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Retail Food Sector

Mainland China Food Retail Annual Report 2005

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Report Highlights:
China's food retail sector continues to grow and develop as hypermarket and convenience store chains expand across the country. Foreign-invested hypermarkets are likely to continue growing as restrictions on their activity and ownership are scheduled to be loosened in 2005.

Includes PSD Changes: No
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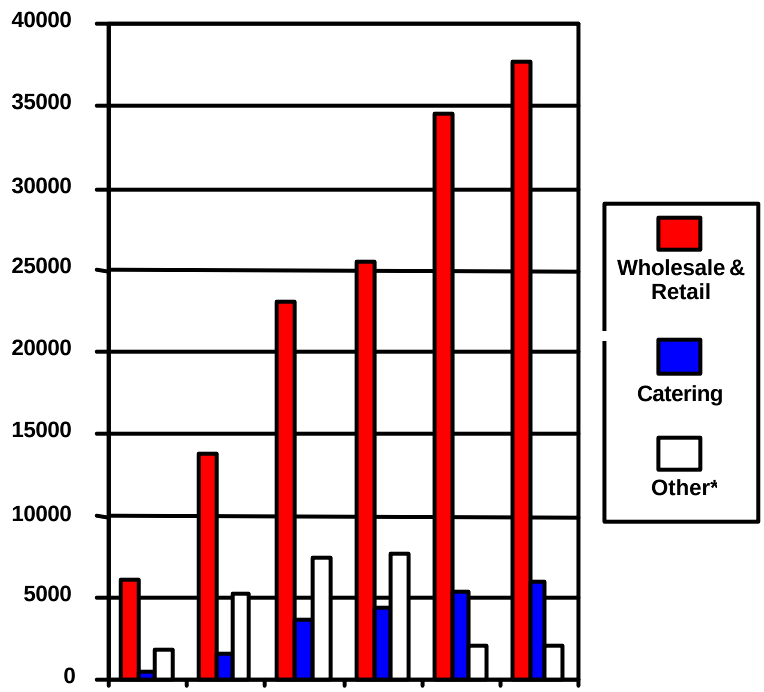
I. Market Summary

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

The transformation of China's retail sector is continuing, and all three of the leading cities, Shanghai, Guangzhou and Beijing, are now home to multiple hypermarkets and convenience store chains. Supermarkets continue to be the most common retail format, but hypermarkets are gaining in popularity, and are now present in most medium and large sized cities. Having reached saturation levels in Shanghai and Guangzhou, convenience store chains have turned their attention to other cities. Although progress has been slow, Beijing has finally become home to several convenience store chains. Meanwhile, many chains have found fertile ground in the booming cities that dot the landscape around Shanghai and Guangzhou. Growth in the cities of Shanghai and Guangzhou may slow somewhat, as both markets are close to saturation levels, particularly with hypermarkets. Beijing shows more potential for near-term growth, but the fastest development is likely to take place in two areas: satellite cities near Shanghai and Guangzhou, and the large second and third-tier cities further inland. Most foreign-invested retailers already present in China have opened stores in these areas and have ambitious plans for further expansion.

