local manufacturers.

Hypermarkets – Hypermarkets have seen the fastest growth of any sector. International retailers are far stronger in this format than in any other. Useful statistics are difficult to come by, as chains tend to lump different retail formats together. This being said, Carrefour appears to be the dominant player, although Lianhua and Hualian also have a large number of hypermarkets. Carrefour added 14 stores in 2005 to reach an estimated total of 70, and plans to add 20 more in 2006. Many of the new stores are located in markets where Carrefour previously lacked a presence. Among international retailers, Wal-Mart is a distant second at 47 stores, but has ambitious plans for expansion. As noted before, Wal-Mart has generally avoided markets that are already well-developed

This Ito Yokado store in Chengdu is one of a growing number of international hypermarkets.

in favor of less well-known markets. Wal-Mart just this year opened its first store in Shanghai, and has yet to establish a presence in Guangzhou, though it has a huge (10 stores) presence in neighboring Shenzhen.

Metro Cash & Carry has expanded more slowly. The German-based retailer currently has 29 stores, but plans to double this number in the next three to five years. Metro's niche-market strategy of selling directly to restaurants and food service, however, makes it more of a player in the HRI sector than in retail, and some international retailers do not regard Metro China as a competitor. Thailand's Lotus, by contrast, has expanded at an extraordinary pace in the past year, estimated at a total of 49 supercenter stores, concentrated primarily in or near Shanghai. This places them ahead of Tesco, which entered the market by buying a 50% share of Taiwan-based Hymall, with 32 (39 as of early 2006) locations in 2005 and plans to open 15 more. Ito Yokado has staked out a position as a high-end retailer, with five stores in Beijing and two in Chengdu, and plans to add five more in Beijing. The long list of other hypermarket companies operating in China also includes Auchan (France), RT-Mart (Taiwan), Trust-Mart (Taiwan), Parkson's (Malaysia), CRC/Vanguard and E-Mart (Korea).

In addition to the major chains, hypermarkets often face competition (especially in Northeast and Central China) from local deparment store operators with one or two locations. These have evolved in the direction of hypermarkets, adding large food stores, while many hypermarkets have taken on some attributes of department stores. Hypermarkets in China tend to be somewhat smaller than their western counterparts, and very few (excepting Metro) follow the big-box format faithfully. In large cities, they are typically multi-story operations. Most act as small shopping malls, setting aside a large amount of space for independent boutiques and eateries, a habit that tends to reinforce the perception of hypermarkets as places for occasional shopping expeditions rather than daily shopping. For the hypermarket proper, the food sales area typically accounts for a good half of total area. Management within the stores tends to be quite good, but distribution has not kept pace.

Convenience Stores – This has been one of the most dynamic sectors for development, yet is still the one with the farthest distance to go. The industry remains overwhelmingly concentrated in Shanghai, which hosts nearly half the convenience stores in the country, and Guangdong Province. The industry continues to be dominated by domestic state-owned retailers, with the largest being Quik (owned by Lianhua), Kedi (owned by Nonggongshang's Bright Dairy subsidiary) and Alldays (directly owned by Nonggongshang).

Table 2. Top Convenience Retailers

Company	Headquarters	Stores (2004)
Quik (Lianhua)	Shanghai	1,734
Kedi	Shanghai	1,079
Alldays (NGS)	Shanghai	1,000
Shanghai Buddies	Shanghai	669
Beijing Wumei	Beijing	548
Qingdao Liqun	Qingdao	492
21 Century/Maya	Shanghai	400
Luohe Shuanghui	Henan	367
Meiyijia	Dongguan	350
Zhongbai	Wuhan	280
Jingong	Tianjin	240
Tangjiu	Taiyuan	228
Suguo	Nanjing	220
7-Eleven	Guangzhou	198
Huacheng	Nanjing	197

Source: CCSFA. Note that these statistics may not be complete due to differing definitions for convenience chains. At least one regional chain appears to be missing.

These giants are being challenged on two fronts. International convenience retailers are expanding more aggressively. 7-Eleven has broken out of Guangdong, and now has a small number of stores in Beijing. Japan's Family Mart (connected to Ito Yokado) and Hong Kong's Sincere have also entered the market. Other international convenience chains in China include C-Store (Taiwan) and Lawson's (a JV between Lawson's Japan and Hualian). The other challenge comes from local chains. In cities where major chains are not well established, local companies are filling the void. Chengdu's Hongqi, Jiangsu's Suguo and Beijing's Wu-Mart providing examples. Faced with growing competition in their home markets, retailers are expanding into new territory or seeking niche markets. Quik and Kedi in Shanghai, and 7-Eleven in Guangzhou, are both expanding into nearby satellite cities, taking advantage of their high incomes, close proximity and lack of local competitors. Other chains, like Lawson's, are seeking niche markets, targeting office workers in commercial districts.

Chinese convenience stores tend to be somewhat smaller than their western counterparts, but all have refrigerator cases and microwave ovens, and most offer a selection of hot food, typically meatballs or fishballs and tofu on skewers. The vast majority are pedestrian stores, with no allowance made for parking, although several chains have entered cooperative agreements to open gas station stores. Since gas sales are controlled by a small number of petroleum companies, these stores are actually co-located with gas stations, rather than being gas-and-go convenience stores, as in the U.S. Convenience stores also offer a variety of services, including bill payment, IP cards and even inflating bicycle tires, all as a means of generating foot traffic.

Traditional markets – These continue to be a presence throughout China, although they are no longer the dominant factor in the larger cities. Traditional markets fall into three general categories: wet markets, variety stores (xiaomaibus), and fruit stands. Wet markets specialize mainly in fresh vegetables, meat, poultry (sold live), eggs, tofu and to a lesser extent, fruit and staple foods. Sanitary standards are extremely low, particularly for meat. Officials generally regard wet markets as an eyesore, as well as a source of both food safety problems and unregulated (i.e., untaxed) commerce. The SARS epidemic, followed shortly by avian influenza outbreaks, provided more impetus to efforts to reform or close these markets. Nonetheless, they persist. The main reason for this is a lack of alternatives for buying fresh vegetables and, to a lesser extent, meat. The selection and quality of vegetables in most supermarkets is poor, and hypermarkets are too far for daily shopping trips. Until competitive alternatives are widely available, wet markets will persist.

The other traditional formats are small variety stores (xiaomaibus) and fruit stands. The typical xiaomaibu is much smaller than even a convenience store, family owned, and stocks an eclectic mix of products. Although they face a serious challenge from convenience stores, the xiaomaibu persists even in Shanghai. While convenience chains follow standard formats and target key sites (train and bus stations, schools, hospitals, etc.), xiaomaibus are infinitely adaptable. Small size and independent ownership allows these shops to adapt to individual sites such as apartment complexes, and adapt their product selection even to match individual consumers. Like convenience stores, xiaomaibus also offer a range of services, such as bill payment and IP card sales.

Fruit stands fill another gap left by the convenience stores, which rarely carry more than one or two types of fruit. Sales are boosted by the tradition of giving gifts when visiting friends, and most fruit stands will wrap fruit baskets to order. Fruit stands frequently carry imported fruit, usually for inclusion in fruit baskets. However, they are generally regarded as poor venues for imported products, as they are generally price driven and poorly regulated. Counterfeiting is widespread in these markets, and where a brand name adds value, it is certain to be copied. As a result, there is little room for marketing and promotion of imported products. While both xiaomaibus and fruit stands will likely continue to decline in numbers relative to convenience stores, China's high urban population densities are likely to support their continued existence for many years.

I.C. Advantages and Challenges for U.S. Products In the Retail Food Market

Table 3. U.S. Products in China's Retail Market	
Advantages	Challenges
U.S. products are generally regarded as high in quality.	U.S. products are routinely counterfeited.
Urban Chinese consumers spend 38% of their income on food.	Overall incomes remain relatively low, with imports selling mainly to higher income groups.
Consumers are interested in new tastes.	Consumers are very price sensitive, and often unwilling to risk spending money on unfamiliar products without trying them first.
Many U.S. brands are widely recognized and respected in China's major urban markets.	Many U.S. companies have established plants in China, manufacturing their products in China with Chinese ingredients.
Incomes are growing rapidly in second and third tier cities, creating a whole new range of opportunities.	Distribution and logistics remain underdeveloped outside of the largest urban centers, making distribution of imported products to interior cities difficult.
Western foods are more widely available than ever, and growing in popularity with consumers.	Lack of knowledge about U.S. products and how to prepare them properly makes consumers hesitant to buy.
China's entry into the WTO reduced tariffs on a wide range of imported products.	Labeling regulations and sanitary restrictions limit access to the market. Enforcement of regulations is haphazard, creating confusion for exporters.
The number of qualified distributors for imported food on the mainland is growing, along with the volume of direct exports.	Many U.S. exporters continue to rely on gray market channels, reducing their level of contact with end users and understanding of the market.
Rapid growth in retail chains has created the potential for bulk sales, with consequent improvement in pricing and handling.	Purchasing by most foreign-invested chains remains decentralized, preventing them from sourcing in bulk. Close relationships between store managers and local distributors help to reinforce this tendency.

II. Road Map for Market Entry

II.A. Basics of Market Entry

General Guidelines

China is not a single amorphous market, but a jigsaw puzzle of small, overlapping markets separated by geography, culture, cuisine, demographics and dialects. As such, there is no single formula for success in China. The best approach to marketing a product will vary depending on the product and the specific market (geographic and demographic) being targeted. Nonetheless, there are some basic guidelines that can be applied to most cases.

1) Understand the importance of relationships. China's legal system is developing, but remains inconsistent. Enforceability of contracts varies widely, but is generally weak. Business in China instead relies heavily on personal contacts and influence (referred to as 'guanxi'). For companies with a serious interest in China, no investment will be more important to their success than the network of relationships that they establish in China. For more pointers on the role of guanxi in Chinese business culture, please see report CH4835, Chinese Business Etiquette.

2) Find a local partner and/or distributor. For smaller companies without the resources to directly market their products in China, a good distributor is critical to success. Distributors provide the network of relationships with buyers, regulators and others, that is needed to do business in China. Unfortunately, these tend to be in short supply. ATOs keep lists of well-known distributors. Keep in mind that contract arrangements with retailers tend to place most of the market risk for new products onto the distributor, so they may require some convincing before they will take on an unfamiliar product. Specialized distributors also exist for certain product categories, most notably wine, seafood and fruit. Be careful in selecting a partner and in establishing an incentive structure: partnerships gone sour are the most common cause of business failure in China. Paying close attention to payment terms can be an important aspect of this (confirmed letters of credit are standard).

