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ALL China Retail Annual Report

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Report Highlights:
In 2007, total food retail and wholesale sales in China reached USD 104.4 billion, a double-digit increase over the previous year, as China's economy continued its impressive growth and central government policy encouraged private sector spending in order to shift the economy to a more consumption-oriented path. International retailers in particular have benefited from their reputation for offering higher quality products than most domestic retailers, thanks to stricter quality control in a country where food safety is a major concern.

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I. Market Summary

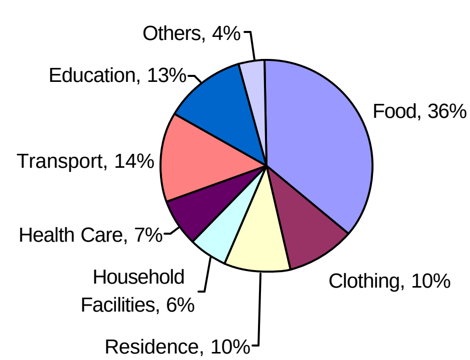
I.A. Overview of the Retail Food Market in China

Source: China Statistical Yearbook 2003-2008
*--Excludes alcohol and tobacco products

In 2007, total retail sales in China reached RMB 7.50 trillion (USD 1.31 trillion), growing by 13% over the previous year; food and beverage sales accounted for RMB 793.1 billion (USD 104.4 billion) of the total retail sales, a 30% increase over 2006, as China's economy continues on an upward path. As a result, consumers are likely to enjoy higher levels of disposable income, and likely to spend an ever increasing amount on consumer goods. The central government's policy is also encouraging private spending, as a way to shift the economy to a more consumption-oriented path. To accelerate growth in consumer spending, several policy initiatives will be carried out in the near future as part of a greater effort to restructure the economy. These will include further revaluation of the currency, which will lower import prices for consumer goods, deregulation of the banking system to accelerate the development of the consumer credit market, and efforts to develop a secure social system through better healthcare and education, in order to lower China's high rate of personal savings and stimulate personal spending. Food purchases still account for over 1/3 of average Chinese urban household expenditures.

Figure 2

Urban Household Expenditures by Category, 2007



Source: China Statistical Yearbook 2008

Metropolitan cities such as Shanghai, Guangzhou, and Beijing still represent the center of business activity for most retailers. Hypermarkets, supermarkets, and convenience stores account for the majority of sales in these cities. While markets in Beijing, Shanghai and Guangzhou are fast approaching the saturation point amid rising rental and manpower costs, many chains are expanding to second and even third or fourth tier cities to attract more consumers. In order to stand out from the competition and strengthen their position, leading retailers continue to put their efforts into merger and acquisition activities. For example, Wal-Mart successfully took a 35% stake in domestic hypermarket operator Trust-mart, improving its overall competitiveness in this category.

Retail Distribution Development

Retail distribution channels have not grown to match the number and quality of retail outlets. Roughly the size of the continental U.S., China still does not have a nationwide network of trucks, highways and cold storage warehouses that can efficiently deliver supplies from the manufacturer or importer to the store shelf. 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. Farther 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.

International retailers have recognized the problem and put a greater effort into improving the logistics system. Right now, Wal-Mart is focusing on building a nationwide distribution network, and its newly built distribution center in Tianjin has just been put into use. The German retailer Metro has a centralized distribution system 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. Carrefour also contracted with a third party logistics company to handle most of its imported grocery items. But fresh and frozen items still rely on importers or distributors to deliver to the stores themselves. The role of the local distributor in handling imports is declining. Nonetheless, for now, distribution remains the key obstacle to sales of imported processed foods in China's retail sector.

I.B. Sectoral Overview

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, have 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 1. Leading food retailers in China: 2007

Company	Ownership/ Headquarters	Business Line	Stores (no.)	Sales (¥ billion)[1]
Domestic Companies				
Lianhua	China SOE[2]	Super/Hypermkt/ Convenience	3774	46.0
Wumart	China Pvt	Supermkt/ Convenience	718	27.9
Suguo	China SOE[3]	Supermkt/ Convenience	1758	26.4
Nonggongshang	China SOE	Super/Hypermkt/ Convenience	3226	22.0
Shanghai Hualian	China SOE	Super/Hypermkt/ Convenience	2108	15.0
Xiuyijia (A. Best)	China Pvt	Department	100	16.7
Kedi	China SOE	Convenience	1245	2.8
Zhejiang Renti (C&U Supermarket)	China Pvt	Supermarket	289	2.0
Beijing Chaoshifa	China Pvt	Supermarket	57	1.9
Multinational Companies				
China Resources Vanguard	Hong Kong JV	Hypermarket	2539	50.2
Carrefour	France	Hypermarket	120	29.6
Wal-Mart	United States JV	Hypermarket	102	21.3
Trust-Mart	Taiwan JV	Hypermarket	101	14.0
Metro	Germany JV	Hypermarket	37	11.0
Tesco	United Kingdom JV	Hypermarket	55	12.5
Auchan	France	Supermarket	20	5.7
Parksons	Malaysia	Supermarket	41	14
Lotus	Thailand	Hypermarket	75	n/a

Source: China Chain Store & Franchise Association 2007 & ATO Shanghai interviews

[1] Sales include food and non-food items
[2] SOE= State-Owned Enterprise
[3] Joint venture with China Resources Vanguard

Hypermarkets – In terms of sales volume and store numbers, the hypermarket format, which is much more concentrated than other grocery channels, is dominated by foreign operators including Carrefour, Wal-Mart, Metro, Auchan and Tesco. This is in sharp contrast to other channels, most notably supermarkets, which is highly fragmented and controlled by domestic players. Multinational chains such as Carrefour and Wal-Mart also benefit from their reputation for offering better quality products than most domestic retailers, thanks to stricter quality control in a country where food safety is a major concern after several disturbing food scandals have occurred recently as well as those in the past several years. Hypermarkets are also the major sales venue for imported food products, due to international retailer's familiarity with imported products and better management and organizing skills. For food products, especially fresh food, hypermarket retailers benefit from better hygiene controls and a higher volume flow rate, and are thus able to ensure better food safety for consumers. As such, an increasing number of Chinese consumers visit hypermarkets instead of independent food stores for grocery shopping. Fresh produce has become an attractive section to draw in Chinese consumers; Carrefour has made great efforts to increase its fresh produce SKUs to the range 3,000 to 5,000 per store.

Carrefour currently operates 120 stores in China, extending even to the far western city of Urumqi. Many of the new stores are or will be located in markets where Carrefour previously lacked a presence. Carrefour's recent overall strategy has been to increase investment and expand into more second tier and or third cities in China, mainly because of an increasingly saturated environment for retail outlets, and rising rental and manpower costs in first tier cities.

Among international retailers, Wal-Mart is in second place with 102 stores, but has ambitious plans for expansion as evidenced by its acquisition in 2007 of a 35% stake in Trustmart, a Taiwanese-owned group with over 100 stores in China. Wal-Mart first entered China in 1996 when it simultaneously opened a Supercenter and a Sam's Club in Shenzhen. Until recently, Wal-Mart's development in China had been mostly limited to the southeastern seaboard area where household consumption is high. In 2005, Wal-Mart finally made an entrance into Shanghai with the opening of a large suburban outlet. Right now Wal-Mart has three outlets in Shanghai, and added further momentum to Wal-Mart's drive to catch up with rivals Carrefour and Metro, both of which have an established presence in China's largest and most prosperous city.

Metro Cash & Carry has expanded more slowly. The German-based retailer currently has 37 stores, a new store will open soon in the coming December, 2008. 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 real competitor. Thailand's Lotus, by contrast, has expanded at an extraordinary pace in recent years, with 75 supercenter stores, concentrated primarily in or near Beijing and Shanghai. Stimulated by the growing demand from second and third tier cities, the company's target is to have a total of 100 stores in the next few years. This places them ahead of Tesco (UK), which entered the market in 2004 by buying a 50% share of Taiwan-based Hymall, with 55 locations in 2007. Ito Yokado has staked out a position as a high-end retailer, with five stores in Beijing and two in Chengdu. The long list of other hypermarket companies operating in China also includes China Resources/Vanguard (HK), RT-Mart (Taiwan), Auchan (France), Park 'n Shop (HK), Parkson's (Malaysia), and E-Mart (Korea).

In addition to the major chains, hypermarkets often face competition (especially in Northeast and Central China) from local department store operators with one or two locations and specialty supermarket stores. Department stores have evolved in the direction of hypermarkets, adding large food stores, while many hypermarkets have taken on some attributes of department stores. Most hypermarkets in China offer free shuttle bus service to carry nearby community residents to the store and also constantly offer different promotional items to attract consumers. These measures successfully draw in heavy traffic to the store, but on the other hand, they also drive away some high-end consumers who desire a less crowded environment and more concentrated products display. Another side effect of these measures is that certain consumers go to the store to buy the promotional items only, which actually reduces the purchase per customer. As a result, specialty supermarket stores such as City Shop in Shanghai and Wuhan Life & Theatre supermarkets, both targeting high and upper-middle class clients, have successfully attracted customers from the hypermarkets.

Wuhan Life& Theatre Supermarkets

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 about half of the total area. Management within the stores tends to be quite good, but distribution has not kept pace.

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. The fastest growing brands are from the smaller chains like Shanghai Nonggongshang Group and Wuhan Zhongbai Group which both experienced 30% growth in terms of the number of outlets. However, most chain supermarkets in China are small sized regional players, which are constrained by the lack of financial resources for further expansion.

Table 2. 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 2006	Stores 2007
Hypermarket	20	22
Supermarket	1652	1784
Convenience	1960	2200

Source: Euromonitor

Although the supermarket format is losing market share to hypermarkets and convenience stores, the actual number of stores continues to grow. In 2006, the number of supermarket outlets in China increased by 10% from the previous year to nearly 70,000, although the rate of growth has been slowing in recent years as fewer resources, particularly land, are available. 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 (although this pattern is changing with younger, urban consumers).

The key weakness of China's supermarkets lies in the poor selection and quality of produce, an item in high demand with daily shoppers, especially with current rising concerns over food safety issues. Several supermarket chains are expanding their line of fresh produce in an effort to capture this business; for example, Lianhua in Shanghai is focusing on upgrading its product offer by selling more fresh goods. The fresh produce section has become an attractive point to bring in more consumers. The movement of supermarkets into fresh produce has also received support from the local government, who regard wet markets as unsanitary eyesores. This movement may also 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.