Figure 1: Retail Sales of Consumer Goods, by Sector, 1990-2003



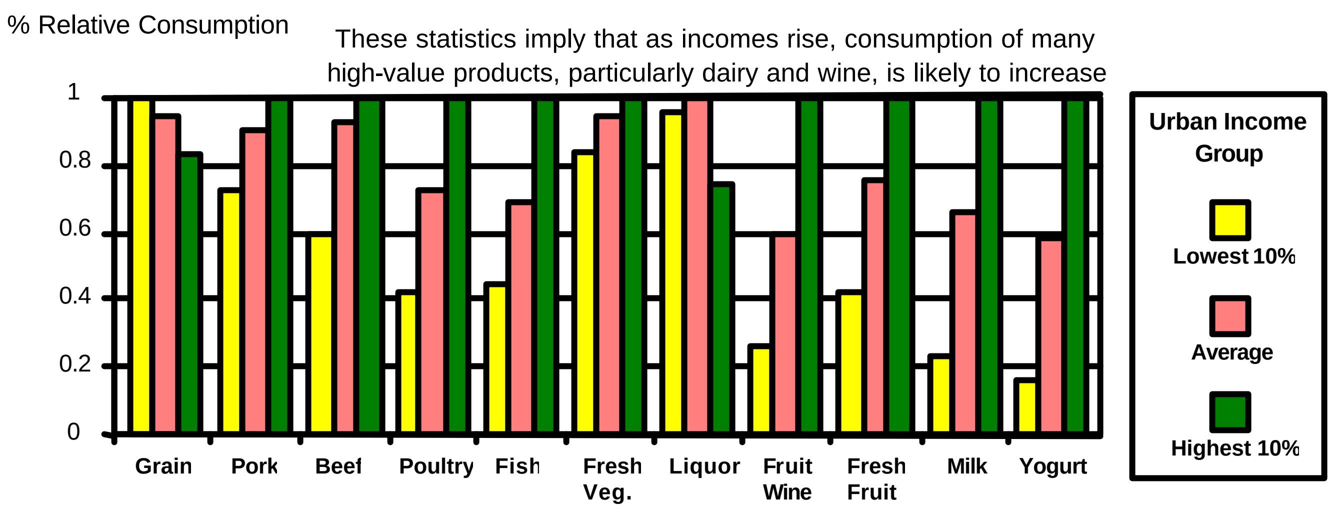
Source: China Statistical Yearbook, 2004, Table 17-3
*Beginning in 2002, direct sales of commodities by farmers were excluded from this figure.

In the leading three cities, the emphasis appears to be shifting toward differentiation, with chains pursuing different strategies to distinguish themselves from the competition. Some with longstanding reputations hope to cash in by offering more house-brand products, while others offer extended store hours or more ready-to-eat products. In all cases, competition is driving down margins and forcing stores to supplement their revenue from other sources. One of the most widely favored sources of income are ever-higher listing fees charged to suppliers of new products. These are becoming an obstacle to innovation, as suppliers are unwilling to take the chance that a new product will not be able to recover the substantial layout for the listing fee. In the post-SARS environment consumers have become more sensitive than ever to food-safety concerns. This has been reinforced by a continuous drumbeat of food adulteration and food poisoning scandals that receive wide coverage in local papers. This heightened awareness has helped to drive consumers to the major chain stores, which are generally seen as less likely to carry counterfeit or unsafe products. On the other hand, at least one major foreign-invested chain in Shanghai was itself caught producing food under unsafe conditions. If repeated, such incidents could undermine the reputation of the entire chain.

The Chinese government has expressed concern over the rapid expansion of foreign-invested chains, and is making efforts to ensure that domestic chains are able to compete. These efforts have taken a number of different forms. Late in 2003, the government hinted that it would pursue violations of the complex licensing rules more aggressively. Carrefour was the most prominent victim, having its expansion plans suspended until issues related to the share of foreign ownership were resolved. The central government also warned local and provincial governments that approvals for foreign-invested retail projects would be contingent on tighter licensing procedures. At the same time, the government is attempting to make Chinese chains more competitive by encouraging mergers. The largest of these was the merger of China's two largest retail chains, Lianhua and Hualian, both state-owned enterprises.

Supermarket chains remain the largest retail format. This sector is dominated by Shanghai-based Chinese chains with Lianhua and Hualian the largest players, followed by Nonggongshang and regional chain Suguo (Jiangsu province). The merger between Lianhua, Hualian and two other companies, has created a massive entity called Bailian. This has had relatively little impact on the retail scene as of yet, as both chains appear to be operating as separate entities. The merger appears to still be in the process of rationalizing the diverse holdings of the four companies: the latest action involves the separation and merger of department store and shopping center assets into a single company called Shanghai Brilliance. Much more significant, Lianhua is ramping up its acquisitions of smaller local chains. In late 2004 the company paid $9.3 million to acquire Wanlifu Supermarket Co. in Hebei province, and another $18.1 million to acquire a shopping center in Hangzhou, (Zhejiang province). The firm announced that it will increase its budget for acquisitions from $73 million to over $100 million in 2005. Lianhua officials have noted that foreign acquisitions in the hypermarket field have inflated prices throughout China's food retail sector. A number of strong regional chains have also emerged, including Suguo in Jiangsu, Jinkelong and Wu Mart in Beijing and Hongqi (convenience stores) in Chengdu. Although Lianhua and Hualian remain the only truly nationwide supermarket chains, Shanghai's Nonggongshang has expanded through much of the Yangtze River basin and into Beijing. Surveys indicate that Chinese supermarkets place their emphasis on dry, and frozen goods, with less than one-third of floor space dedicated to fresh products, including fruit, vegetables, eggs and meat.