3) Know the rules. Chinese regulations are often vaguely worded, arbitrarily enforced and opaque. Your distributor can (and should) handle this for you. However, weak enforcement has made short-cutting a common practice, and exporters that rely entirely on Chinese partners for this are often unaware that their products do not conform to the rules until a problem arises. To defend against the unexpected, exporters should try to be reasonably familiar the actual regulations. Product registration, labeling and product expiry dates are the top concerns in this area. To enter the retail market, food products must receive a hygiene certificate from the local government where the product will be sold. Food products must also be labeled in accordance to Chinese government standards, with the labels pre-approved by the government. Functional or health foods must obtain a health-food certificate, and claims of health benefits on packaging or in advertising are strictly regulated. Foods containing GMO ingredients may be subject to additional labeling requirements, as are organics. Please see the FAS FAIRS reports for China on the FAS website for details (www.FAS.USDA.gov; attache reports) or the website for China's Administration for Quality Standards, Inspection and Quarantine (AQSIQ) at www.AQSIQ.gov.cn.

4) Get to know the market. As noted above, China is a surprisingly diverse place. Tastes, customs, culture, business practices and government regulations vary from place to place. Experience in other markets will not necessarily help in China, and some aspects of the market need to be witnessed to be fully understood. The best strategy is to target a specific place and get to know it well. The scope of your effort will determine whether you select a single city or a whole region. Travel to China is highly recommended to evaluate partnerships, build guanxi (see above), and identify new opportunities and potential obstacles. (Partners are frequently hesitant to mention problems in formal communications, but will be more forthcoming over informal events like dinners). FAS market briefs offer a good source of information on the market, and are available for free on the FAS website noted above.

5) Find your market niche and focus on it. China is a very, very big place. The mass market may be huge, but it is driven entirely by price and dominated by lowest-cost local producers. Better returns are to be had from targeting a specific niche. The country has a nearly infinite number of niche markets, some of them quite large. Examples include the high-end gift market, where margins are high but packaging is crucial (wine, ginseng); the expatriate market (famous brands from home like Betty Crocker and Post); or health-conscious young parents (prunes, almonds, fresh fruit).

6) Invest (wisely) in consumer research. To outsiders, Chinese tastes can seem fickle. Tastes poorly received in the U.S. may prove successful in China, while products targeted to one market niche may end up finding their greatest success in a completely different one. To avoid unpleasant surprises and find new opportunities, exporters with a long-term interest in China are advised to research the market and test new products directly. Be careful how you invest research money, however. The quality of research by international market research firms is often not much better than that of much less expensive local companies. ATO-sponsored activities offer good opportunities to field test new products or packaging.

7) Adapt your products. Exporters should be prepared to adapt their products to the demands of their Chinese consumers. 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 unfamiliar products if they can't actually see them, so including a transparent window in the box or offering free samples can help sales. Products that are marketed as gifts, such as wine, should place extra emphasis on the packaging, as this is considered an important part of any gift. Many exporters seeking to break into the gift market have special packages manufactured in China, which can also help to address labeling issues.

8) Be flexible. Things don't always work as expected in China. This can be a good thing, provided you can take advantage of opportunities when they arise. Exporters who enter the market with preconceived notions of how to market their products often miss out. ATO activities routinely turn up unexpected opportunities: for premium boneless pork in Chengdu; for d'anjou pears and cherries in Shanghai; for Mexican food in Wuhan. By the same token, a product may find its best niche in an unexpected place. Washington State apples have done quite well in China despite tough competition from local products, because superior appearance and consistent quality made them the top choice for gift baskets.

9) Pursue gradual but sustainable growth. A common pitfall is the temptation to pursue explosive growth, focusing on geographic penetration rather than sustainability. This may produce impressive short-term results, but exporters with limited means may find themselves overextended very quickly. If the exporter is unable to meet the expectations of their customers, they may turn to other sources (such as local copycats or counterfeiters) or demand may collapse. Alternatively, the exporter may find themselves overly reliant on local agents that they do not know well, and who have little interest in the long-term success of the product. The go-slow approach gives exporters time to learn the markets, accumulate customer feedback, and build their distribution channels.

10) 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 often have advantages on price, familiarity and local brand recognition, while imports can be aided by aggressive promotional 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, focused trade shows for your particular market segment is a good way to start. In-store promotions are also a cost-effective way to support your product and build relationships 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 strongly advised to explore joint marketing opportunities with ATOs or with a State and Regional Trade Group (such as NASDA, WUSATA, MIATCO or SUSTA). These events tend to be cost effective and draw more attention than standalone promotions.

Entry Strategy: Hypermarkets and Supermarkets

Hypermarkets: The hypermarket sector represents the best high-volume option for U.S. food exporters. International retailers generally have a higher level of familiarity with imported brands and products, and recognize the value of bringing new products to market and promoting them. Hypermarkets frequently source high-volume merchandise directly from manufacturers, but rarely do so with imports. Even in the largest and most sophisticated markets, they tend to source from local distributors.

The first task is to get to know your retailer. Policies vary widely among different chains: some charge listing fees, while others do not. Some require two months' credit, while others pay up front. Although these problems are usually handled by the distributor, they will affect your sales. Another reason to get to know your retailer is that hypermarkets in China tend to develop groups of favored distributors. They dislike working with unfamiliar companies unless they can offer a large number of SKUs, strong marketing support or some other sweetner. Distributors for their part, tend to be very conservative in introducing new products, due to the high level of market risk (see section I.A.). As a result, exporters with a limited product range need to work both ends of the problem at the same time, identifying a retailer that is interested in the product, and identifying a distributor that either has an existing relationship or is willing to work with the retailer.

The alternative is to identify a distributor that is willing to aggressively market the product directly to retailers, and count on them to find markets for your product. This requires that the distributor be fully convinced of the marketability of the product, given their high level of risk. Distributors generally fall into one of two categories. The largest distributors tend to have longstanding relationships with the major retail chains, and can source in larger volumes and place products in a larger number of stores. However, they also tend to carry a large number of SKUs, and cannot dedicate resources to marketing any one particular item. Specialty distributors tend to be focused on one area or product type. Although they sometimes lack the volume and connections of larger distributors, they tend to be more aggressive in marketing products and better at identifying and selling into specific niches. The quality of these smaller distributors varies widely, however, and exporters need to be extremely careful in selecting a partner.

Products that are already in the market but being sold mainly through gray channels or sub-distributors tend to be the most attractive to distributors. A handful of retailers also act as distributors. Although they tend to provide less marketing support, they can be an effective means of getting product to retailers that have already expressed an interest, but cannot handle the import formalities themselves.

Supermarkets: Imported food is relatively rare in Chinese supermarkets. Products that do well in this sector tend to be commodity products already widely available, such as fresh fruit, frozen vegetables and nuts. Supermarkets rarely if ever import directly, or even buy directly from an importer, tending instead to rely on wholesale markets and local manufacturers or distributors. Stores with a significant expatriate community nearby are likely to carry imported breakfast cereals and a perfunctory selection of imported sauces (especially pasta sauce) and seasonings. The best possibilities are in the smaller, privately held chains, which are more likely to see the value of high-margin imports and tend to have better integrated distribution systems. Such chains may carry products as varied as wine, exotic fruit (avocados, in one case) or confectionery, but only in low volumes. Even so, price will remain a consideration. State-owned supermarket chains generally have less integrated management and distribution. Opportunities exist, but only on a fitful basis with a small number of stores, and only for products already present in the market. For either state-owned or private supermarkets, direct contact with company officers is the best means of introducing a new product.

Entry Strategy: Boutique Stores

This category includes expatriate-focused gourmet stores and specialty stores for organic foods, wine, cheese and similar high-end products. These stores have proliferated in recent years, particularly in Beijing and Shanghai. Although volumes tend to be quite small, price pressure is not as high as in the hypermarkets. In addition, managers tend to be more aware of famous brands and actively search for niche products not otherwise available in the market. Many high-end and specialty products first enter the Chinese market through these types of outlets before moving on to larger venues. A handful of these companies also include import/distribution operations, and can assist exporters with issues such as labeling and product registration. Otherwise, exporters will need to identify a good distributor. In the case of high-end and specialty products, HRI-focused distributors (who are familiar with the products but may lack experience with labeling issues) may be as helpful as larger retail-oriented distributors (who often lack experience marketing high-end products), particularly in emerging city markets. Because of the small scale and highly varied nature of this market segment, interested exporters should contact the relevant ATO for a list of potential venues.

Entry Strategy: Convenience Stores

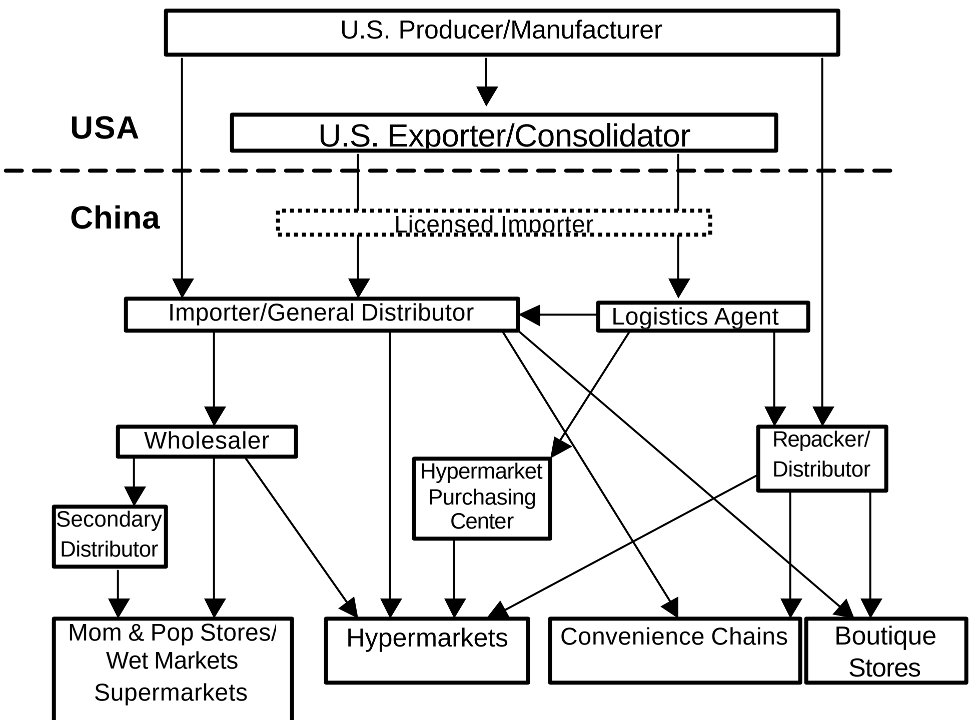
Convenience stores represent the greatest untapped potential. The sector is very new, and most chains have cutting-edge management systems and integrated distribution. The industry also tends to be highly concentrated geographically, giving chains larger bulk sourcing capabilities. Competition is also driving a rapid move toward specialization, in turn creating new niche opportunities. Import penetration, however, tends to be relatively low, despite a high level of interest on the part of several chains. Being largely domestic companies, management at convenience store chains tends to be less familiar with imported products than their counterparts in the hypermarket sector. A second difficulty faced by imports is packaging: convenience stores typically require smaller package sizes, being focused mainly on single-serving products. Exporters are advised to open discussions directly with chain officials to identify products with potential, and ensure that packaging meets their needs. Then the exporter will need to identify a local distributor that can handle the import paperwork and labeling issues. One alternative to this is to work with an importer/repacker, who can import in bulk, then package the products in China with Chinese labels and packaging appropriate to the convenience market. This strategy has proven extremely successful for U.S. prunes. Competition also tends to make convenience stores somewhat conservative about pricing, though ATO/Shanghai's experience indicates that chain managers are more price sensitive than their customers.