Specialty supermarket stores – Specialty supermarket stores have existed in China to meet the demand of upscale consumers who require a better shopping enviroment and higher quality of food. Imported products make up the majority of items carried in these stores. CityShop in Shanghai is a distinctive representative among these stores. It carries nearly 10,000 different products, with 80% imported from all over the world. With the diversification of consumers, and shifting focus from low price to health, quality and service; not only expariates but also domestic high-end and upper-middle class consumers join the clientel of these specialty supermarket stores. Another successful example is Wuhan Life & Theatre supermarkets, operating in a second-tier city in Wuhan which has far fewer resident expatriates; it mainly targets domestic upscale customers. It carries more than 4,000 SKUs of products, and more than 80 percent of those are imported products. Besides hypermarkets, these specialty supermarket stores offer another ideal venue to promote imported products. Their targeted consumers—upscale to upper-middle shoppers are exactly the clientele for imported products.

Convenience Stores – This has been one of the most dynamic sectors for development, yet is still the one with the farthest to go. Although the number of convenience store outlets grew at a slower pace in 2007 compared to the previous year, double digit growth is expected to continue for several more years. The industry remains overwhelmingly concentrated in first tier cities such as Shanghai and Guangzhou, which hosts more than half of the convenience stores in the country. Because convenience stores generally charge higher prices for their products, the target customer base is comprised mainly of urban white collar workers and students who lead busy, hectic lifestyles. In most small and medium-sized cities, the lifestyle is not as fast as in first tier cities, which therefore reduces the need for convenience stores. 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).

Convenience store development is constrained by its higher requirement for product delivery especially fresh and ready-to-eat products delivery capability and its open trade-off between time and money. The limited shelf and storage space in each outlet requires two to three deliveries per day, while the current logistics system in China can only guarantee once a day delivery for most of the stores. Its format, trading higher prices for quicker shopping time, has still not caught on completely for the majority of Chinese consumers. One source told us that most convenience store operators in China are losing money. Lawson's Japan has sold out its shares in Lawson's (a JV between Lawson's Japane and Hualian) to its Chinese partner Hualian. Many convenience store operators are probably looking at their long-term prospects in the China market rather than focusing on short-term profits. International convenience retailers like 7-Eleven continues expanding its number of outlets and added another 104 store just last year. Japan's Family Mart (affiliated with Ito Yokado) and Hong Kong's Sincere have also entered the market. Other international convenience chains in China include C-Store (Taiwan) and Sugo (Japan).

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 fish balls and tofu on skewers. Imported products are rare in these stores due to small package size requirements and limited shelf space in each outlet.

Table 3. China's 10 Leading Convenience Store Retailers by Outlets

Store	No. of Outlets in 2006	No. of Outlets in 2007
Quik C-stores, Shanghai	1,960	2,200
Kedi C-stores, Shanghai	1,208	1,400
HD/Alldays	1,650	1850
7-Eleven	1171	1275
Liangyou Buddies	960	1075
Liqun	700	770
Lawson	420	483
Wumart	420	418
CR Sugo	298	328
Jingkelong	127	150

Source: Euromonitor

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 of 2003, 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. With local government support, however, supermarkets' efforts to expand the fresh section, and especially with consumers' growing concerns over food safety, these traditional markets will gradually be phased out.

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 telecommunication 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, poorly regulated and lack the means to store fruit properly. 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

Overall, U.S. products enjoy a high image in the China market. Rising incomes and growing concerns over food safety among Chinese consumers after numerous episodes of food contamination, including the latest scandal involving milk products tainted with melamine, mean there will be more opportunities for U.S. products, which are largely perceived as safe and wholesome. On the other hand, price is still one of the barriers for U.S. products to reach more Chinese consumers; other challenges include labeling regulations, distribution, and limited product knowledge. Table 4 below provides further details in this regard.

Table 4. U.S. Products in China's Retail Market

Advantages	Challenges
U.S. products are regarded as high in quality, and manufactured with high safety standards.	Many U.S. products are costlier than their local counterparts.
Urban Chinese consumers spend 36% 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 essential to doing 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 Kraft, 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 Groups (such as MIATCO, WUSATA, Food Export USA/NE, or SUSTA). These events tend to be cost effective and draw more attention than stand-alone 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. The notable exception is Metro, who set up its own importing and distributing company called "Gourmedis" that is 100% owned by Metro itself. Right now Gourmedis handles not only Metro private label imports but also its other high-volume and high profit margin import products, thus creating a potential conflict with its distributors, whose profit margins are further eroded by Metro. Other 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 sweetener. 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.

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.

The alternative is to identify a distributor that is willing to aggressively market the product directly to retailers, and counting 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 limited 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: Specialty Supermarket Stores and Boutique stores

This category includes expatriate, upscale and upper-middle Chinese consumer-focused gourmet stores and specialty stores for organic foods, wine, cheese and similar high-end products. These stores have proliferated in recent years, not only in first tier cities such as Shanghai but also in some second tier cities like Wuhan. Some high-end and specialty products could first enter the Chinese market through these types of outlets before moving on to larger venues. Some 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

Import penetration in this sector, 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

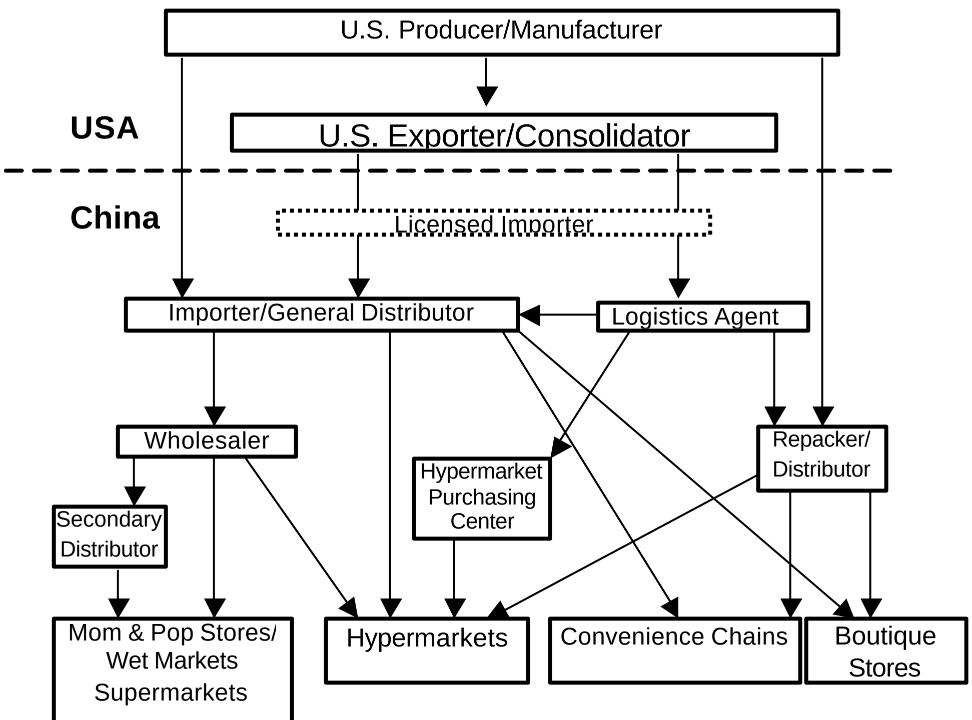
Distribution varies widely throughout China based on geography, product type and retail sector. As a general rule, the three cities of Shanghai, Guangzhou and Beijing have the best infrastructure and the largest number of experienced distributors. Increasingly, those systems are being extended to the 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 4. Imported Goods Distribution Chain: Major Port

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.

Farther inland, there are a number of large cities with good market potential. Logistics can be problematic, but improvements in the national highway system have made trucking direct from Shanghai or Guangzhou far easier than it was just a few 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

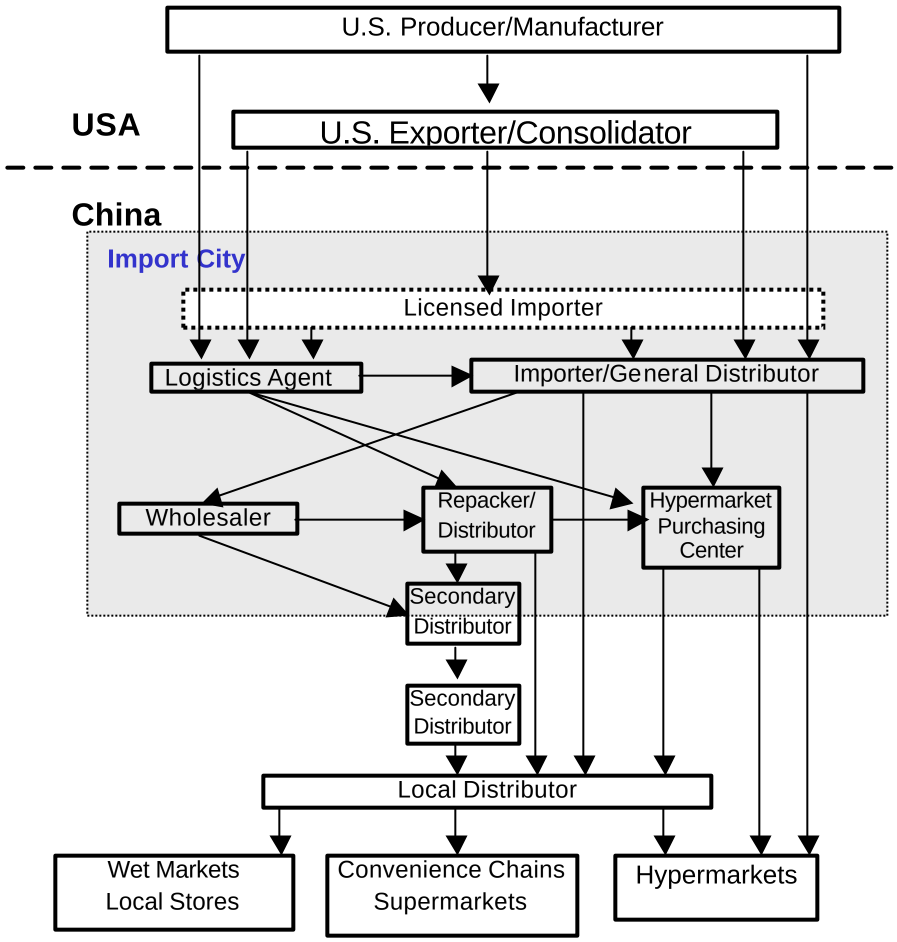


Source: ATO/Shanghai research

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 final 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 5. Imported Goods Distribution Chain: Emerging City via Major Port