Figure 2. Relative Consumption of Selected Food Products By Income Group, 2003 (volume basis)



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

The supermarket format has lost ground to hypermarkets and convenience stores in recent years. This trend is likely to continue for the near term, but may be limited by a combination of factors. The first is the very limited product variety and high prices in convenience stores. Convenience stores act less as major food outlets than as service centers offering bill paying and other services, as well as impulse purchases. Few convenience stores offer much beyond snack foods and some boxed lunches. The second factor is the high population density of Chinese cities, combined with the small size of most supermarkets. This allows for a very large number of locations: in cities like Shanghai, most homes have a supermarket within walking distance. Hypermarkets, by contrast, are typically located in less densely populated suburbs. Although private car ownership is rising, the vast majority of Chinese households must rely on public transport to reach these hypermarkets, making daily excursions inconvenient, while the relatively small size of Chinese refrigerators (and apartments in general) makes monthly mass-buying trips less practical. The current supermarket format may, however, get a run for its money from discount stores specializing in shelf-stable products at deep discounts. Carrefour recently introduced its Dia brand discount stores in Shanghai and has extremely ambitious plans (up to 3,000 stores by 2007) for this chain. The store size is similar to a small Chinese supermarket, although the product selection is much more limited.

Hypermarkets have seen the most activity in the past year. This sector has by far the largest foreign presence, and interest is growing as the promised date of December15, 2004 approaches. This is the date when China has agreed to remove restrictions on foreign investment in retailing. Current regulations require foreign retail chains to establish joint ventures with Chinese companies. This has created a complex web in which foreign chains often have joint ventures with Chinese competitors. Although there may be considerable delay as various administrative and regulatory details are ironed out, this date is still viewed by many as a watershed. Wal-Mart appears to have been waiting on this date before establishing stores in Shanghai. Having constructed a distribution center in the city sometime earlier, it recently announced that it's first store in Shanghai will open in summer, 2005, followed by two others. Japanese retailer Ito Yokado, already owner of five joint-venture stores in China, has announced plans to establish wholly-owned stores as well.

Changes in the ownership regulations raise important questions about the status of existing joint ventures. Regulations limiting foreign Much will depend on precisely how the liberalization takes place. Some chains are expected to buy out their joint venture partners if possible, since these are often competitors. Some chains, however, seem content to continue with the joint venture arrangement. Germany's Metro, for example, has been quoted as saying that it has no plans to buy out partner Jinjiang Group. (This may be because Metro's partner, Jinjiang Hotel Group, is not seen as a competitor. In fact, Jinjiang's strength in the hotel business works well with Metro's strategy of acting as a supplier for restaurants and hotels). Likewise, although it has announced its intention to establish wholly-owned stores, Ito Yokado does not appear to have plans to buy out the partners in its existing JV stores.

Convenience Stores remain one of the most dynamic categories for food retail, though development in Shanghai and Guangzhou appears to have slowed from the frenetic pace of previous years. The sector is dominated by domestic chains, though the imminent appearance of 7-11 in Beijing will finally give it a toehold outside of South China, and Japan's Family Mart recent established itself in Shanghai. (Interestingly, Ito Yokada is an investor in both 7-11 Beijing and Family Mart in Shanghai).

Many chains are seeking to expand into new markets where competition is less fierce. Development in second and third tier cities appears to be taking on two paths: expansion by chains that are already established in the key markets, and development by a strong local chain. In the areas surrounding Shanghai and Guangzhou, the first pattern appears to dominate, as local giants Quik and Kedi (in Shanghai) and 7-11 (in Guangzhou) expand to nearby cities such as Suzhou, Wuxi and Shenzhen. Beijing is also following the first pattern, as Quik and 7-11 are moving into that large and still underdeveloped market. The second pattern seems to dominate further inland. In Nanjing local chain Suguo is the major player, while convenience in Chengdu is overwhelmingly dominated by local chain Hongqi (Red Flag).