II.B. Market Structure

Distribution By Market Type

Distribution varies widely throughout China based on geography, product type and retail sector. As a general rule, the three cities of Shanghai, Guangzhou and Beijing have the best infrastructure and the largest number of experienced distributors. Increasingly, those systems are being extended to the large webs of satellite cities surrounding Guangzhou and Shanghai. Ports in these cities offer a growing array of services, including bonded storage (with temperature controlled facilities, if needed) and online inventory tracking. Some have duty-free industrial zones where products can be repackaged or further processed, with duty paid only on the original import value, and only after products leave the zone.

Figure 3. Imported Goods Distribution Chain: Major Port



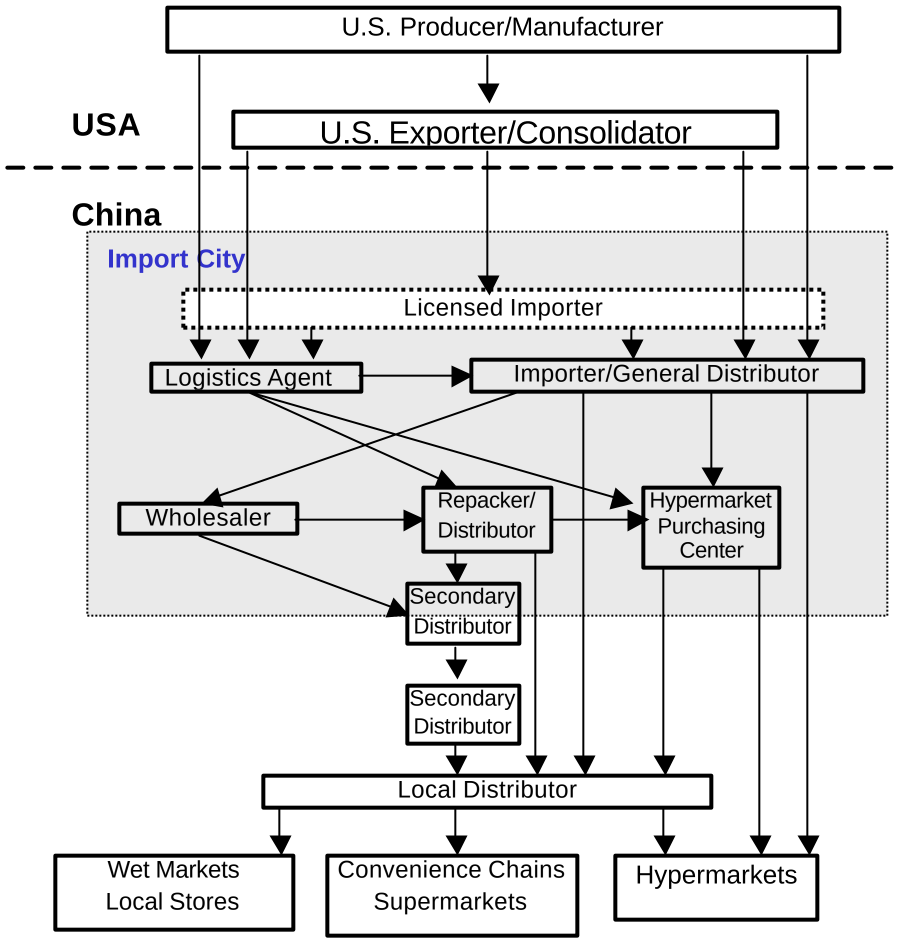
Source: ATO/Shanghai research

Other major cities along the eastern seaboard, beyond the reach of the 'big three,' generally have good logistics infrastructure, but most still rely on one of the 'big three' as an entry point for imports. The number of distributors handling imported products in these cities is usually limited. These tend to be good markets for commodity products such as meat, poultry, fruit and seafood, as well as sauces, condiments and wine.

Deeper inland, there are a number of large cities with good market potential. Logistics can be dicey, but improvements in the national highway system have made trucking direct from Shanghai or Guangzhou far easier than it was just four years ago. As a result, high value and sensitive products shipped by truck directly from the importer to a local distributor do surprisingly well, while lower value and shelf-stable products that ship on local roads through conventional distribution chains face more difficulties. Distribution in these cities is generally underdeveloped. Many cities have only a single distributor for imports, particularly high-value or temperature sensitive products. Products going through conventional distribution channels typically change hands numerous times before reaching their destination.

Distribution channels for HRI tend to be better developed, and may be the best place to start for exporters seeking to develop new markets.

Figure 4. Imported Goods Distribution Chain: Emerging City via Major Port



Source: ATO/Shanghai research

Distribution also varies widely by product type. Channels for shelf-stable grocery products tend to be the most heavily fragmented and the most dependent on the good graces of local distributors. This is partly because market risk is perceived to be higher: although shelf stable, the number of SKUs tends to be high and turnover low compared to other product categories. Hence the risk that a product will not sell (and the distributor will have to accept a return) is higher. Meat, poultry and seafood also face fragmented distribution, but the combined demand from HRI and retail venues is sufficient to warrant special arrangement for these high-value products. Fresh fruit appears to have the best distribution, working through a patchwork of wholesale markets and specialized distributors that works better than it should. Imported frozen corn and mixed vegetables are almost universally available, reinforcing the notion that the problem is less one of logistics than of distribution. Wine deserves special mention, due to the presence of a community of specialized distributors, some of whom act as exporter, importer and distributor all in one, taking product direct to retailers.

Industry Profiles

Statistics on China's food retail industry have serious shortcomings, for a variety of reasons. Mergers, buyouts and cross-investment, combined with the effects of China's previous requirement for foreign companies to work through joint ventures, has created a hopelessly tangled web of ownership. It is difficult to be certain whether revenues do or do not include income from joint ventures or subsidiary chains. Store numbers are less opaque, but still present problems. Many retailers operate a range of different store formats, and it is not always clear whether a number includes only hypermarkets, supermarkets, or convenience stores, or some combination of the three. Lastly, the retail sector is expanding at such a rapid pace that store numbers can change on a weekly basis. Keeping these difficulties in mind, the following table provides a rough outline of the current state of the retail industry.

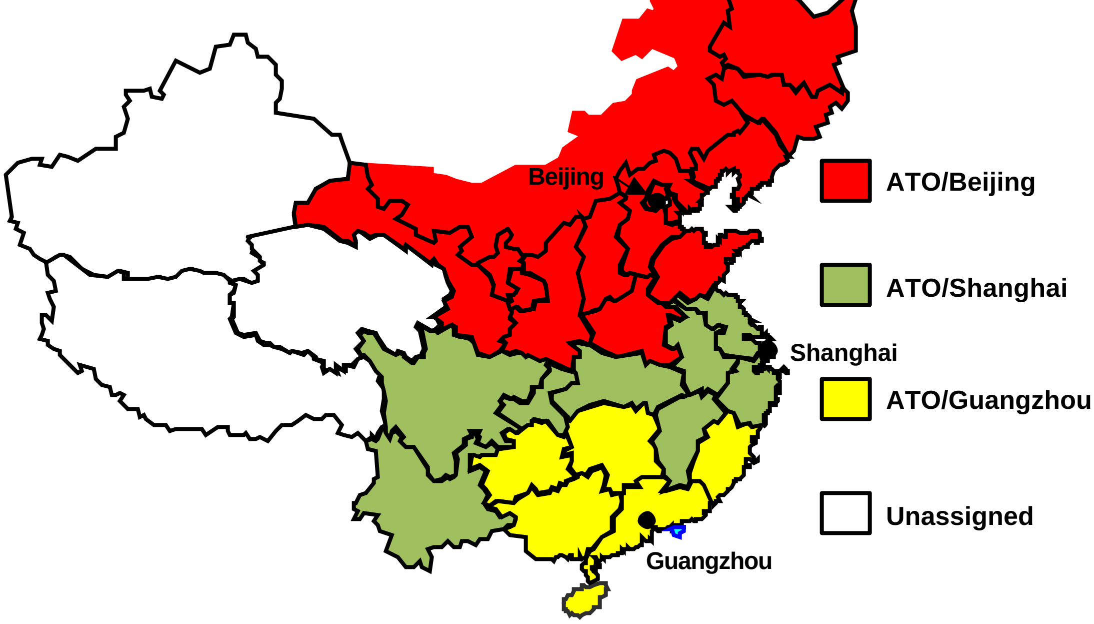
Table 4. Top Food Retailers

Company	Ownership	2004 Revenue (million RMB)	Stores 2004	Stores 2005*	Business Line	Location
Lianhua	China SOE	30,681**	3,123	3,377	Super/Hypermkt Convenience	Nationwide
Hualian	China SOE	21,518**	1,693	NA	Super/Hypermkt Convenience	Nationwide
Carrefour China	France JV	16,241	62	72	Hypermarket	Nationwide
Beijing Hualian	China SOE	16,000	70	NA	Hypermarket	North China
Suguo	China JV	13,880	1,345	NA	Supermkt/Conven	Jiangsu/Shandong
Nonggongshang	China SOE	13,703	1,232	NA	Super/Hypermkt Convenience	East China
Beijing Wumei	China Pvt	13,277	608	NA	Supermkt/Conven	Beijing/Hebei
Trust Mart	Taiwan JV	12,000	88	90	Hypermarket	Nationwide
Huarun Wanjia	JV	11,014	476	NA	Department	
RT-Mart	Taiwan JV	9,500	40	NA	Hypermarket	Nationwide
Xinyijia	China Pvt	8,500	58	NA	Department	
Wal-Mart	US JV	7,635	43	47	Hypermarket	Nationwide
Parkson	HK JV	7,400	30	NA	Department	Nationwide
Lotus	Thail. JV	7,394	41	49	Hypermarket	Nationwide
Hymall/Tesco	UK/Taiwan JV	7,000	31	39	Hypermarket	Nationwide
Metro	Germ. JV	6,459	23	29	Hypermarket	Nationwide

Source: China Chain Store Franchise Association, except * obtained through direct contact with chains, and ** from Shanghai Statistical Yearbook, 2005.