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

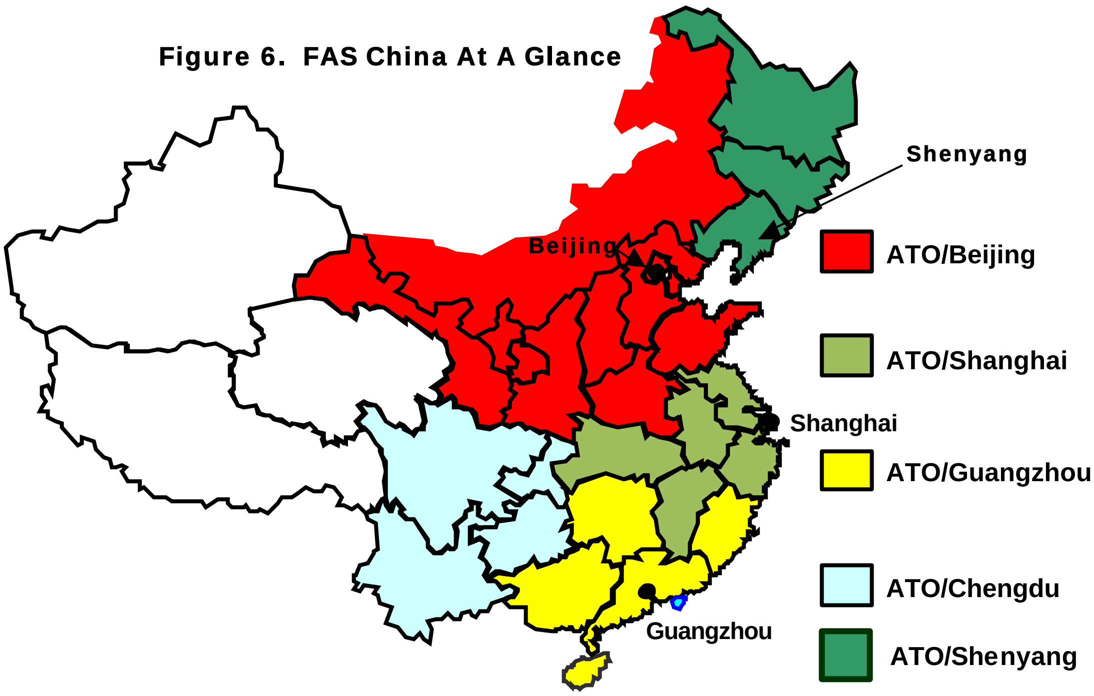


Source: ATO/Shanghai research

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 directly to retailers.

II.C. Regional Market Profiles

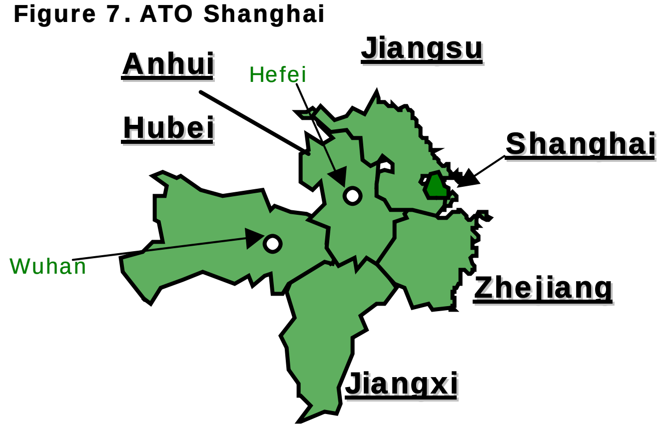
Figure 6. FAS China At A Glance



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 five offices in China, with Agricultural Trade Offices in Beijing, Shanghai, Guangzhou, Chengdu and Shenyang (opening in 2009), and an Agricultural Affairs Office in Beijing. Individual market profiles for each region are offered in the following sections.

Shanghai Region Market Overview

Figure 7. ATO Shanghai



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 mainland China's GDP. Massive infrastructure investment has led to major improvements in logistics and drawn the region closer together. The opening of the Yangshan deepwater port facility in 2007 is expected to make Shanghai the world's largest container port within the next few years. Shanghai's large expatriate community (estimated at 500,000) 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 increasingly saturated, 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 6. Top Players in Shanghai Retail, 2007

Company	Outlets in Shanghai
Lianhua	2,171
Carrefour Hypermarket	20
RT-Mart	8
Nonggongshang	2123
Hualian	957
Lotus	20
Metro	4
Hualian GSM	18
Shanghai Lianjia	12
Shanghai Homegain	122
Jieqiang Tobacco, Sugar & Wine	192
Auchan	4
Watson	51
Jiajiale	38

Source: Shanghai Statistical Yearbook, 2008 & ATO Shanghai interview

Hypermarkets

In 2007, there were 133 hypermarket stores in Shanghai; of this total, 74 were foreign retail stores which accounted for 78.6% of total sales volume, enjoying an overwhelmingly dominant position. Hypermarkets constitute the single best retail venue for imported products. International chains such as Carrefour and Wal-Mart are both familiar with these 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 in the Pudong area have it down to a science. Despite this, imports rarely constitute more than 5% of total SKUs even in 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.).

Hypermarkets are eating into market share for supermarkets as growing car ownership 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 expertise to upgrade their management to compete with the international retailers.

While Carrefour continues to dominate at the high end, with 20 hypermarkets presently in Shanghai alone, Lotus has quietly expanded and now actually also 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 and added two more stores in 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 five stores in Shanghai, also plans to ramp up its efforts, having recently opened a store in Tianjin and another in Shanghai. 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.

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 its competitors. To this end, Metro has added a training kitchen to its facilities in Shanghai. 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 some 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 registered only 730 million RMB in sales in 2006, 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 three years ago to form the behemoth Bailian, the largest retailer group in China, 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 the challenge of 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.

In order to compete with hypermarkets, Shanghai's supermarkets are putting more efforts into enlarging their fresh section, catering to the taste and sanitary demand of local consumers. The local government is also encouraging supermarket chains to create 'fresh' supermarkets, expanding the floor space dedicated to fresh products from less than 1/3 to over 1/2. Over 300 stores in Shanghai have finished the change. And sales of fresh produce are gradually increasing. 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 discounts, but does not carry fresh products. The threat from Dia should not be understated. Carrefour had 263 of these stores in Shanghai in 2007. Dia stores are small, carrying a limited range of products, and most of them located nearby to residential areas. Nonggongshang has also established a chain of discount stores called 'One Price' or '5 Reminbi,' offering most products for less than $1. They had 300 stores in 2007. The key to success for discounters lies in appropriate product selection; currently each Dia store has an average of only 30% private label products, and this fairly low proportion of private label products cannot leverage the company to have products at significantly lower prices than other retail formats such as hypermarkets and supermarkets, while the convenient location of most discounter outlets offers local residents another shopping alternative.

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 (recent anecdotal information suggests that Lawson has already sold out all its shares back to Hualian). 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

Shanghai's convenience store industry is by far the most developed in the country, with the city playing home to an estimated 5,650 convenience stores—nearly 1/3 of the national total. One source estimates the number at 1 store per 4,400 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, although recent source told post that Lawson already sold out its shares back to Hualian). However, new investment is coming from international convenience chains. Japan's Family Mart entered the city two years ago, and now has 126 stores in Shanghai. 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. Convenience stores development faces a very challenging environment, limited shelf and storage spaces make stores heavily rely on a sophisticated logistic system that can provide 2 or 3 times daily delivery on fresh and ready-to-eat products that are attractive offering in these stores, while even in Shanghai, most of convenience stores are just guaranteed one time delivery per day. In addition, the requirement for small package size has also limited its supply source. Its concept of trading higher prices for convenience will still take time to be accepted by more consumers.

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). 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.

Specialty supermarket stores and Boutique Stores

Boutique and specialty supermarket stores in Shanghai have multiplied, becoming a force unto themselves. Expatriate grocery stores continue to expand. The most venerable, City Shop 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 Shop 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 Napa Reserve, which features a wide range of wines from that region of California. (Please see CH8802 Shanghai Retail Wine Shops).

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).

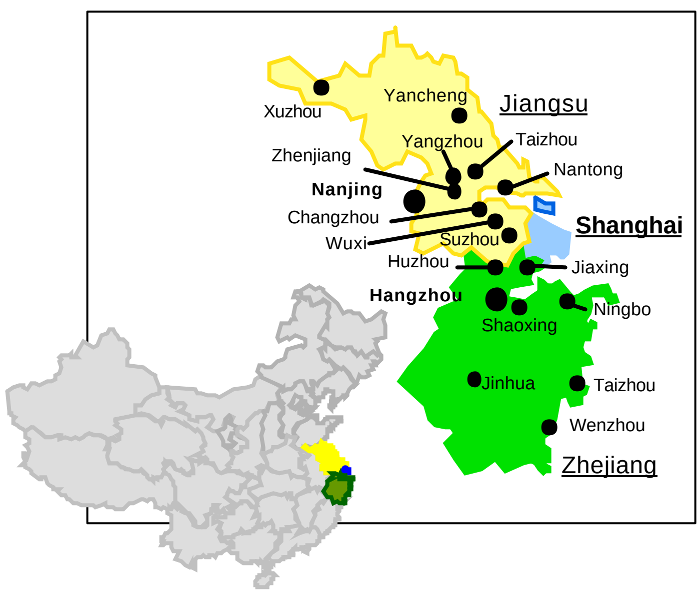
The capital of Zhejiang Province, **Hangzhou** is home to Carrefour, Metro, Lotus, Auchan, Wal-Mart, Lianhua, and Hymall, among other super- and hypermarkets. Hangzhou's retail market is doing far better than expectations: in an ATO-organized nationwide retail promotion involving 24 Carrefour stores, the Hangzhou store ranked 7th in sales: ahead of Guangzhou and following stores only in Shanghai (4 stores) and Beijing (2 stores). In addition, the Hangzhou store was extremely aggressive in recruiting distributors and products for the event, and ultimately carried far more items than originally agreed. (Please see CH7819).

Suzhou's market is steadily growing, and a privately-owned cold chain already exists, with temperature-controlled warehouses and delivery trucks. Metro has established itself in Suzhou as the destination for one-stop shopping, and its membership is already 130,000 strong. To further stimulate market growth, the city's infrastructure is developing at light speed. Several new highways were built recently; bridges cross the Yangtze River, and a light rail system has been scheduled for completion in 2008. (Please see CH7816).

Development is now moving on to a third tier of cities. Particularly notable are **Wuxi**, 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.

Nanjing's market and imported product consumption have increased substantially. Based on ATO/Shanghai interviews, major retailers including Metro, Walmart and Carrefour stated that the higher the percentage of imported food items in their store, the better their sales, indicating the high potential for imported food in Nanjing. Nanjing is also home to Suguo, a retail giant which dominates more than fifty percent of the city's market share.