The other means being pursued to maintain profits while expanding is niche marketing. Last year Quik announced an agreement with a subsidiary of Sinopec Petroleum to provide convenience stores in gas stations, and Kedi is pursuing similar deals. The gas-station store trend is most advanced in Guangzhou, where British Petroleum is already one of the largest convenience store chains. Other stores are seeking very specific market niches, including high-end malls and combining operations with other types of retailers. Convenience continues to be dominated by domestic chains, although the imminent appearance of 7-11 in Beijing will give it its first presence outside of southern China. The largest chains are directly or indirectly connected to either major supermarket/hypermarket chains (such as Lianhua, Hualian and Nonggongshang) or food processing companies.

Traditional markets continue to be a presence throughout China, although many of the wet markets in big cities are being closed or consolidated. Local authorities in most cities view wet markets as unsanitary, not to mention that tax revenues from these markets are small relative to those from supermarkets. The SARS outbreak provided a pretense for intensifying closures and consolidations in major cities such as Beijing and Shanghai. For those markets that remain, regulation is much tighter than before. Despite this, wet markets persist. The main reason is the lack of quality fresh meat and vegetables at local supermarkets and the inconvenience of traveling to hypermarkets for fresh products. In fact, street vendors selling fresh vegetables outside of supermarkets are a common sight, and appear even to be encouraged by the supermarkets as a way of generating foot traffic.

The other major traditional formats include small variety stores (xiaomaibus) and fruit stands. The typical xiaomaibu is much smaller than a convenience store, privately owned, and stocks an eclectic mix of products. Although facing a serious challenge from convenience stores, the xiaomaibus remain a significant presence in Chinese cities, and appear likely to continue for some time. The convenience chains have focused their attention on high-traffic sites near schools, bus and subway stations and hospitals, leaving ample territory for the xiaomaibus, which often serve a single apartment complex. Small scale and private ownership also allow the xiaomaibus to tailor their product selection to match the specific needs of individual customers. Like convenience stores, most xiaomaibus offer a range of other services, such as bill payment and IP card sales. Fruit stands fill another gap left by convenience stores, most of which carry few if any fresh products. They are further supported by the Chinese tradition of giving a gift, often of fruit, when visiting friends. While imported products are virtually nonexistent in xiaomaibus, fruit stands stock a surprising number of imported and counterfeit-imported products.

I.B Major Food Retail Chains in China

Revenue, Lies and Statistics

All statistics on China's food retail industry have serious shortcomings, a result more of the tangled web of ownership than any shortcoming in reporting. A particular problem is reporting income for foreign invested joint-venture stores. Sometimes the income is listed under the Chinese JV partner, sometimes separately. In cases where Chinese JV partners report income from the JV, it is often unclear what proportion of the JV income is being included. In addition, many companies have other lines of business, such as logistics or hotels, which are not separated when income is reported. On the other side, it can be difficult putting together the total income of a foreign chain operating in China, because many form JVs with different partners in different regions.

Compounding this are similar complexities in patterns of domestic ownership. For example, the Kedi chain of convenience sotres is owned indirectly by Nonggongshang through its ownership of Bright Dairy, but is listed separately in most statistics. Nonggongshang, however, also owns the Alldays convenience store chain. While Alldays is not listed separately in any statistics, it is not entirely clear whether it is included in the total numbers for Nonggongshang. Likewise, Lianhua's Quik convenience store chain, the largest in China, is not listed separately, but is clearly not included in the number of stores reported by Lianhua in 2002. Lianhua's store number more than doubles in 2003, however, indicating that the convenience stores are likely now being included. Whether Quik's revenues were also excluded from Lianhua's in 2002 is unclear, though it seems unlikely as the change from year to year was quite small. Lianhua also happens to be the JV partner for Carrefour in the Shanghai area. How much of the income from the Carrefour JV is being reported in Lianhua's revenue figures is unclear.

Keeping these shortcomings in mind, the following table provides some sense of the size of the food retail sector and the key players.