II.C. Regional Market Profiles

Figure 5. FAS China At A Glance

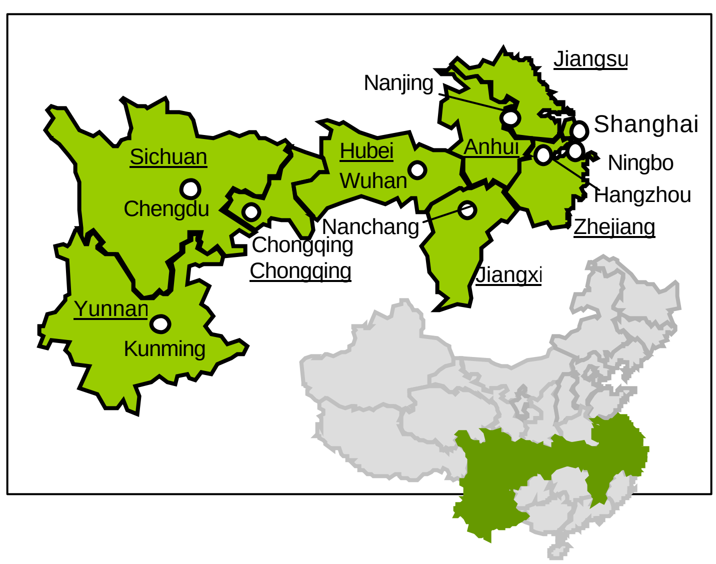


As noted many times before, China is a diverse place, and fragmented distribution and logistics systems help to reinforce existing divisions. To assist exporters in dealing with these divisions, FAS maintains four offices in China, with Agricultural Trade Offices in Beijing, Shanghai and Guangzhou, and an overall Agricultural Affairs Office in Beijing. Individual market profiles for each region are offered in the following sections.

Shanghai Region

The city of Shanghai is a massive market unto itself, with a population estimated at 20 million, and incomes among the highest anywhere in China. As costs in the city have risen, the economy has begun to shift away from manufacturing and into financial and management services. Manufacturers seeking to escape high costs in the city while taking advantage of the infrastructure and massive consumer base have created an economic boom in the surrounding region. The city is located at the center of a web of economic development that includes the provinces of Zhejiang and Jiangsu, and is collectively referred to as the Yangtze River Delta (YRD). This region accounts for nearly 1/3 of China's GDP. Massive infrastructure investment has led to major improvements in logistics and drawn the region closer together. The

Figure 6. Shanghai Region



opening of the Yangshan deepwater port facility last fall is expected to make Shanghai the world's largest container port within the next few years. Shanghai's large expatriate community (estimated at 350,000) is dominated by Taiwanese, who bring with them a familiarity with foreign brands and a taste for U.S. and Japanese foods.

Shanghai's retail sector is well developed, and home to a large number of supermarkets, hypermarkets and an extremely strong convenience store sector. Supermarkets remain the dominant, and oldest, modern retail format, with relatively weak management and infrastructure. Supermarkets are losing ground to hypermarkets and convenience stores. This loss in market share, however, is counted in growth not captured: new stores continue to open. The supermarket format is quite durable owing in part to Shanghai's high population density (the highest in China and one of the highest in all of Asia), which makes it possible to have a small supermarket within walking distance of virtually any place in the city.

Table 5. Top Players in Shanghai Retail, 2004

Company	Total Outlets	Outlets in Shanghai	Sales Volume ($million)
Lianhua	3,290	1,796	3,835
Hualian	1,693	583	2,690
(Carrefour China)	*70	*7	*2,030
Nonggongshang	1,224	1,164	1,713
RT-Mart	25	5	1,736
Metro	23	4	796
Hualian GSM	25	16	520
Lotus	12 *41	10	570 *924
Jieqiang Tobacco, Sugar & Wine	312	193	227
Jiadeli	117	105	208
Auchan	3	3	162
Changfa Dept. Stores	1	1	50
E-Mart	2	2	48
Watson	17	17	50
Jiajiale	39	39	38

Source: Shanghai Statistical Yearbook, 2005, except for * derived from CCSFA figures. Note that CCSFA and Shanghai Yearbook numbers for Lotus differ sharply.

Hypermarkets

Hypermarkets constitute the single best retail venue for imported products. International chains such as Carrefour and Wal-Mart are both familiar with the products, and count large numbers of expatriates in their customer base. Most are experienced in promoting new products, and flagship stores like Carrefour's Gubei store or Lotus' Superbrand Mall store have it down to a science. Despite this, imports rarely constitute more than 5% of total SKUs in even the high profile stores. As elsewhere in China, the most decisive component in hypermarket food promotion is free sampling. Shanghai consumers are cautious rather than impulsive buyers, and will rarely spend money on a product they have not had a chance to try. Hypermarket promotions also come with many strings attached: most charge listing fees and demand that promoters be provided at the distributor's expense (some even charge fees to have the promoters on their premises). Other conditions include accepting returns of unsold products at the end of the promotion. (These issues are discussed in detail in Section I.A.).

The hypermarket industry in Shanghai has expanded quickly, reaching an estimated total of 121 stores by the end of 2005. The sector is dominated by international retailers, with over 67 outlets in Shanghai accounting for 76% of the sector's combined 21.4 billion RMB in sales. Hypermarkets are eating into market share for supermarkets as growing ownership of cars and larger refrigerators make bulk shopping trips more practical. Management of these stores is generally modern, and SOE hypermarkets such as Lianhua's Century stores are bringing in foreign experts to upgrade their management to compete with the international retailers.

While Carrefour continues to dominate at the high end, with 7 hypermarkets in Shanghai alone, Lotus has quietly expanded and now actually has 20 stores in Shanghai, although turnover for these stores is lower than for Carrefour stores. Wal-Mart finally established a presence in the city by opening its flagship Nanpu store in late 2005. Two more Wal-Marts are planned for 2006. Tesco's purchase of 50% of Taiwan-owned HyMall has given it a foothold in Shanghai, but experience with Hymall indicates that Tesco may need some time to integrate its management with HyMall's. Korea's E-Mart, which currently operates three stores in Shanghai, also plans to ramp up its efforts, having recently opened a store in Tianjin and with another scheduled to open in Shanghai in 2006. E-Mart's final target is 33 stores in the region, ten of them in Shanghai. A total of 14 retailers have hypermarkets in Shanghai, including Auchan, RT-Mart, Trust-Mart and Hyodo. Most have announced plans for further expansion.

Under pressure from competition, hypermarkets are seeking ways to differentiate themselves. Wal-Mart has announced a cooperative effort with a Chinese pharmacy company to provide pharmacies in their stores, and Carrefour is in talks to do the same. Lotus' flagship store in the Superbrand Mall last year became the city's first 24-hour hypermarket. Although Carrefour's flagship Gubei store quickly extended its hours, few others have been willing to follow suit. Most hypermarkets in Shanghai now stock a wide range of ready-to-eat products such as rotissiere chicken, and have in-house bakeries. House brands are also becoming popular as retailers seek to cash in on their reputations. Carrefour leads the way through heavy house branding in its Dia discount stores. Chinese hypermarkets are following suit, led by Century Lianhua.

Table 6. Structure of Shanghai's Food Retail Sector, 2005

Sector	Total Sales (million RMB)	International Retailer Sales	International As % of Sales
Supermarket	*67,900	630	1
Hypermarket	21,400	16,300	76
Convenience	9,300	630	7
Source: Shanghai Daily			

Metro relies on its niche-market strategy of targeting small and medium sized restaurants, effectively positioning itself as an HRI wholesaler and distancing itself from competitors. To this end, Metro has added a training kitchen to its facilities in Shanghai. ATO has worked with Metro on a number of occasions, arranging for USDA cooperators to provide training in the purchase, handling and use of U.S. food ingredients, while Metro provides facilities, and recruits from their customer base of restaurants. Parkson's, with a presence across China, offers relatively small spaces for food sales in their department stores, but focuses on very high-end products, including imports.

Supermarkets

Supermarkets have the lowest penetration of imported products of all the modern retail venues in Shanghai. U.S. food products in these venues are typically limited to frozen corn and mixed vegetables, frozen potato products and occasionally fruit (apples or oranges). Other items tend to appear on a haphazard basis: past checks have turned up breakfast cereals, low-end wines and California avocados. The sparse selection of imports is rooted in the customer base of these stores, which focus on working class shoppers, who are notoriously price sensitive and less inclined to try new products than the more well-heeled customers that frequent hypermarkets and convenience stores. Distribution is also a problem, as stores tend to source from local distributors, directly from manufacturers, or from local wholesale markets.

The supermarket sector in Shanghai is dominated by domestic companies. The only foreign-invested supermarkets in Shanghai are Tops and Watson's, which combined only registered 630 million RMB in sales in 2004, out of a sector total of 67.9 billion RMB. State-owned companies are dominant, with Shanghai serving as headquarters to three of China's top ten food retailers: Lianhua, Hualian and Nonggongshang, all state-owned. Although Lianhua and Hualian were nominally merged two years ago to form the behemoth Bailian, they continue to operate as distinct (and competitive) chains. Bailian appears to be more focused on rationalizing its diverse portfolio, and developing its shopping mall management component. Both Lianhua and Hualian have expanded aggressively through acquisitions of other chains, leaving both companies with a challenge incorporating them into already weak SOE management structures. Inspired by foreign-invested companies (Dia carries 1,000 SKUs of house brands), the Chinese chains are paying greater attention to branding, and most now carry a substantial number of house brands.