Figure 8: The Yangtze River Delta



Although **Wenzhou** is one of the richest cities in China, its market for foreign imports is still relatively underdeveloped. Wenzhou was only opened to international retail giants in 2006 and while its market was slow to open, the retail sector is growing quickly. ATO/ Shanghai is conducting a multi-level promotion in Wenzhou in 2008. According to the Wenzhou Retail Association, a "Sourcing Alliance" consisting of all the important retailers in Wenzhou will be organized in 2008 to consolidate the sourcing of imported food products, to strengthen the bargaining power of Wenzhou retailers against food importers. (Please see CH7814).

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.

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. As income levels rise throughout urban areas in China, potential markets are emerging in growing cities everywhere. In September and October 2007, the ATO/Shanghai led a multi-level campaign promoting U.S. food products in Wuhan, in cooperation with the Hubei Culinary Association and Wuhan Wushang Bulk sale Chain Co. Ltd. As the sales revenues generated in the Wuhan catering industry rose by 17% in the first half of 2007, the ATO's promotion further revealed the city's potential market through a seminar, cooking demonstration and contest, tabletop shows, food tasting reception, one-on-one meetings with local traders, and a two week in-store promotion. The city itself seemed receptive to American products, and with the rapid increase of supermarkets, hypermarkets and convenience stores, as well as more than 40,000 restaurants, it has a reasonably developed retail sector. (Please see CH7815)

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 Market Overview

Rapid economic growth in northern China continues to transform consumption patterns, especially in the wealthiest cities. Northern China's retail food sector grew in 2007 with sales increasing by 16.0 percent in Beijing and 18.2 percent in Tianjin. Although the northern retail business has developed more slowly than in the south and east because of its relatively larger rural population and lower incomes, interest in the region is rising sharply. Multinational retailers and local retail operators have increased their presence because of increasing competition and retail market saturation in China's coastal and first-tier cities.

The two largest ports in the region are Tianjin (see CH8413) and Qingdao (see CH7417). Qingdao, which trades with more than 450 ports globally, is the country's largest agricultural port in terms of import-export volume. It is also the largest refrigerated port in the region with a total capacity of 393,000 refrigerated containers. Qingdao imports nearly 20 percent of China's agricultural products from the United States each year. Tianjin, meanwhile, handles cargo for both North and West China, and is a major channel for the import of fruit, nuts, grains, dairy products, poultry, meat products, cotton, soybeans and wood products.

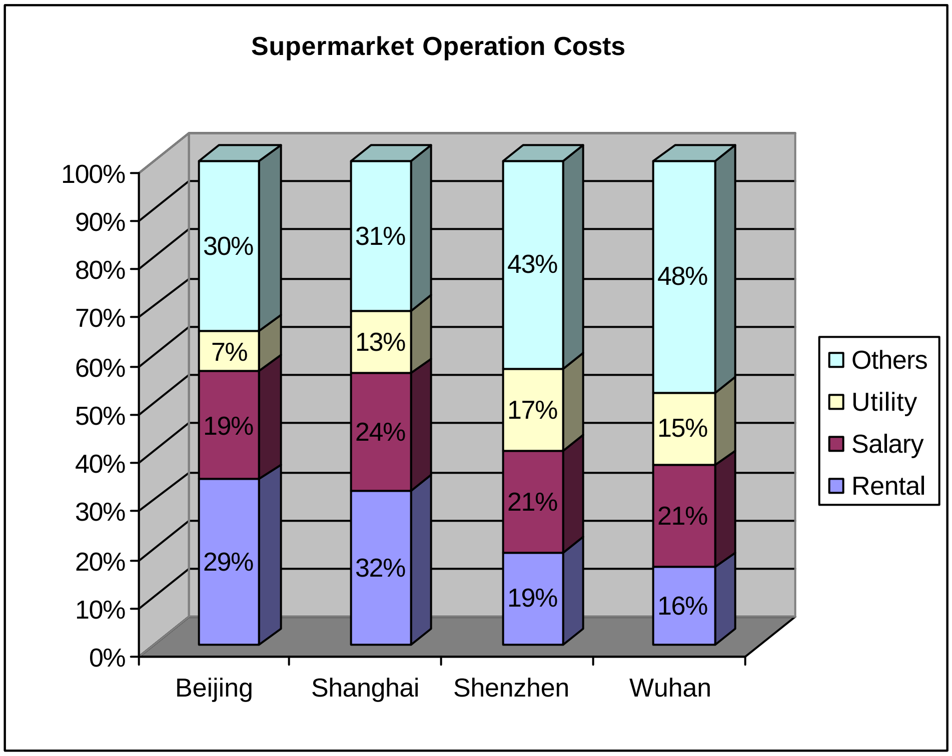
While the majority of the rural population still purchases fresh food, the demand for packaged, brand-name products in urban areas has grown quickly because of rising incomes and growing interest in convenience, health and quality. In response, retail operators are shifting their consumer targets. Simultaneously, one-stop shopping is losing its attraction among a significant swath of consumers because many now prefer to shop from specialty stores. With discount prices and one-stop shopping concepts no longer attracting a growing number of customers, some retailers are increasing the variety of fresh products available. Carrefour is an example of a major store that has established an array of fresh product suppliers that allow it to sell quality goods at competitive prices.

Since China's retail sector remains underdeveloped and highly fragmented, the modern large-scale 'hypermarket' retailing format is still more or less limited to cities. This is because of the difficulties of penetrating rural regions where infrastructure is poor and populations are spread out. In general, hypermarkets are typically adjacent to larger shopping and entertainment complexes, which can include monopoly stores, coffee shops, restaurants, cinemas and children's playgrounds that enable consumers to combine shopping trips with leisure activities. As an added convenience, most hypermarkets in Beijing, Tianjin and Qingdao offer free parking facilities to attract more car-owning shoppers. For shoppers without cars, these stores often provide shuttle bus services that stop at nearby upscale communities.

Compared with most hypermarkets, which are usually operated by multinational retailers, most supermarkets in China are run by domestic companies. The top three retailers in terms of the value of sales are all domestic players: China Resources Enterprise Co. Ltd, Shanghai Nong Gong Shang (Group) Co. Ltd and Lianhua Supermarket Holding Co. Ltd. Meanwhile, there are still many other supermarket retailers operating in different regions.

The number of convenience stores in China increased by 11 percent in 2007, while their total sales value reached RMB 19 billion (USD 2.7 billion). Unfortunately, convenience stores are often limited by logistical issues and competition from other retailers so the speed of their expansion in China has been lower than other retail formats. Because of their low inventory and limited variety of products, convenience stores require a more sophisticated on-time distribution system. Some special products may even require delivery a couple of times per day. These stores do, however, provide convenience through flexible shopping hours (usually open 24-hours), service and their short distance from consumers. Most customers in China though, especially those over the age of 40, are still sensitive to price and prefer to spend a greater amount of time shopping at larger retailers instead of at the more expensive convenience stores.

Evolution of the retail sector has also been affected by increasing rents in Beijing and Shanghai which now account for a higher proportion of operation costs compared to other Chinese cities. According to CCFA, these rental fees increased by 5 percent in 2007. Higher inflation, especially for food products, and recent labor laws that require all employers to sign legal contracts with their employees have also increased operation costs and reduced retailer margins in 2007.



Source: CCFA data

Overview of Multinational Retailers in North China

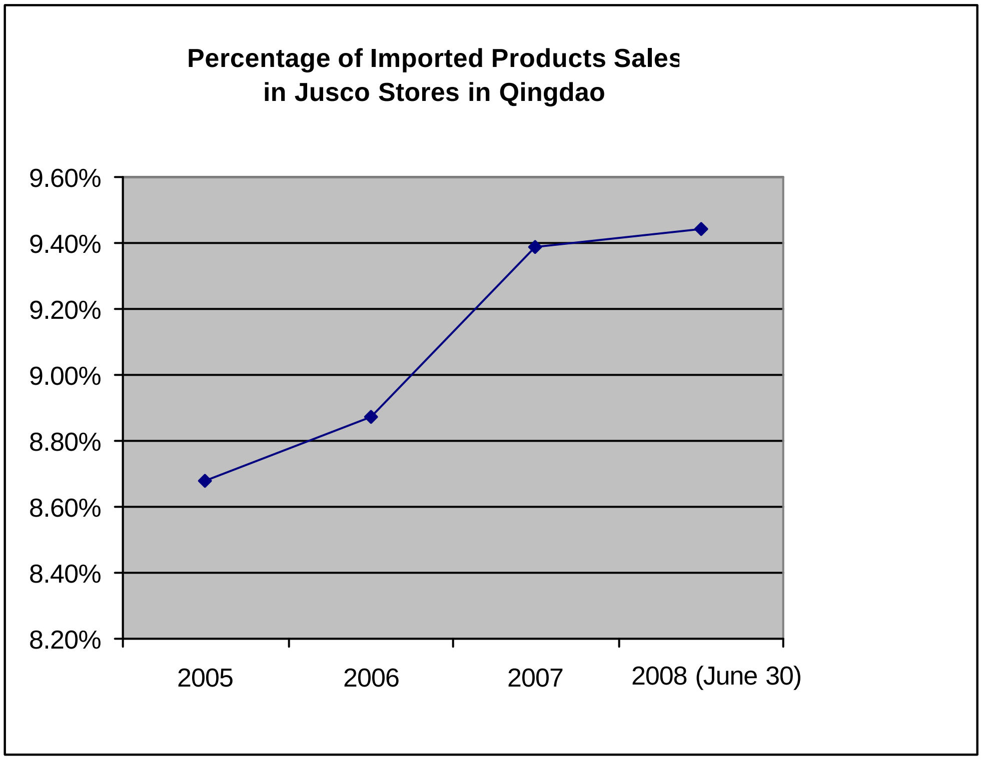
Retailer	Beijing	Tianjin	Qingdao	Dalian	Harbin
Carrefour	9	5	2	3	5
Wal-Mart	5	2	1	3	3
Metro	2	1	1	1	1
Tesco	2	4	0	3	0
RT-Mart	0	1	2	0	2
7-Eleven	66	0	0	0	0

Northern China Retailers

Hypermarkets

Hypermarket sales grew 19 percent in 2007, boosted by the opening of 249 new outlets. This has attracted many new competitors, both international and domestic. Tesco, the UK's biggest retailer, opened its first hypermarket in Beijing in 2007. The store is located in the CBD area, covers 8,000 sqm and receives about 8,000 customers a day. CRC purchased its rival Home World Hypermarket Co., which operated 55 hypermarkets in China. Jusco opened its first hypermarket in Qingdao in 1998 with more than 40,000 sqm of sales area and over

1,000 parking spaces. It has become a top choice for foreigners and upper-middle class customers based on its location, quality products and good service.