Despite the dominance of SOE retailers, Shanghai has several smaller, privately owned chains. The largest of these, Jiadeli, operates some 130 stores in the Shanghai area, and is actually larger than Nonggongshang in the supermarket sector. All are seeking ways to survive in an increasingly competitive landscape. Industry sources claim that a U.S. fund manager plans to buy a 32% stake in Jiadeli, injecting a large amount of cash to take the brand nationwide. Another local chain, Jieqiang, is cooperating with China Life Insurance to sell travel insurance policies through their stores. Lianhua and Alldays convenience stores are also working with China Life on this project. Most supermarkets have imitated the convenience chains by offering a wide range of additional services such as bill payment, at a nominal fee.

Shanghai's supermarkets are small and focus on daily necessities, but are weak on fresh produce. It is not uncommon to find vegetable sellers with blankets covered with vegetables for sale outside of supermarkets, and fruit stands tend to locate close to supermarkets. This started to change after the SARS and avian influenza scares. City officials throughout China tend to regard informal and wet markets as unsanitary eyesores. In Shanghai, after years of unsuccessfuly trying to shut down informal markets, they are now attacking the other end of the problem by encouraging supermarket chains to create 'fresh' supermarkets, expanding the floor space dedicated to fresh products from less than 1/3 to over 1/2. Shanghainese place an extremely high value on clean, well-lighted venues, and it is highly likely that the presence of a reasonable alternative to wet markets will do more to hasten their decline than efforts to force them to close. To date, only Nonggongshang has made a public commitment to this strategy, converting over 100 (current numbers are not available) of their stores. Supermarkets throughout the region (including Suguo) appear to be moving in this direction, but are being slowed by problems in sourcing large quantities of quality product.

Aggressive competition from Carrefour's Dia discount stores may push more supermarkets to carry fresh products. Dia carries many of the same staple goods as supermarkets at deep discounts, but does not carry fresh products. The threat from Dia should not be understated. Although Carrefour has opened only 150 of these stores in Shanghai to date, they plan to reach 300 in 2006 and open new stores at a rate of 20 per month after that. Dia stores are small, carrying a limited range of products, mostly house brands. Anecdotal information indicates that the Dia stores are competing quite well. Nonggongshang has also established a chain of discount stores called 'One Price' or '5 Reminbi,'offering most products for less than $1. They planned to open a total of 160 free-standing discount stores by the end of 2005.

All three major SOE supermarket chains (Lianhua, Hualian and Nonggongshang) have hedged their bets. Lianhua owns the Quik convenience store chain and is the partner in Carrefour's Shanghai joint venture. Hualian is the JV partner with Japan's Lawson's in their chain of convenience stores in Shanghai. Nonggongshang owns the Allday's chain of convenience stores, as well as the area's largest dairy company, Bright, which owns yet another major convenience store chain, Kedi. All three have also opened branded hypermarkets in and beyond Shanghai, and Lianhua is putting a particularly strong effort into its Century Lianhua hypermarkets. Although Nonggongshang's market share has slipped, it is attempting to expand its reach to match Lianhua and Hualian, opening NGS hypermarkets in distant cities like Nanchang, with mixed results.

Convenience Stores

Convenience stores are rapidly becoming a more favorable environment for imported foods, as stores seek ways of distinguishing themselves, while the higher prices for higher-quality imports provide a better per sale return. Again, Lawson's is leading the way in this field, having worked with ATO/Shanghai and U.S. product distributors to launch a U.S. food festival in selected stores, promoting Sun Maid Raisins, Planter's Nuts and macadamia nuts from Hawaii, among other things. The results made clear that products need to be adapted to the convenience store format, most particularly in terms of reducing package sizes. One of the most successful suppliers of U.S. product to the sector imports U.S. prunes and re-packs them into single-serving packets that are sold to schoolkids at 1 RMB (about 12 cents) apeice. U.S. frozen potato products, cooked and sold ready-to-eat, have also been successful in this format.

Shanghai's convenience store industry is by far the most developed in the country, with the city playing home to an estimated 4,500 convenience stores—nearly half of the national total. One source estimates the number at 1 store per 3,800 residents (not including immigrant workers), comparable to saturation levels in Japan and the U.S. Despite this, the sector continues to grow. Shanghai's convenience sector is overwhelmingly dominated by subsidiaries of the giant SOE supermarket chains: Quick (Lianhua), Alldays (Nonggongshang), Kedi (Nonggongshang via its Bright Dairy subsidiary) and Lawsons (a JV between Hualian and Lawsons Japan). However, new investment is coming from international convenience chains. Japan's Family Mart entered the city two years ago, and now has in the range of 120 stores in Shanghai, with plans for 350 by the end of 2006. Hong Kong's Sincere has announced plans to enter the market with 300 stores by the end of 2006. Aside from Family Mart and the Lawson's JV, Taiwan's C-Store franchise is the only international convenience retailer currently with stores in Shanghai. Stores compete aggressively for good locations, and it is not uncommon to see three different convenience stores within 100 feet of each other in prime areas.

Management in convenience store chains is probably the best of any retail sector. All stores have refrigerator and freezer sections, microwave ovens, and most have a selection of hot snacks (mostly meatball or tofu on skewers). More to the point, most chains have integrated distribution systems, including fully automated, real-time inventory and ordering. The main exception is for fresh products (mostly dairy and prepared meals) which are often distributed directly by the manufacturer. Store layouts are highly standardized, although some chains have developed more complex systems that customize product selection to the peculiar location based on past sales patterns.

Ferocious competition has spurred efforts to innovate and to target niche markets. Quik and Kedi have both entered into deals with gas station operators to open markets in their stations. Lawson's pioneered efforts to target white collar employees and service staff in shopping districts with high-quality Japanese style lunch boxes. Kedi is now following this lead with a 'Korean Taste' campaign, providing all three daily meals in Korean styles and a selection of other Korean food under a house-brand label. Family Mart expects to benefit from superior management and technology (they may be surprised by the local competition). As noted earlier, nearly all convenience stores offer a range of services to draw foot traffic, with Alldays ushering the latest innovation by providing China Life travel insurance policies at their stores. 21 Century went a different direction, merging with the Maya music chain to create food and music stores.

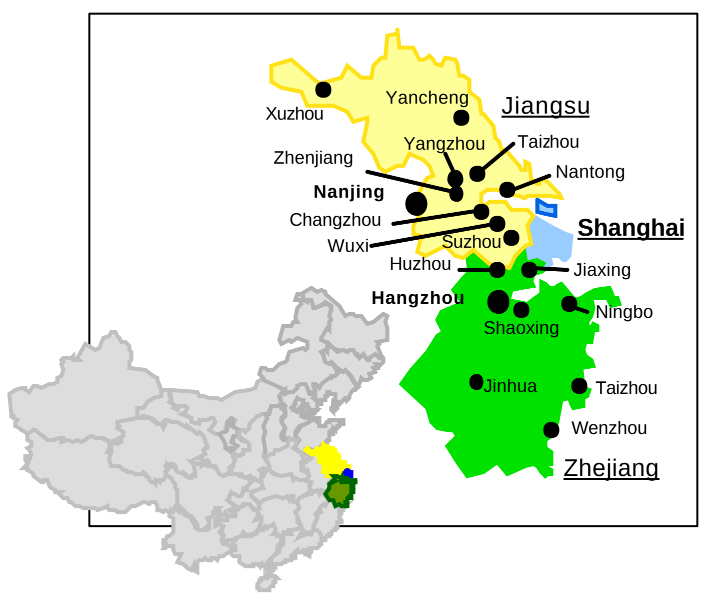
Boutique Stores

Boutique and specialty food stores in Shanghai have multiplied, becoming a force unto themselves. Expatriate grocery stores continue to expand. The most venerable, City Supermarket, continues to be one of the best single venues for imported food in Shanghai, and now does significant business as a distributor of imports to other stores. Chiro Group's (Singapore) Pines The Market stores are providing City Supermarket with competition, carrying a high-end selection of gourmet products. Another trend is in specialty wine retailing: several specialty wine outlets have opened (not to be confused with the traditional state-owned hard liquor and tobacco stores). The most notable is Cheese and Fizz, which features a wide range of wines and imported cheeses. Yet another trend is in organics. While City Supermarket markets its own brand of locally grown organic vegetables, California's O-Store last year opened its first all-organic food store in Shanghai, with ambitious plans as both a retailer and distributor of imported organics. O-Store imports mainly from Germany, Japan and the U.S.

Beyond Shanghai

The immediate area surrounding Shanghai (the Yangtze River Delta, or YRD) is a beehive of industrial and commercial activity. In the key cities, retail development is already well advanced. Suzhou and Hangzhou are home to Carrefour and other hypermarkets (including Auchan, Lotus, RT-Mart, Tesco/Hymall and Trust-Mart) and Quik, Kedi and C-Store convenience stores. Hypermarkets throughout the region source imports through Shanghai, taking advantage of the region's outstanding logistics and Shanghai's large community of experienced food importers. The supermarket sector in these cities is typically dominated by either Lianhua, Hualian or Nongongshang, but with a preponderance of independents (with the notable exception of Nanjing's Suguo)

Figure 7. The Yangtze River Delta



During a recent FAS/China nationwide retail distribution exercise with Carrefour, stores in **Suzhou** and especially **Hangzhou** performed far beyond expectations, with sales of U.S. food products at the Hangzhou store matching or exceeding levels in larger and better-known cities. Hangzhou is becoming a major market in its own right, and was selected by Forbes Magazine in 2005 as the best place to do business in China. Development is now moving on to a third tier of cities. Particularly notable are **Wuxi** (Forbes' #2 choice), which has become a major distribution center for seafood and meat products in the YRD area; **Ningbo**, which has average incomes on par with Shanghai but a less well-developed retail sector; and **Nanjing**, the capital of Jiangsu province.