Source: Jusco

In line with increasing incomes and changing tastes, the sales volume of imported products at hypermarkets has continued to increase. Consumers can find a variety of imports from Korea, Japan, Thailand, US and European counties that include snack foods, beverages, wine, seasonings and dairy products. With the market becoming increasingly saturated in first-tier cities, many hypermarket operators are now looking at second-tier cities. For example, CRC has expanded its retail network into inland areas by opening outlets in Luoyang, Henan Province. Jusco also opened a new hypermarket in Yantai in July 2008 with an area of more than 80,000 sqm. With this most recent store, Jusco now owns three outlets in Shandong Province. The company plans to open another three stores in Shandong in 2009 in the second-tier cities of Jinan, Weifang and Weihai.

Supermarkets

Supermarket sales grew by 17 percent in 2007. Compared with the hypermarkets, which are mostly run by multinational retailers, most supermarkets in China continue to be operated by domestic retailers. After taking over its rival Home World, CRC has become the country's top local supermarket operator in terms of sales. The acquisition also gave CRC a significant market share in the northwest region. Most supermarkets are located near large residential areas and sell food products, basic cosmetics and toiletries. With support from local governments, some of these local retailers have expanded their networks to rural areas.

Discount Stores

Driven by their price advantage, discount stores developed rapidly from 2002 to 2007. The Carrefour-owned discount store DIA currently has 126 outlets in Beijing. Because of the low profit margin, these focus more on private label products (over 70 percent of the total) as well as limited fresh food products that target low income consumers. Many Chinese consumers, however, still lack interest in private label products because of poor perceptions about quality. This has created a major obstacle to store expansion.

Convenience Stores

Convenience stores saw strong growth in 2007, increasing sales by 11 percent to almost RMB 19 billion. Seven-Eleven leads in retail sales, accounting for 39 percent of the total for convenience stores. As of June 2008, Seven-Eleven owned 66 stores in Beijing. Most are located near upscale communities and business centers to provide service to white-collar workers, upper-middle class people and a younger generation that demands convenience. These stores feature daily necessities and ready-to-eat items. The strategy of the company is to accelerate expansion in mainland China over the next five years.

Regional Retailers

Because of their geographic advantage and good relationships with local governments, regional retailers have become strong competitors to the multinational retailers attempting to expand their business in China.

Jia Jia Yue Supermarket

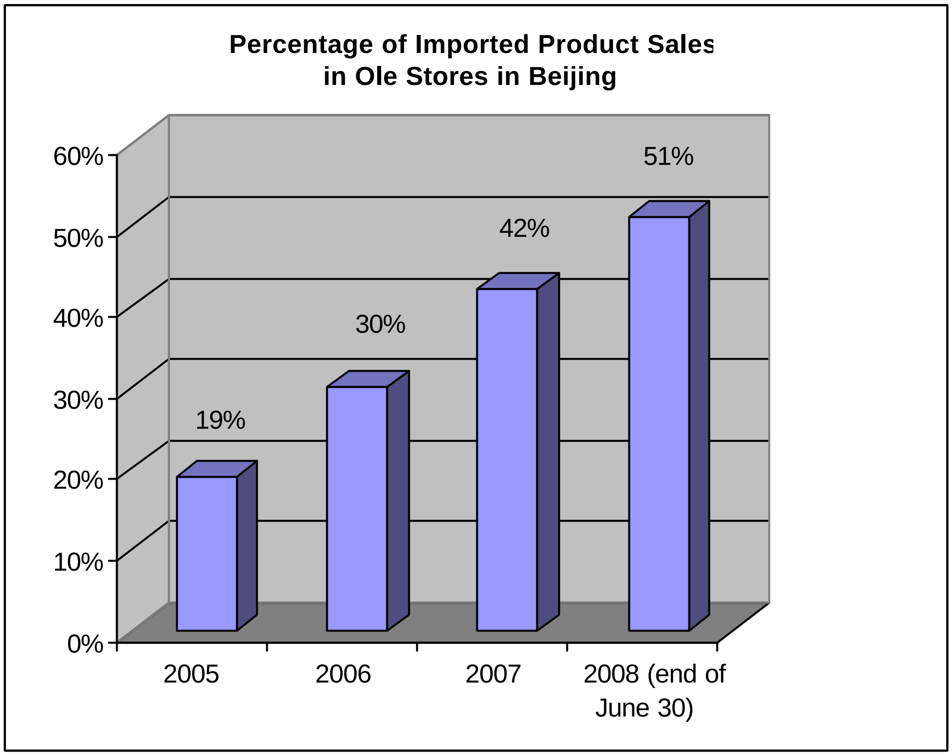
Jia Jia Yue Supermarket, which is based in Weihai, Shandong Province and owns more than 100 stores, three grocery product distribution centers and one fresh product distribution center, is becoming one of the most powerful competitors in Shandong's retail market. To ensure stable sales and high quantity, the company signed contracts with local famers to grow products to the supermarket's guidelines.

Li Qun Supermarket

Li Qun Group, the No.1 retail company in Shanghai, is based in Qingdao and operates throughout Shandong Province. The Group owns 27 hypermarkets with more than 10,000 square meters in addition to 700 convenience stores that target upper-middle level shoppers with limited imported products. Their sales reached RMB 12.2 billion in 2007.

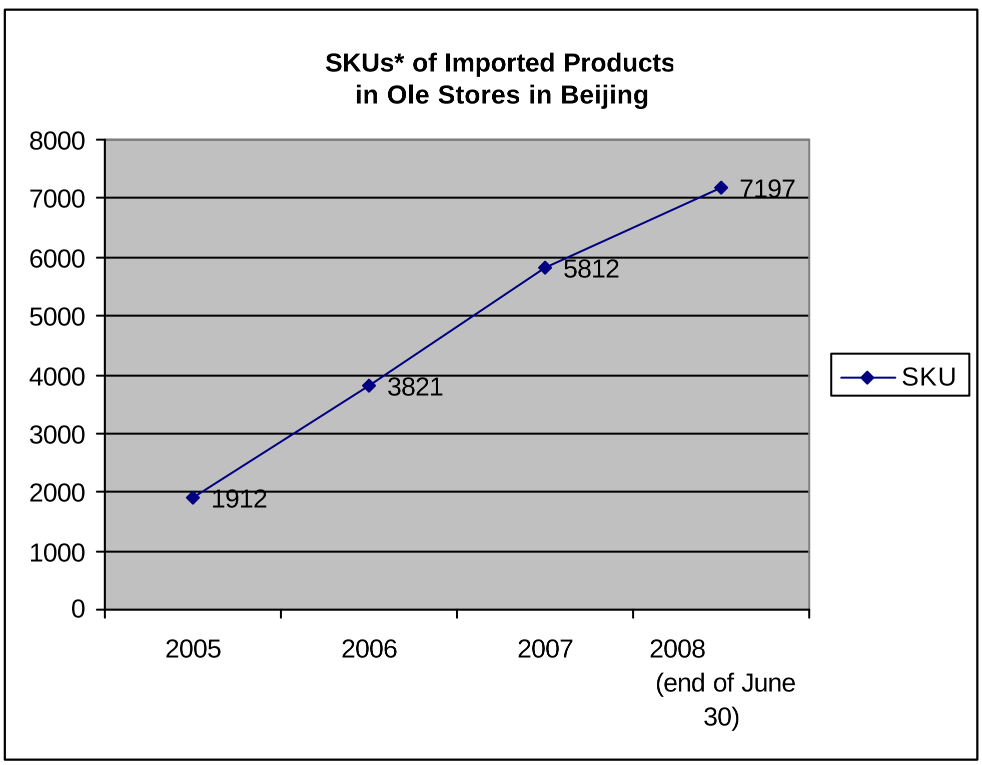
CR Vanguard Co. Ltd

CRC bought its rival Home World in 2007 to become the top supermarket operator in terms of retail area, surpassing Carrefour. CRC's sales in 2007 amounted to RMB 55 billion (USD 7.86 billion). CRC now owns two hypermarkets, seven Ole stores and twenty-four convenience stores in Beijing. All Ole stores are located at business or shopping centers and target upper-middle income shoppers and white-collar workers. Sales of imported products reached 51 percent of Ole's total sales by mid-2008.



Source: CRC

Earlier in 2008, CRC held a US food festival in its seven Ole stores in Beijing that featured 500 various U.S. food products, including 150 that were new to the market. The total sales from this 25-day promotion totaled more than RMB 0.8 million (USD 0.11 million). CRC continues to expand its high-end market share through the accelerated opening of new stores in Beijing, where it plans to open four more by the end of 2008.



**SKU: Store Keeping Unit*
Source: CRC

Northern Regional Update

As the host city of the 2008 Olympic Games, Beijing had new opportunities to boost consumer spending over the next few years because of improved infrastructure and living conditions. The Beijing Municipal Statistics Bureau estimates the city will see no less than a 2 percent increase in its GDP. In addition, 1.82 million jobs will be created, which will accelerate the development of the retail sector. For the Olympic Games, a special monitoring center for food safety was set up to issue warnings about food risks and food-related emergencies during the games. This will increase food safety awareness among Chinese consumers and help improve the food safety in retail outlets.

Retailing companies have also increased interest in late-night shopping in Qingdao and are planning to open more 24-hour convenience stores there. A Qingdao-based retailer said that the stores in that city have seen increased profits during the late night hours. His company's stores that operate at night make about the same income as they do during the daytime. Food, cigarettes and wine are the bestselling goods at night, particularly during the peak hour between 2 and 3 am. There are currently more than a hundred such stores operating in Qingdao. The retailer also said that although there remain considerable differences between Qingdao and larger cities like Beijing and Shanghai, the southern part of the city offers great potential for new convenience stores.

Northern Retail Trends

Penetrating second-tier cities

Because of fierce competition and near-saturation of the retail market in first-tier cities (Beijing, Shanghai, Guangzhou), multinational retailers are shifting their focus to second-tier cities with a significant potential for development. As of 2007, Carrefour owned three stores in Urumqi in the western region of Xinjiang and opened its 1,000th outlet in the world in Tongzhou District in rural Beijing. Carrefour has stated that approximately 40 percent of its outlets are located in secondary regions and cities. Wal-Mart has ventured into the impoverished Henan Province, choosing to build its first store in the province in the second-tier city of Loudi instead of the capital of Zhengzhou.

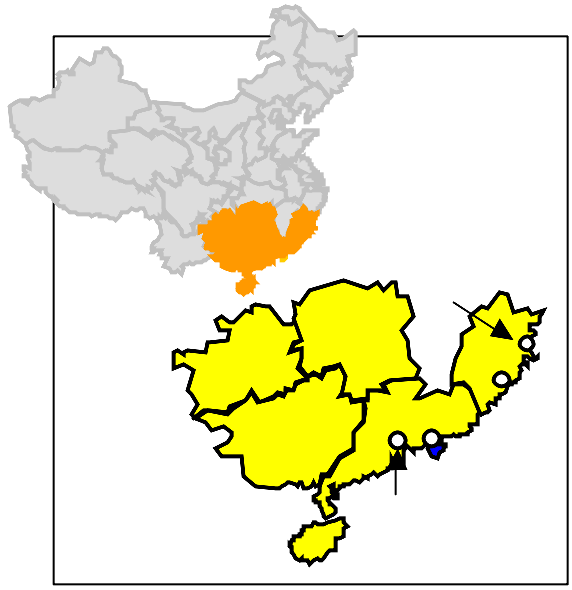
Internet shopping

Fifty-five million domestic internet users shopped online last year, spending a total of RMB 59.4 billion (USD 8.6 billion). According to Alibaba's vice president, Taobao is the top online shopping website in China with a transaction volume is expected to surpass RMB100 billion (USD 14.4 billion) in 2008, an increase of 130 percent from the previous year. These websites target young consumers who have a fast-paced lifestyle and surf online regularly. Competitive prices and convenience are the primary reasons for online purchases. On Taobao (www.taobao.com.cn), consumers can find imported products including fruit, snack food, beverages, cookies, seasonings and sausages. Some food importers and distributors in North China have also attempted to enter this market. However, obstacles such as vendor credit, bank e-transfer systems, delivery issues and quality assurance can hinder the development of these businesses.

Local sourcing and local management (Establishing regional distribution centers)

Because of China's expansive territory and regional differences, many multinational retailers have altered their strategies when entering and exploring this market. Carrefour adopted a strategy that focuses on locally sourced products, particularly fresh foods. This is especially the case in China, where around 95 percent of Carrefour's items are purchased domestically. Similarly, around 90 percent of the products offered at Wal-Mart's Chinese stores are produced domestically. Additionally, Carrefour has developed direct sourcing agreements with Chinese farmers. In 2007, the company acquired a 160 sq km plot of land where up to 40,000 farmers will produce food for the company. A greater emphasis on partnerships with farmers enables Carrefour to reduce costs and have better control over food quality. Many multinational retailers have recruited more local employees to encourage the transfer of knowledge and to better adapt to local tastes.

Figure 1. South China Region



South China Market Overview

The economic and cultural environment in South China for U.S. agricultural products is bright. In the past decade, rising incomes and continued urbanization have led to diversity of diet and greater receptiveness to imported foods.

The retail sector keeps growing in a stable but competitive way. Retail sales for Guangdong and Fujian provinces were estimated at USD 201.3 billion in 2007, up 29.4 percent from the previous year. Food accounts for 36 percent of this total retail figure.

With increasing concern for health and quality lifestyle, the demand for imported foods is also on the rise. Though demand for imported foods grows, it only accounts for a small fraction of the total food sales in this region.

Table 1. Key Southern Population and Retail Sales Volume (2005-6-7)

Rivalry in supermarkets and hypermarkets was fierce these past three years, and in 2008, retail competition in South China has gotten tougher. Many of the global retail giants are making ambitious expansion plans in Guangzhou and Shenzhen as well as second and third tier city markets.

The key retailers in South China are *Wal-Mart* (38), up by nine from the previous year; *Carrefour* (25), up by three; *Jusco* (13), up by two; *Metro* (7) up by two and *Tesco* (5), up by two.

	Total Population	(in millions)		Retail Sales		(in billions)
	2007	2006	2005	2007	2006	2005
Guangdong	94.49	93.04	91.94	US$154.72	US$119.97	US$103.72
Fujian	35.81	35.58	35.35	US$46.53	US$35.58	US$30.87
Hunan	63.55	63.42	63.26	US$49.0	US$37.29	US$32.36
Guangxi	N/A	47.19	46.60	N/A	US$21.06	US$18.38
Hainan	N/A	8.36	8.28	N/A	US$4.06	US$3.53

(Source: 2008 Guangdong Year Book, ATO/Guangzhou)

Jusco, Ole, Metro and Sam's Club are the best venues for U.S. imported products sales while other retailers carry fewer SKUs. Some branded items are selling well in these hypermarkets and supermarkets.

Every so often, these retailers will launch 'in-store food festivals' and promotions to attract more traffic. Many U.S. imported food items are available on key retailer shelves in South China.

Popular U.S. food items include *Alaska* seafood, U.S. poultry, U.S. produce items such as *Sunkist* oranges, *Washington* apples, *Northwest* cherries, as well as various grocery items such as breakfast cereal, fruit/vegetable juices, spaghetti sauces, condiments, cheese, dried fruits, nuts, candy, olive oil and wines etc.

Newcomers intensify the competition. *Tesco*, for example, set its sights on South China by opening a new *Tesco* store and setting up its South China administrative headquarters in Guangzhou early this year.

Recent merger and acquisition activities include *Wal-Mart China Investment*, which purchased 35 percent of *Trust-Mart* and; *AEON Stores* (Hong Kong) which acquired 100 percent stake of *AEON Shenzhen*.

Convenience stores are another dynamic retail format in South China, especially in Guangzhou and Shenzhen. Many have started to stock imported food items as well as fastfood counters to boost profits over lower-margin, daily items. The most popular imported food items include chocolates and juices. Some even add a fresh produce display in small fancy packages.

In addition, there are some specialized imported grocery stores available, featuring various imported varieties from different countries. However, this kind of store' outlet number is limited and the store size is relatively small. Their target consumers are expatriates living in South China.

Emerging Market Trends

Organic and natural products are a new selling point for many multinational retailers. With increasing concern for health, food safety issue and quality lifestyle, more Chinese consumers are willing to pay premium prices for new products with more nutrition, i.e., food that contain vitamins, zinc, iron, calcium, and less pest residues.

Local retailers also tend to upgrade their store image and add special areas to display imported products including organic and natural products. Imported wines, fruits, baby foods, and snacks are the most popular categories. *CR-Vanguard* (Zhuhai Store), for example, recently opened a special imported food area featuring over 400 SKUs of imported food items.

As there are more concerns about environmental issues, retailers stopped distributing free plastic shopping bags this June.

'Theme promotions' on special occasions and Chinese holidays are the new highlight for retailers. *Spring Festival*, *Mid-Autumn Festival*, *Dragon Boat Festival* plus *National Day* in October are traditional holidays. Western festivals such as *Valentine's Day* and *Christmas* are becoming increasingly important events for food item promotions.

Decorative materials, fancy gift packages and waterfall display during these important festivals help retailers persuade consumers to spend money on food items including imported products.

In order to differentiate from other competitors, cold chain management and organic merchandising were introduced into several key retailers. Refrigerated counter displays have increased during the last two years.

However, cold chain infrastructure development is still a major concern for retailers in the South. New distribution centers and modern expressways are better connecting ports with key markets throughout the South. This enables more imported foods to be reliably and effectively distributed throughout the region. However, while local importers and distributors expand operations, Hong Kong transshipments still play a significant role in food trade.

Guangdong Retail Market Update

Guangdong Province has the highest GDP at USD453 billion (RMB 3,108 billion) of any single province in China, with retail sales valued at over USD154.7 billion (RMB 1,059.8 billion) in 2007, up 29 percent on 2006 figures. Cantonese are famous for eating and open-minded when it comes to trying new products. In fact they were one of China's earliest consumers of Western-style foods.

Driving Guangdong's economy is the *Pearl River Delta (PRD)*. Guangzhou sits at the apex of the *PRD* and its economic and political influence resonates throughout Guangdong and into neighboring provinces. Shenzhen is the second largest city in the *PRD*. Enjoying a *Special Economic Zone* status and easy access to Hong Kong and Macau, Shenzhen has attracted a large affluent migrant population from all over the mainland and abroad.

In Guangdong, retailers competed aggressively to win prime new shopping mall space. This growing trend of combined leisure and cultural experiences with retail developments is fairly new, but gaining ground. For example, in Shenzhen, new *Holiday Plaza*, where the new *Ole* store located, has similar entertainment facilities (ice-skate rink and theatres) as the *Mix-City*.

Several big shopping malls are being developed in neighboring cities such as Dongguan, Foshan, Zhuhai, Zhongshan, as well as other fast developing cities throughout the Pearl River Delta.

Key retailers in Guangdong include multinational players such as *Jusco* (13 stores), *Carrefour* (14), *Wal-Mart* (19), *Metro* (2) and *Tesco* (5) as well as domestic players such as *CR-Vanguard* (191) and *Parkn'shop* (37). All have expansion plans in the coming years.

There is one *Sam's Club* in Shenzhen. A new club will be opened soon in Guangzhou, which signifies *Wal-Mart's* initial foray in Guangzhou's high-end retail market. Other high-end retailers include *Ole, Metro and Jusco.*

In the South China convenience sector, *7-Eleven* still is the lead with more than 480 outlets concentrated in Guangzhou, Shenzhen and neighboring cities like Dongguan and Zhuhai. Taiwan-based *XiShiduo (C-Store)* has 100 convenience stores in the Guangzhou and Shenzhen. Most are located in upscale communities. Plans are underway to establish a branch office in Shenzhen and open more stores there, along with adopting a franchise management approach.

In addition, *BP* gas station stores have expanded to 322 outlets, *OK* has 90 stores, *Quanjia* 14 stores and *Jiadeshi* 38 stores in Guangdong.

Updates on Fujian and other key markets in South China

Fujian is a key retail market in South China. It was one of the earliest provinces to open for foreign trade in China's history. It is also one of the major hometowns of over ten million overseas Chinese living in over 160 countries and regions in the world. Among them, over one million are permanent residents in Hong Kong and Macao. It is estimated that 80 percent of the Taiwanese are Fujian descendents.

As a result, Fujian people have an open attitude towards the western culture. In 2007, Fujian has a total population of 35.8 million, with a GDP of US$134 billion (RMB916 billion). Its total retail sales were about US$46.5 billion (RMB318.8 billion).There are many retailers in Fuzhou and Xiamen.

Fuzhou and Xiamen are key markets for imported foods. Quanzhou, Zhanzhou, and Jijiang are the emerging markets that most retailers have targeted including *Wal-Mart, Carrefour* and *Metro*.

Carrefour was the first to open with two supermarkets in Fuzhou city and the other in Xiamen. *Metro* also selected Fuzhou to open its first store in South China. Later, it opened new stores in Quanzhou and Xiamen.

Currently *Wal-Mart* has three supercenters and one *Sam's Club* in Fuzhou, and two supercenter stores in Xiamen as well as one each in Quanzhou, Zhangzhou and Jingjiang. All carry imported food items.