Many of these cities are home to relatively strong independent chains, particularly those further from Shanghai. Voluntary chain IGD has entered into talks with Ningbo's Sanjiang Shopping Club. Interestingly, Sanjiang is linked through a voluntary association to Shandong's Jiajiayue, which is working with voluntary chain SPAR. Local officials in China tend to protect local businesses aggressively, a fact that could work to the advantage of voluntary chains, particularly in the community of wealthier cities with distinct identities that lay at the edges of the YRD, such as Wenzhou, Nanjing and Ningbo.

Farther inland, the picture becomes less clear. Retail development has progressed at different paces and with widely differing results. Most large cities host at least one international hypermarket, typically with several local imitators and independent supermarket chains. The following section touches briefly on the key markets and offering some perspective as to the degree of variation.

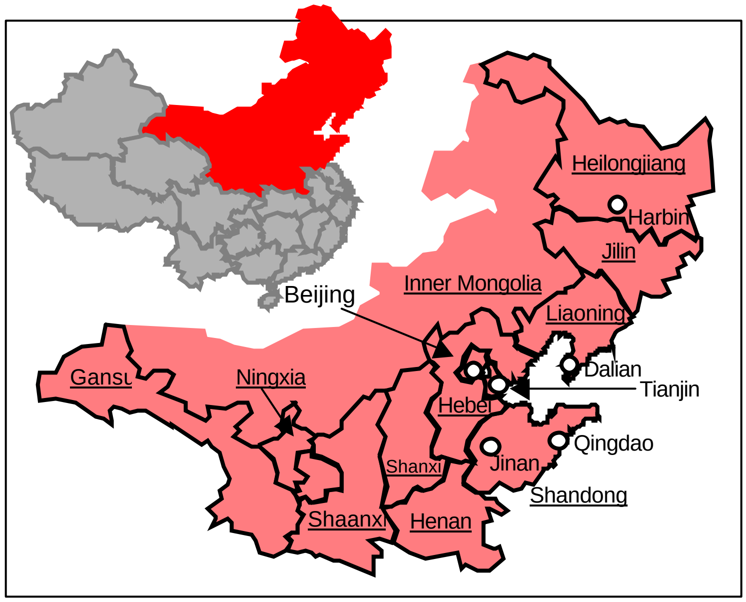
Kunming, in Yunnan province, developed at an astounding pace, ultimately attracting 10 international hypermarkets, including Wal-Mart, Carrefour, PriceSmart and Metro, in the space of a few years. This pace exceeded local demand, however, and many of the stores have languished with a few closing. **Chengdu**, by contrast, developed more slowly, and is now home to more than 6 international hypermarkets, all of which appear to be doing well. One international retailer referred to Chengdu as the only city in West China where they routinely turned a profit. Incomes are generally lower than in coastal cities, but the residents of Chengdu appear to have a very high propensity to spend, particularly on food. ATO/Shanghai's efforts with both Ito Yokado and Carrefour stores in this city were immensely successful. Nearby **Chongqing** is less well developed. Although it has strong potential for the future, the best opportunities appear to be in the HRI sector.

Wuhan, in Hubei province offers a mid-range prospect. It has a reasonably well-developed retail sector, with Metro, Carrefour and Wal-Mart all represented. Past efforts with Metro found a surprisingly strong market for Mexican-style foods, while Carrefour's Wuhan store was one of the strongest markets for fruit during last September's distribution exercise with that chain. Wal-Mart's remarkable success in **Nanchang**, the capital of Jiangxi province, provides a good case study for retail in China. Nanchang was not generally regarded as a retail market in the same class as Kunming or Chengdu. However, close cooperation with local officials netted Wal-Mart a prime location, just as the city launched a major redevelopment effort, making for a major success. The success of this venture is all the more striking given the relatively weak performance of Nonggongshang's NGS hypermarket, established several years earlier in the same city, and demonstrates the value of local market knowledge.

Beijing Region

Beijing's retail scene has the most room for future expansion of China's 'big three' cities, a byproduct of its relatively slow development. Beijing experienced consumer goods retail sales growth of 14.4% in 2004 compared to 2003, with a 22.7% increase in retail food sales

Figure 8. Beijing Region



compared to 2003. Unlike Guangzhou or Shanghai, Beijing is not at the center of a wider economic development web, with Tianjin the only nearby urban area worthy of mention. However, the broader region is home to some of China's most dynamic coastal cities, including Dalian and Qingdao, and the major Northeast China cities of Shenyang and Harbin. Shandong Province in particular is becoming a major industrial and commercial center.

In Beijing proper, the most rapid development is taking place in the fast expanding suburbs, where skyrocketing auto ownership now adds about 1,500 new car registrations daily. Beijing's retail sales totaled $35.8 billion in 2005. Many **hypermarkets** are locating in the borderline areas between city and suburb in hopes of attracting customers from both. The sudden surge in car ownership means that for the first time parking lots have become a major requirement. By the end of 2004, there were some 3,760 retail outlets including large supermarkets, hypermarkets, convenience stores and warehouse clubs or a 22.8% increase over 2003. Beijing's unique status as the national capital has allowed it to attract an extremely large and varied expatriate community that supports a large number of boutique and specialty grocery stores that carry imported products. Jenny Lou's operates half a dozen stores around Embassy compounds and expatriate communities. The store has a thriving business having found its own niche-market charming expatriates with good service and familiar foods from home. In addition to expatriates, these stores target growing numbers of up-market Chinese consumers who have lived or studied abroad. The presence of the expatriate community is also felt in department stores, often including high-end food sections as part of their operations.

Acquisition and consolidation in retail industry appears to be a continuing trend in recent years. Tesco has invested $260 million in China to acquire a 50 percent stake in Hymall, a Chinese chain operating 31 hypermarkets nation-wide. This expansion will enable Tesco, third-largest retailer in the world and the largest in the United Kingdom, to challenge Wal-Mart and Carrefour in China's increasingly competitive marketplace. Tesco will open a 20,000 square meter shopping mall in Beijing near the 4th Ring Road in early 2007. At the beginning of 2006, Wu-mart, 10th largest chain store operator in China and the largest retail chain operator in Beijing took control of competitor Merry-Mart, the fourth largest retailer in Beijing. The acquisition signaled increasing competitiveness in the domestic retail business now rife with expansion and consolidation. This consolidation should result in greater procurement bargaining and purchasing power for Wu-mart. Wu-mart claims to be the fastest growing consumer goods seller in Beijing and self-predicts it will become the major wholesale channel in Beijing as well.

Overseas retail giants continue to be aggressive in this market. French retail giant Carrefour, the largest foreign player in China, plans to open 20 stores across China this year after establishing 14 in 2005. As of February 2006, Carrefour operates 71 stores nationwide with 24 in North China. Yet, Chinese regulators routinely favor domestic firms at the expense of foreign operators, and some State Operated Enterprises still receive 'soft loans' from state-run banks in order to finance local retail expansion.

Table 7. Major Hypermarkets/Supermarkets in Beijing

Retailer	Ownership	2004 Total Sales (Million USD)	% of Sales Increase over 2003	No. # outlets (Dec. 2003)
Beijing Hualian Group	China	2000 (nationwide)	25	70(nationwide)
Beijing Wu-mart	China	1660	61	608
Beijing Jingkelong	China	655	3	140
Beijing Chaoshifa	China	267	13	43
Beijing Shoulian	China	245.4		56
Beijing Shuntianfu	China	76	8	18
Carrefour	France JV	2,030 (nationwide)	21	70 (nationwide)
Wal-mart	US	954.4 (nationwide)	30	43 (nationwide)

Source: CCFA / ATO Beijing

Despite the strength of its expatriate community, percentage of imported foods in Beijing hypermarkets rarely reaches above 3-4% of sales. Stores routinely adjust quantities of imported food in a particular store based on neighborhood incomes, expatriates, etc. Warehouse stores generally target higher-income consumers or those who own cars, and generally stock more and higher-value imports. Sam's Club stores in Beijing sell three times as much imported food as Wal-Mart Super Centers, but the ratio of imported products is still only 3-4% of sales. Beijing retailers hold US products in high regard for their quality although European, Korean and other suppliers are increasingly popular. Shelf surveys reveal special sections devoted to imported beer, fruit, wine, etc. Dairy cases are expanding often displaying imported cheese. Substantial displays of imported breakfast cereals, biscuits and beverages are also becoming common. Although most stores boast extremely large frozen food sections, these are stocked mainly with frozen dumplings, excepting imported frozen mixed vegetables, corn and peas.

Hypermarkets in the Beijing area generally expected to make higher profits on imported foods, because the market risk is higher. They also expect promotional assistance for new-to-market items, including in-store demonstrations, sampling, and negotiated fees for promotional efforts. Some retailers, like Carrefour, charge slotting fees whose cost can reach as high as RMB 10,000 ($1,200) per slot, per store. Other retailers like Wal-Mart and Auchan appear to put most of their effort into keeping prices as low as possible.

Modern **convenience stores** are just beginning to make an appearance in Beijing and other northern cities with many operated by the same state-owned chains dominating Shanghai, and other parts of China. These stores are characterized as clean, well managed, heavily automated, with real-time inventory systems. In many places they are rapidly replacing the traditional xiaomaibu stands that sell snacks and drinks, but stock few imported products. Initial reports indicate convenience store chains are re-thinking their Beijing strategy where the consumer culture is driven by the automobile. In addition, 24-hour service is less of an advantage in the cold North than in the warmer South where most of China's convenience chains are currently based.

In the race to develop Beijing and North China, state-owned behemoth Lianhua has moved quickly into the lead with its Quik chain. On the other hand, 7-Eleven, with a strong foothold in South China, began opening Beijing outlets in April 2004. However, the stores have never made money. Rapid growth in car ownership has created great interest in gas marts that may be a more important source of growth for the retail sector in the future here. However, overall, the convenience sector has been relatively slow to develop. Beijing's government has made a concerted effort to limit growth in this sector, fearing both over development as in Shanghai, and the displacement of traditional family-owned stores. The generally unfavorable regulatory climate may also be a factor, as permits and licenses can be difficult to obtain in Beijing even at the best of times.

Beyond Beijing

Beyond Beijing, retail growth has been impressive. While hypermarkets in Beijing have begun catering to car owners, this has not been the case in other northern cities, where shoppers most often walk, ride bikes or use public transportation. As a result, the volumes that can be purchased on a single shopping trip are limited. Shoppers at warehouse stores are more likely to drive cars or small trucks, or to arrange for delivery. One variant on the hypermarket in China are department stores with large food sections. Most are older stores, but Malaysian-invested Parkson's is trying to develop a niche in imported food. Stores often measure more than 30,000 square meters. Although the food departments are generally about the size of a domestic supermarket, they stock higher quality products and a higher percentage of imports. This particular format is still important in parts of North China and in inland provinces, although the expansion of modern retailers has placed their long-term viability in doubt.