The convenience store sector keeps growing in Fujian. In Xiamen alone, there are over 150 convenience stores. The city has the capacity for one convenience store per every 3,000 inhabitants; that equates to a potential of 400 stores to satisfy the population of 1.2 million. *Beatrice* is locally regarded as the leading operator in this retail sector and is headquartered in Xiamen.

Hunan is also a fast developing retail market in South China. In 2007, it had a population of 63.5 million. Its total retail sales reached US$49.0 billion. Changsha is the capital city with presence of three *Wal-Mart* stores, two *Carrefour stores* and one *Metro*. Other emerging cities in Hunan are Loudi, Zhuzhou, Chenzhou and Yueyang.

In addition, Nanning, the capital city of Guangxi province is another emerging market.

Opportunities for U.S. Importing Foods into Southern China

There has been increasing demand for imported food items in the past five years. The most popular include baby foods/infant formula, chocolates, dried fruit and nuts, fresh fruit and vegetables, potato chips, popcorn and canned foods such as soup.

Washington apples, Sunkist oranges and California table grapes are commonly found on the shelves as are durians and lichees from Thailand, butter from New Zealand and cheese from France and Australia.

High value Northwest cherries have enjoyed good sales in the past three years. There is also increasing demand for U.S. blueberries.

While California wines are readily available, they need to compete with French, Italian, Australian, South African and Chile varieties in this market.

Other fresh and packaged foods from the United States are also widely available; however, consumers lack the basic knowledge of how to prepare and serve them prompting most consumers to hesitate rather than buy. In response, the U.S. Agricultural Trade office in Guangzhou actively encourages U.S. produce exporters to register their products and provide labels in Chinese.

Brand reputation and quality assurance are the key drivers as health and food safety concerns grow. Southern Chinese palates are opening to Western-style foods. As their purchasing power grows, so does their willingness to buy such premium price imported food items.

Promising U.S. food categories with little presence today include cheese, beef, fresh fruits, baby food, nuts, natural fruit/vegetable juices, snack foods and ice-cream.

Table 2

Popular U.S. imported items	Main foreign competitors
Oranges	New Zealand, South Africa
California Table Grapes	Chile, China
Washington Apples	Chile, N. Zealand, China
Red Meat (beef)	Australia
North West Cherries	Chile, New Zealand, China
Breakfast Cereal	U.K.
Frozen Potatoes	Canada, New Zealand
Dairy & Cheese	New Zealand, Australia, EU
Poultry (chicken wing)	Brazil, China
Nuts: (pistachio, almonds)	Iran
Wine	Chile, Australia, France, Italy, Spain
Fruit juice	France, Japan, Austria, Spain, Germany, Korea, Australia
Vegetable juicy	Japan, Korea, Austria
Alaska seafood (king crab, salmon)	Canada, Norway, Russia
Spaghetti Sauce	Italy, France, EU
Coffee	Japan, France, South Africa
Candy, Chocolate	Swiss, Italy, France, Belgium, Germany, Japan

(Source: ATO/Guangzhou)

Southwest China Market Overview

One in every 33 people on earth lives in Southwest China. With a population of over 200 million and a regional gross domestic product (GDP) of USD 290 billion in 2007, the area is twice the size, six times the population, and three times the GDP of Central America. The economic growth the region is experiencing is raising incomes and increasing the market for foreign products. The region is also known for its passion for food. Consumers are keen to try imported products and are willing to pay a premium for a quality product.

According to some estimates, middle-income consumers now represent almost 35 percent of urban population and at current growth rates will exceed 50 percent by 2010 and 7 percent of the total population by 2015. Economic growth in the provinces of Southwest China is some of the highest in the world, averaging between 12.0 and 15.6 percent in 2007. Growth in the regions two largest emerging city markets (ECMs) in the region, Chengdu and

Table 1: Rapid Growth in Value of Imports by Province

Region	Imports (million USD)		2006 Growth in Imports
	2005	2006	
Sichuan	3200.36	4396.70	**37.4%**
Chongqing	1772.26	2118.66	**19.5%**
Yunnan	2101.72	2833.34	**34.8%**
Guizhou	544.63	579.28	**6.4%**

Source: 2007 China Statistical Yearbook

Chongqing, accounting for 20 percent of the region's population, reached 17 and 18 percent, respectively, in 2007.

Table 2: Southwest China Hypermarket Retailer Distribution

Retailer	Ownership	Chengdu Outlets	Chongqing Outlets	Kunming Outlets
Carrefour	French	5	4	4
Metro	German	1	1	1
Ito Yokado	Japanese	3	0	0
Isetan	Japanese	1	0	0
Auchan	French	3	0	0

Chengdu: An Emerging City Market Ripe for Development

The markets of Southwest China are less saturated with imports than developed port cities, providing several advantages to marketing products in the region. There is less foreign competition despite burgeoning demand. In addition, marketing dollars go further because new imports face less foreign competition in Southwest China than in the more developed port cities. Finally, Sichuan food plays a leadership role in food trends. It is held in high esteem across China and influences both the national market and other regional markets.

Chengdu, the capital of Sichuan province, is the wealthiest and most advanced city in the region. Chengdu currently has the largest market for imported products. Chongqing is growing rapidly, but incomes have not risen to the levels of Chengdu yet, so it has a smaller consumer base. Incomes in Kunming and Guiyang are not as developed yet. Outside of Metro in Chongqing, which has large contracts for imported products with Yangtze riverboat tours, hypermarkets in these cities carry a smaller percentage of imported products than in Chengdu.

Getting Your Product to Market: Local Distributors, Importer-Direct, and Regional Distribution Centers

There are three main channels for distributing products to Southwest China: local distributors which purchase their product from port cities and then sell their products to retailers; regional distribution centers, normally associated with a single retailer; and importer direct, when retailers often working with a referred importer, bring products directly from the port. Regional distribution centers are responsible for purchasing and logistics for regional and national stores. Importer direct tends to be exercised by chains with less national presence, like Ito Yokado, or with highly perishable products.

Products directly purchased from port city importers and shipped directly to retailers or their central distribution centers are largely cash transactions. A significant quantity of imported products is purchased by local distributors from port city importers and then sold to the retail market. Most transactions with local distributors are carried out on a credit basis. Local distributors take on some of the retail risk by agreeing to the returns of expired or unsold products.

Upscale Hypermarkets Require Two-Pronged Approach

The higher-end hypermarkets tend to use national distribution systems, often using national purchasing managers. Metro uses this model. Retail chains with more centralized purchasing systems give local store managers less control over which imported products are on their shelves. The less centralized retailers give their local managers more control over what products are in stores, but often what is available is still determined by regional or national hubs. Carrefour and Auchan fall into this model.

Lower-End Retailers' and Local Distributors a Barrier to Introducing Imports

Lower-end hypermarkets and supermarkets tend to use local distributors for their products. Local distributors provide more favorable terms with retailers, including paying slotting fees and selling products on credit. As a result, local distributors are reticent to offer unfamiliar foreign products with unknown market potential. Combined with the reduced purchasing power of low-end retail consumers, this makes breaking into the lower-end segment of the retail sector more difficult.

Meats, Produce, High Value and Value-Added Products: Product Influences Marketing Channels

The majority of imported meats are purchased by retailers or their distribution centers directly from port city importers. Most imported meat is frozen. Imported fresh fruits and vegetables frequently are handled by local wholesalers. While produce is generally locally purchased, some is directly purchased from importers. Imported processed foods are the most likely to go through local distribution channels, especially when there is no central distribution system. These local distributors will often arrange more favorable terms of agreement than central distributors in port cities, for example return of expired or unsold products. They often work on commission. In addition, local distributors tend to promote imported products through retailers to increase product sales.

Strong Growth Opportunities for Those Who Overcome Logistical Challenges

Consumers are interested in quality food products, and the local food culture promotes experimenting with new food products. Another asset is the reputation of U.S. products. They are held in high esteem for their quality and safety.

Key obstacles include logistics and knowledge of how to use new-to-market products. The distance from major port cities such as Shanghai and Shenzhen is a challenge for some U.S. imports. Except for air transport, port to retail transportation time is from two to five days, and the cold chain is not always reliable.

Table 3: Market Entry into Southwest China	
Advantages	**Challenges**
Growing middle class: An estimated 35% of the 65 million urban residents in Southwest China are middle class or higher. This is projected to reach 50 percent by 2010.	**Intellectual property rights**: fraudulent labeling of domestic products as imports, imports via grey channel relabeled as "Made in China"
U.S. products valued for safety and quality	**Strong local competition** for fresh produce and some meat products
Sichuan cuisine sets trends for "Chinese" cuisine throughout all of China	**Limited infrastructure and distribution**, especially for perishable products; weak cold chain infrastructure
Regional interest in trying new foods	Geographical **distance from port cities**
Retailers receptive to import promotions	Many local customers perceive frozen meat as inferior to fresh products.
Retail outlets increasingly perceived as cleaner, safer than traditional wet markets.	**Lack of importer and retailer knowledge and training** in purchasing, handling, and merchandising U.S. products

Sidestep Domestic Competition by Marketing U.S. Imports as High Value Products

Differentiating U.S. products' quality, safety, and value capitalizes on their reputation with consumers. The growing number of affluent consumers in Southwest China is willing to pay a premium for a superior product. In response to safety and quality concerns, the presence of "green food," the Chinese equivalent to organic, in the supermarkets has exploded. Superior quality and safety helps to differentiate U.S. products from their domestic counterparts. This is critical when competition is strong, as it is for meats, fruit, and vegetables. For this reason, it is important that the integrity of imported products be maintained throughout the distribution chain from port city to emerging city markets. Further development of the cold chain in many Emerging City Markets is essential for maintenance of refrigerated product quality. For example, a market currently exists for premium non-muscle meat poultry products, like chicken paws and wing tips.

Intellectual Property Rights Violations Pose a Threat to U.S. Product Reputation

Throughout China, fraudulent labeling in the retail sector is a problem, and Southwest China is no exception. An estimated 20 to 30 percent of products are counterfeit. IPR violation harms the reputation for quality and safety held by imported U.S. products and cuts into market share. Protecting intellectual property is a critical part of doing business in China. Avoiding infringement requires patent, copyright, or trademark registration with the appropriate Chinese registration office. Companies must also be proactive in pursuing enforcement mechanisms available to halt infringers.

Road map for market entry

Upscale Hypermarkets Ripe for Promotion of Imported Products

Hypermarkets targeting the upper income and upper middle income levels are the most promising segment of the retail market for introducing imported products. They have the highest saturation of imported products. Sales of imported products in there hypermarkets represent 3 to 10 percent of revenues, with room for expansion. Predominantly wealthy Chinese consumers purchase these imported products. In Chengdu, there is a relatively small expatriate community, and only an estimated 15 to 20 percent of revenues from import sales are generated by foreigners. Upscale hypermarkets are Metro, Ito Yokado, Isetan, Carrefour, and Auchan. The market share of imported products in supermarkets and hypermarkets targeting middle to lower income consumers, i.e. TrustMart and WalMart, imported products is generally less than 1 percent of sales.