The current development trends show that existing transport and infrastructure bottlenecks will be significantly relieved, and some northern cities that have been difficult to access previously are becoming much more attractive locations for domestic and foreign investors. As industries in these cities begin to develop, there will be major demands for more and better retail. On the other hand, small northern retailers are going bankrupt in unprecedented numbers, battered by the winds of intense competition brought by increased foreign involvement in the sector. Small retailers start looking at some practical choices such as joining voluntary chains. The biggest voluntary retail chain in Europe SPAR entered the Chinese market after signing a deal with Shandong retailer Jiajiayue supermarket in November 2004. The agreement will result in the opening of 15 new SPAR supermarkets in Shandong Province over the next three years.

Shandong, a coastal province to the south of Beijing, is home to a number of growing industrial cities and rising incomes. Climate and soil conditions are ideal for a variety of food and agricultural products such as poultry, beef, fruit, peanuts and aquatic products. Companies from nearby Japan and Korea have invested heavily in the development of the province's modern infrastructure, including cold chain and container port facilities. While no single city has per-capita incomes approaching those of Beijing, the cities of Qingdao, Yantai, Weihai and Jinan are among the most prosperous in China, and have developed a significant middle class. In 2005, retail sales of the top ten Qingdao retailers experienced a 39.8% growth compared to the previous year. In addition, Shandong's long history of trade has made the local culture more open to imported products than most other parts of China. In March 2005, ATO Beijing partnered with Qingdao Jusco for an American Food In-store Promotion soon after Jusco's completion of 30,000-sqaure meter store space expansion. Nearly 350 U.S. food and beverage items including U.S. pork, Alaska Seafood, Washington Apples, Sunkist citrus and canned salsa were featured during the 2-week promotion period. To Jusco and ATO Beijing's surprise, shoppers for featured U.S. food products turned out not to be expatriates but local consumers.

Another standout market is the port city of Dalian, one of the fastest growing cities in China and gateway to the large yet relatively untapped Northeast China market. Similar in many ways to Qingdao, Dalian is a trade-oriented city with heavy investment from Japan and Korea. Dalian has excellent infrastructure and high disposable incomes compared to other cities. During the last few years Dalian's food retail sector has undergone a radical transformation given the rapid rise of supermarkets and hypermarkets. These retail formats have extensive dry and frozen goods, fresh and frozen meat and seafood, fruit, vegetables, prepared food, and food service sections. Many of these outlets are located in mall settings or a shopping destination for the whole family with restaurants, theatres, fashion boutiques, sporting goods stores, and other specialty shops. Relative to domestic supermarkets, imported foods have a significant presence in foreign operated supermarkets and hypermarkets even if imports account for no more than 3-4% of total store sales. However, local retailers should not be ignored either as Dalian's very own 'national' retail food chain Dashang recorded the second highest sales for all of China in 2003, well ahead of Carrefour (4th) and Wal-Mart (10th), not to mention a 42.2% increase over 2002 sales. Most retailers state the main reason they do not stock more imports is the high price. While Dalian residents consider U.S. food to be equal or superior to most other imports, high prices are the largest constraint.

Harbin, the capital of Heilongjiang province in the far Northeast, is the largest provincial capital in China, and has become a hotspot for retail development. A few short years ago this city of 10 million had no large supermarkets. Besides Carrefour and Metro, Wal-Mart has set up shop in the town, choosing Harbin as the location for its first store in the northeast. Local supermarkets, convenience stores and other format of retails outlets have a rather complicated web of ownership and yet are quite consolidated. Newly built residential communities have high expectations as consumers seek higher quality, consistency, sanitation and convenience. At end of 2005, Dashang, with 120 stores in 26 cities in the Northeast and North China, announced its merger with Harbin's No. 1 Department Store, one of largest department stores in the country. The new venture will preserve the name Harbin No.1 Department Store and create on its original site, a golden area at Daoli District Harbin, a refurbished store and a New-Mart Plaza in front of the store. The merger bodes well for Group's expansion into the Northeast retail market.

In other parts of North and Northeast China, retail development has lagged due to a legacy of large and unproductive state-owned enterprises. These holdovers from the Mao-era's command economy still dominate much of production and employment in this part of the country, and have acted as a drag on both development and reform. Despite this, modern retailing has come to every major city in the region, and development is likely to continue for the foreseeable future, creating a wealth of opportunities.

Guangzhou Region

South China's food sector is quickly transforming into a modern retail system as supermarkets and hypermarkets continue to pop up across the region. While these types of outlets are already well-established in Shenzhen and Guangzhou, many retailers are penetrating into nearby secondary cities. Food retailers are also increasingly locating within state of the art shopping malls like CR Vanguard's Mix-City in Shenzhen. With a total surface area of over 180,000 square meters, this store attracts younger generations by combining various activities with grocery shopping, such as high-end clothing shops, restaurants, movie theaters and ice-skating rinks. Convenience store chains continue to expand as well, with 7-11 dominating the market in South China.

Cold chain logistics have always been a major concern for retailers in South China. However, new expressways and distribution centers in the Pearl River Delta are facilitating the introduction of new, imported food products throughout the region. A network of local importers and distributors is expanding in the region, while Hong Kong transshipments of many products still plays an important role in the local food trade.

South China's 280 million residents enjoy higher-than average incomes thanks to the region's rapid economic development. Guangdong province is located in the southern most part of China and now is a home for major modern hypermarkets and supermarkets. With its close relationship with Hong Kong and Macau, Guangdong has benefited from the Closer Economic Partnership Arrangement (CEPA) where goods can enter Guangdong more easily than in the past. Every year, nearly 50 percent of all food products imported into Hong Kong are transshipped to mainland China, primarily through Guandong.

Consumer Trends

Consumers in South China continue to seek safe and nutritious foods for themselves and their families. Market demand also shows the trend towards healthy diets based on functional foods. While Chinese cuisine still dominates restaurant menus and home-cooked meals, Western-style foods are becoming increasingly popular as China's integration into the world economy accelerates. Once a small novelty market, Western food has developed into an emerging industry and an essential part of Chinese food culture. Chinese children are all too familiar with McDonalds, Pizza Hut, and KFC. They are developing appetites for ice cream and cheese on their pizzas.

One of mainland China's earliest consumers of Western-style foods, South China's growing middle-class has the purchasing power to afford imported foods. This group also has a strong preference for these products in part due to their reputation for high quality, but also for health and food safety reasons. Within this affluent market segment, the consumption trend is towards "green" and "organic" foods. The most popular imports include baby foods/infant formula, chocolates, dried fruit and nuts, fresh fruit and vegetables, potato chips, popcorn and canned foods such as soup.

Although Chinese consumers are extremely price sensitive, Washington Apples, Sunkist oranges and California table grapes are commonly found on supermarket shelves in South China. Durian and lychees from Thailand, butter from New Zealand and cheeses from France and Australia are also typical imported products. California wines are available, but wines from Australia, South Africa, Chile and France also have a strong presence in this market.

Many other fresh and packaged foods from the U.S. are now available as well, but consumers still lack knowledge of U.S. products and how to prepare and serve them. This makes consumers more reluctant to buy. ATO/Guangzhou is encouraging both US exporters and Chinese importers to make every effort to register their products and to provide proper labels in Chinese.

Figure 9. Guangzhou Region

Supermarket retailers

In South China, hypermarkets, supermarkets have gradually gained a larger piece of the market and are quickly replacing traditional "wet" markets. Competition among these retailers has turned South China into an Olympic battlefield for retail business, with each key player trying to expand and gain more market share in the region.

Expansion plans in South China are in the works for both global giants like Wal-Mart, Carrefour, Metro, Jusco and HK based or domestic players such as Park'n Shop and CR Vanguard. Growth in the cities of Guangzhou and Shenzhen may slow somewhat as these markets become saturated. Supermarkets continue to be the most common retail format, but hypermarkets are gaining in popularity and are now present in most medium and large sized cities. The fastest development is likely to take place in two areas: satellite cities near Shenzhen and Guangzhou, such as Dongguang, Zhuhai, Zhongshan and Foshan, and the large second and third-tier cities further inland. To facilitate this growth, retailers Wal-Mart, Carrefour and Jusco are currently establishing large purchasing centers in Shenzhen, bringing their American, French and Japanese product standards and sales concepts to South China.

Regional supermarkets and hypermarkets purchase products from local importers, wholesalers and distributors, who face difficulties in obtaining and/or transporting imports to the mainland. For example, some lack sufficient information on where to source imported food and beverage products. However, many companies directly and indirectly purchase foreign products that have been transshipped to the mainland via Hong Kong. This allows importers and distributors to avoid paying VAT and customs duties, and exposes the market to some products currently banned from the mainland. The "gray channel" trade makes it difficult for US exporters and most western-style supermarkets that insist on using proper invoices and health certificates to be competitive with contraband products. The ATOs in China are encouraging US companies to do their homework and to develop direct trade relationships with buyers in the mainland to avoid the gray channel and to look at the long-term potential of the China market.

Domestic competition is also on the rise. The key domestic players in Shenzhen: CR Vanguard, A.Best and ShuiBao, have proposed to open more stores in Guangdong Province in order to increase their market share. However, they still lag far behind their foreign counterparts in terms of management experience and capital strength. There is also a movement in South China to upgrade traditional wet markets, since these will continue for the near future to be the main food source for lower income consumers with limited purchasing power and access to transportation. Many of these markets are being cleaned up and moved into structures with roofs and proper cold storage and food handling facilities.

Profiles of select retail outlets

Wal-Mart Up to now, Wal-Mart has opened 56 stores in mainland China, 26 in South China alone. Wal-Mart continues to aggressively open new stores with the goal of penetrating into mainland second-tier and third-tier cities. In November, Wal-Mart's Jinjiang Supercenter was opened in Fujian. This milestone marked the first Wal-Mart store set in a Chinese second-tier city with approval from the Chinese Ministry of Commerce. By the end of 2006, South China could have as many as 43 Wal-Mart stores. The company, headquartered in Shenzhen, will celebrate its 10th year anniversary in China this summer. To date, three Sam's Clubs have been opened, including one in Shenzhen, one in Beijing, and another in Fuzhou. The Shenzhen store is reported to be one of the most profitable Sam's Club stores in the world.

Carrefour In 2005, Carrefour claimed a whopping 25 percent sales increase in China while the global sales rose a mere 6.1 percent. Carrefour already has 72 stores in China, with 13 in South China.
In January of this year, the French-based giant announced plans to open 20 new stores in 2006, including an additional two stores in Guangzhou, three more in Shenzhen and one in Hainan.

Metro This German chain, which is the third largest retailing group in the world, opened its first cash-and-carry hypermarket in Guangzhou in January 2006. This is Metro's 29th store in mainland China and its third in Guangdong Province. It is estimated another two new stores would be soon launched in Guangzhou and Shenzhen

Trust-Mart With over 100 stores in mainland China and 28 in South China, Trust-Mart is one of the biggest retailers in the country. Trust-Mart recently announced they may sell a 25 percent share of their presence in the China market. The Taiwanese company has 19 stores in Guangzhou and four in Shenzhen, as well as others in the second-tier cities of Donguang and Zhanjiang. Some people in the trade speculate that Wal-Mart might be interested to take over some of the Trust-Mart properties. Especially since Wal-Mart doesn't have a single store in Guangzhou.

Convenience stores

When it comes to convenience stores, 7-Eleven is a leader in the South China market. At the same time, many domestic retailers are struggling to turn a profit. Quik (Lianhua) owns 100 outlets in Guangzhou. Over the next three years, Quik expects to expand this number to 300. Meanwhile, Hong-Kong based OK now owns 36 outlets. OK announced also to open more within three years to reach 500 outlets. Taiwan-based XiShiLi has over 50 convenience stores in the Guangzhou area.

The Taipei-based President Chain, which controls 7-Elevens in South China, is the world's third-largest 7-Eleven franchise. This group is trying to broaden its revenue base into China as growth in Taiwan slows. In 2004, it set up a joint venture in Shenzhen and expects to open 100 stores in that area in five years. Total 7-Eleven outlets in Guangdong Province are expected to reach 400 in 2006.

One factor contributing to 7-Eleven's success is the chain's ability to differentiate individual stores based on location. Managers tailor product selections to fit the neighborhood. For example, they might place fresh fruit and more imported products in a store near a five-star hotel, while a store in a middle-class residential neighborhood might have more local products.

7-Eleven and OK have also added fast food counters to boost profits over the low-margin common commodities sold in convenience stores. These retailers are earning profit margins as high as 30 percent on these products, compared to the 10 to 15 percent margin earned on regular packaged products.

It is anticipated that, on March 1, 2006, the government will enact a new policy allowing the provincial government to approve the establishment of convenience stores with less than 300 square meters of retail space. The new policy would also shorten the approval period to one or two months and is an attempt to encourage the establishment of new convenience stores as residential communities are growing and there is more rural to urban movement.

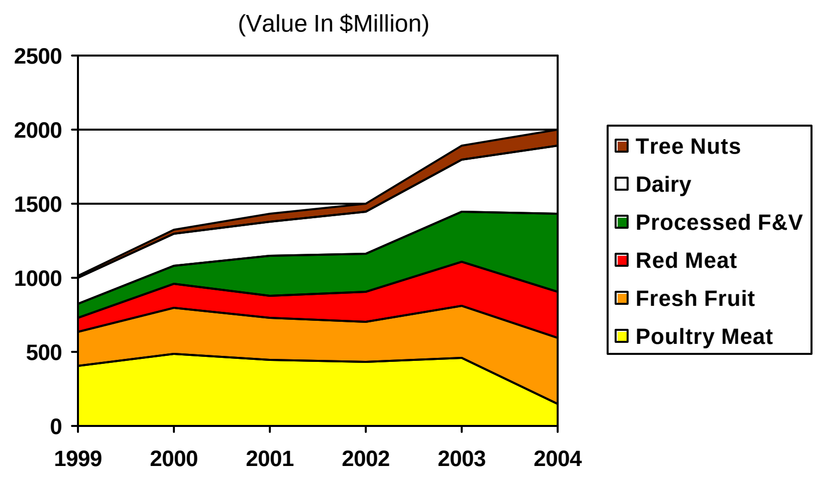
III. Competition

The most serious competition for U.S. food exporters comes from local and joint venture food producers and processors. The quality of fruit and vegetables in particular has increased rapidly, and many local traders now contend that the best of China's fruit is similar in quality to imports. The general lack of coherent marketing systems continues to plague China's industry, however, making it difficult to source significant quantities of products with consistent quality. While oranges similar in quality to U.S. navel oranges are available, the transaction costs of dealing with large numbers of small farmers, then sorting and packing raises the final market price to levels similar to imports. The formation of farmers' voluntary organizations such as the Zhejiang Pear Association has the potential to reduce these problems, but such organizations are still relatively new.

Competition is equally intense for processed foods, although differences in taste mean that the primary competition comes from third country competitors or joint venture manufacturers. Shelves may appear to be stocked with famous foreign brands such as Pringles and M&Ms, but close inspection reveals that most of these products are manufactured locally or in Southeast Asia. This allows manufacturers to cash in on brand identification, take advantage of low labor costs in China, and adapt their products to Chinese tastes and labeling regulations, all at the same time. Years of food adulteration scandals have made Chinese consumers cynical, however, and most will attribute a higher level of accord to products that are genuinely imported.

The general trend to date has been for local manufacturers to push imports out of the price-driven mass market and into niche markets where quality and novelty are more important than price. This has already happened to varying degrees with pet food (Mars' locally manufactured Pedrigree and Whiskas labels dominate the middle market), wine (Chinese labels dominate at the low end), apples (Washington State apples sell extremely well in gift markets) and confectionery. Growing local competition has emerged for table grapes, and domestic sweet cherries, lemons and almonds appear to be improving in both volume and quality, albeit from a very low base. Certain products, particularly western-style prepared foods, face little or no competition from local manufacturers, constituting a niche unto themselves. Improvements in quality and increased efforts at brand development are allowing Chinese companies to compete more effectively for some niche markets, but local manufacturers face the same distribution problems as imported products, as well as a high level of skepticism among consumers.

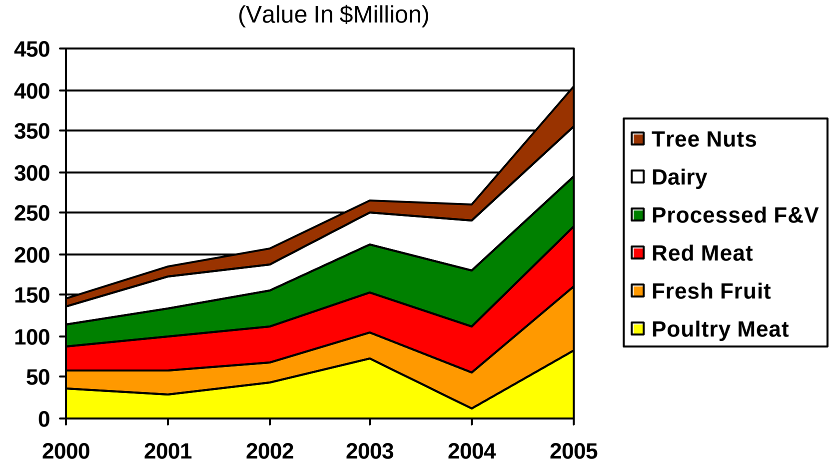
Fig. 10. Imports of Selected High-Value Products
All Sources, 1999-2004



Third country competition comes in two distinct areas: commodity-type products such as frozen meat, poultry, seafood and fresh fruit, and western-style niche products such as canned and prepared foods and ethnic cuisines and ingredients. Competition in the fresh and frozen meat, fruit and vegetables arena, as well as dairy, comes primarily from Pacific rim neighbors, including Thailand, New Zealand, Australia, Canada and Chile, as well as South Africa and Brazil. Competition for western-style prepared foods is much more global, with competitors playing to their strengths in individual products such as olive oil, wine, pasta sauces. The following list gives an idea of the range of countries and products competing in China.

The U.S. remains the largest single exporter of consumer-oriented food to China, with a 21% share of China's total imports in 2004, and is the only exporter with a presence in most categories. According to U.N. data, market share dropped in 2004 owing mainly to reduced shipments of poultry and beef (other sources show a smaller decline). This is projected to recover in 2005 due to the restoration of poultry trade and increased shipments of pork, as well as a sharp increase in shipments of fresh fruit. China is attracting a growing level of interest from other countries, however, and has signed or is negotiating bilateral trade pacts with most of its neighbors. Following is a brief outline of key products and competitors.

Fig. 11. Imports of Selected Products from the U.S. 2000-2004



Top Products and Competitors

- Oranges	U.S., New Zealand, South Africa
- Grapes	Chile, U.S.
- Apples	U.S., Chile, N. Zealand
- Cherries	U.S., New Zealand
- Lemons and Limes	U.S., New Zealand
- Red Meat (f/c/f)	U.S., Canada, Denmark, New Zealand, Australia
- Breakfast Cereal	United Kingdom, U.S., Korea
- Cheese	New Zealand, Australia, EU, U.S.
- Frozen Proc. Potatoes	U.S., Canada, New Zealand
- Frozen Corn	U.S.
- Dairy (not incl. cheese)	New Zealand, Australia, France, U.S.
- Poultry	U.S., Brazil
- Tree Nuts	Russia, Korea (chestnuts), Iran (pistachios), U.S. (almonds, pistachios, walnuts, hazelnuts), Mongolia
- Premium Chocolate	Switzerland, Belgium, Italy, France
- Premium Ice Cream	France
- Seafood	Russia, North Korea, U.S., Canada, Norway, Japan
- Wine	Chile, France, Australia, U.S., Italy
- Ginseng	Canada, U.S., Korea

IV. Best Product Prospects

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

- Nuts and dried fruit (prunes, raisins)
- Seafood
- Poultry meat
- Red meat
- Frozen vegetables (esp. sweet corn)
- Infant formula

- Baby food
- Dairy products (esp. ice cream)
- Frozen potato products
- Fresh fruit (oranges, apples)
- Premium ice cream

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

- Fresh fruit (cherries, pears)
- Processed/dried fruit (blueberries, cranberries)
- Mexican food
- Ready-to-cook and ready-to-eat foods
- Organic foods (niche market)
- Functional foods

V. Post Contact and Additional Resources

FAS has four offices in China:

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