Table 4: Chengdu Retail Market at a Glance

Targeted Clientele	Retailer	Ownership	# Outlets
HRI, Upper & Upper Middle income	**Metro**	German	1
Upper and Upper Middle income	**Ito Yokado**	Japanese	3
	Isetan	Japanese	1
Middle and Upper Middle income	**Carrefour**	French	5
	Auchan	French	3
Lower and middle income	Trust Mart	China/U.S.	10
	WalMart	U.S.	3
	A Best	Chinese	2
	Century LianHua	Chinese	5
	Beijing Hualian	Chinese	4
	Wang Fujing	Chinese	1

Source: ATO/Chengdu

Degree of Centralization of Purchasing Determines Method of Entry into Upscale Hypermarkets

The first step to entry into the hypermarket sector is to ascertain the degree of centralization of the purchasing department. Retailers with less centralized purchasing systems give their individual store managers more control over the products that are on their store shelves. In general, it is necessary to work with the retailer's national import manager, their principle importers, and individual store purchasing managers.

Retailer Fees Can Increase Cost of Selling Product through Certain Retailers

Some retailers are known to increase the cost of doing business by charging slotting fees, shelf fees, festival fees, and chef fees. Some retailers charge promoters fees to have promotions in their stores, while others simply ask that the promoter provide the product to be given out in samples.

In-Store Promotions Essential for Success in Hypermarket Sector

In-store promotions like sampling and recipe cards are critical to introduce new-to-market products. Consumers are eager to try new, unfamiliar products, but if they do not find uses for the product the first time they purchase it, they are unlikely to purchase it again. One retailer described how the store introduced a high quality biscuit, but over time the majority of the customers that purchased the product were those that had experience with the product overseas. The retailer believed the product would have been much more successful if there had been an in-store promotion with samples to introduce uses of the product.

Profiles of Key Retailers

Metro's clientele is predominantly the Hotel, Restaurant, and Institutional (HRI) sector and other bulk purchasers. Metro has the widest selection of imported products of any of the key retailers, and 10 percent of their sales revenue is from imported products. Metro has a membership system similar to that of Sam's Club or Costco. Their large section of frozen processed foods, including desserts, frozen vegetable mixes, and frozen potato products, is easy to use and open to U.S. products. Metro's main competition is the local wholesale market, not other high-end hypermarkets.

Metro has a centralized distribution system in Shanghai. Local store managers can suggest the introduction of a specific product (imported or domestic) to their stores, but the Shanghai purchasing office makes the final decisions for individual stores.

Carrefour targets predominantly upper-middle class and middle class consumers. Imports constitute between three to five percent of sales. Chengdu Carrefour is the headquarters for the Western Region, which includes the five stores in Chengdu and four in Chongqing. Imported products are ordered by the head office for China, and distribution of imported products is outsourced to Elee Logistics, which manages the logistics and transportation of imports.

Local store managers have the discretion to choose which imported products they wish to order, but the availability of imported products store managers can choose from is determined by the head office based local demand for imported products and the affluence of customers. Stores with higher rankings can choose from a larger list of products.

Ito Yokado and **Isetan** are high-end, Japanese-owned stores that target upper class consumers. These retailers' emphasis on expansion in to these second-tier markets suggests that there is easier access for high-end retailers in the second-tier markets. China wide, Ito Yokado has two stores in Beijing and one store in Chengdu. Isetan's Chinese stores are in Shanghai and the second-tier cities of Jinan, Tianjin, Chengdu, and Shenyang.

Auchan has stores in Shanghai, Beijing, and Chengdu. Its customers are largely upper-middle and middle class consumers. Auchan has a centralized system for import distribution. There is no purchasing center in Southwest China. Its purchasing and distribution departments are located in Shanghai.

Demand for Processed Imports in Convenience Stores Expected to Grow

Convenience stores are a relatively new phenomenon in Southwest China. They have a low penetration of imported products. A survey of Chengdu convenience stores by Post found a limited quantity of imported convenience foods, including premium ice cream products, cookies and wafers, and candy products. The three convenience chains in Chengdu—WoWo, Red Flag, and Hu Hui—operate approximately 2,000 convenience stores in Chengdu. This market is newly developing, and market potential for targeted convenience foods, like nuts and dried fruits, is expanding rapidly.

Insufficient Cold Chain Distribution a Barrier to Entry

In a survey of Chengdu wet markets, post found limited amounts of imported products. The cold chain storage facilities are older-generation models and lack sufficient moisture and temperature controls necessary to maintain product quality on a consistent basis. There is a lack of distributor awareness of food safety practices. There are often breaks in the cold chain during transportation from cold storage to retail or HRI facilities.

Differentiating U.S. Products from the Local Competition

Imported meats and produce face their strongest competition from domestically produced products. The Southwest provinces are major agricultural producers. Lack of dependable cold chain and the transport time from the port cities is a major obstacle. The majority of fruits, vegetables, and meat products offered in hypermarkets and supermarkets are locally produced. U.S. wine faces competition from numerous European and Latin American wines already present in the market.

Selected Best Product Prospects

Interest in health, safety, and high-end gourmet products has increased with increased income levels. Consumers are increasingly buying produce from supermarkets and hypermarkets instead of traditional markets because they are perceived as cleaner and safer.

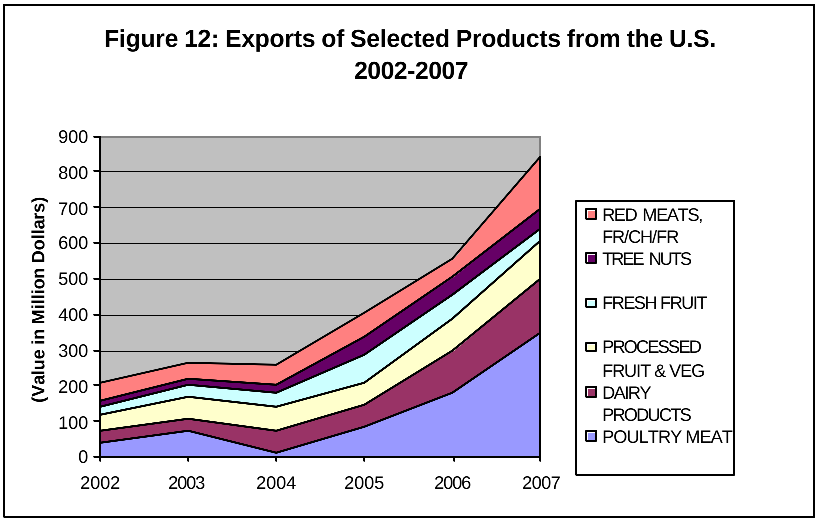
Post finds that these trends have led to opportunities for specific products. Health conscious products have been especially popular with the Chinese consumers. Red wine and olive oil have been widely accepted by Chinese consumers. Imported dairy products have increased in popularity due to the melamine dairy scandal, but dairy products face strong competition from New Zealand, Australia, and EU producers already in the market.

While there is strong local competition for meats, fresh vegetables, and fresh fruits, there is demand for specialty products and organic or “green” produce. U.S. imported produce could be successful if it is successfully marketed as a high value product. U.S. muscle meats, as well as chicken paws, wing tips, and other non-muscle meats are also strong prospects, again especially if sold as a high value product.

Selected Products Present in the Market With Good Sales Potential:
Poultry; especially chicken paws and wing tips
Oranges
California table grapes
Washington apples
Cherries
Breakfast cereal
Cheese and dairy
Spaghetti sauce/tomato products
Candy and chocolate
Nuts
Seafood
Dried fruit; especially prunes and raisins
Premium ice cream
Baby food/infant formula

Select Products Not Present in Significant Quantities Which Have Good Sales Potential:
Red meat
Frozen processed products
Wine
Ginseng
Peanut butter, other specialty condiments

III. Competition



Source: USDA-BICO Commodity aggregations

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 Kraft, Lays 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 quality safeguards to food 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 (Mars). 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.

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 and pasta sauces.

The U.S. remains the largest single exporter of consumer-oriented food to China, and is the only exporter with a presence in most categories. China is attracting a growing level of interest from other countries, however, and has signed or is negotiating bilateral trade pacts with many of its neighbors. The following is a brief outline of key products and competitors.

Selected U.S. Imported Products	Main Foreign Competitors
Red Meat	Canada, Denmark, New Zealand, Australia
Poultry: chicken paws & wing tips	Brazil, Argentina
Oranges	New Zealand, South Africa
California Table Grapes	Chile
Washington Apples	Chile, New Zealand
Cherries	New Zealand
Breakfast Cereal	United Kingdom, Australia, EU
Cheese and Dairy	New Zealand, Australia, EU
Frozen Processed Products	Canada, New Zealand
Wine	Australia, France, Italy, Spain, Chile
Spaghetti sauce/tomato products	Italy, France, EU
Coffee	Japan, France, South Africa
Candy and Chocolate	Switzerland, Italy, France, Belgium, Japan
Nuts	Iran (pistachios), Mongolia, Korea (chestnuts) Russia
Seafood	Russia, North Korea, Canada, Norway, Japan
Ginseng	Canada, Korea
Dried fruit: prunes and raisins	France and Italy (prunes)
Baby food/infant formula	New Zealand, Switzerland
Premium Ice Cream	France, New Zealand

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 (U.S. beef and related products are currently <u>not</u> permitted entry into China)
- Frozen vegetables (esp. sweet corn)
- Infant formula
- Baby food
- Dairy products (cheese and butter)
- Baking ingredients and bread bases
- Frozen potato products
- Fresh fruit (oranges, apples)
- Premium ice cream

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

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

V. Post Contact Information and Additional Resources

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VI. Other Relevant Reports:

Business Etiquette Report GAIN Report #CH4835
Shanghai Retail Wine Shops GAIN Report #CH8802

Emerging City Markets

- Hangzhou GAIN Report #CH7819
- Suzhou GAIN Report #CH7816
- Wenzhou GAIN Report #CH7814
- Tianjin GAIN Report #CH7417
- Emerging City Markets: The Next Economic Miracle GAIN Report #CH7403

- Wuhan Gain Report #CH7815

Jusco In-Store Promotion Evaluation Report 2007 GAIN Report #CH7614

Market Development Report

- Qingdao #CH6414
- Harbin #CH6406

Wal-Mart Great American Food In-Store Promotion 2006 GAIN Report #CH7602 (referenced page 39)