Table 1. Top Ten Retailers in China

	2003			2002		
	Company	Store No.	Revenue (Billion RMB)	Company	Store No.	Revenue (Billion RMB)
1	Lianhua	2579	24,031.20	Hualian Group	1921	21,473.00
2	Hualian	1388	18,033.00	Lianhua	1200	18,330.02
3	Beijing Hualian	62	13,600.00	Beijing Hualian	53	10,300.00
4	Carrefour	41	13,436.82	Carrefour	35	10,693.45
5	NGS	1213	12,381.40	NGS	702	8,730.00
6	Hualun Wanjia	467	10,323.59	Hualun Wanjia	456	8,591.07
7	Suguo	1162	9,580.00	Suguo	931	7,054.00
8	Beijing Wumei	518	8,504.51	Beijing Wumei	357	5,067.25
9	Wal-Mart	33	5,853.29	Wal-Mart	25	4,739.58
10	Metro	18	5,620.64	Metro	16	5,310.29

Source: China Chain Store & Franchise Association, 2003

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

Table 2. Strengths and Challenges for U.S. Products In the Retail Food Market

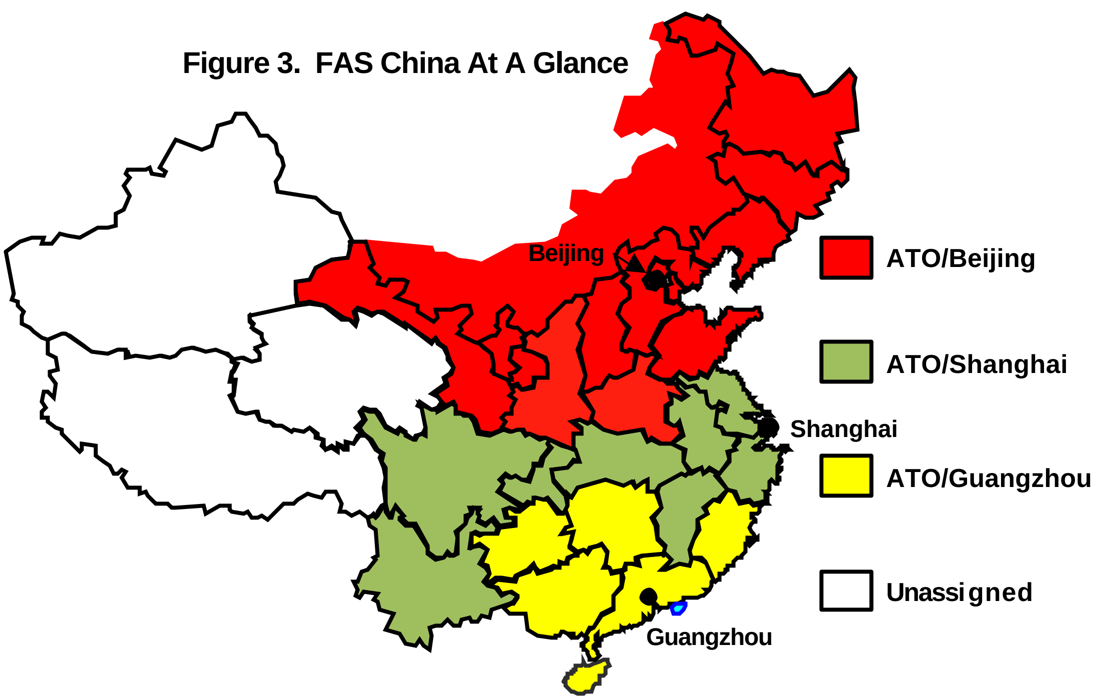
Advantages	Challenges
Chinese consumers generally regard U.S. products as being of high quality.	U.S. products are routinely counterfeited.
Chinese consumers spend over 1/3 of their income on food.	Consumers are extremely price sensitive, and are often unwilling to risk spending on products they are unfamiliar with.
U.S. brands are widely known and respected in	Many U.S. companies have established plants in

China's urban markets.	China, manufacturing their products using Chinese ingredients.
Incomes are growing rapidly in second-tier cities, creating a whole new range of opportunities.	Distribution and logistics remain underdeveloped, making distribution of imported products to interior cities extremely difficult.
Food is a central part of Chinese culture, and consumers enjoy trying new tastes.	Lack of knowledge about U.S. products and how to prepare them makes consumers more hesitant to buy.
China's entry into the WTO has reduced tariffs on many imported products.	Labeling and sanitary restrictions act as non-tariff barriers. Enforcement of these rules is haphazard, creating additional uncertainty.
The Agricultural Cooperation Agreement opened the Chinese market to many U.S. products that were previously banned.	U.S. exporters that have relied on gray market channels in the past lack direct contact with Chinese buyers.
Rapid growth in retail food chains has created more opportunities for bulk purchasing.	Purchasing by most retail chains remains decentralized. Few purchase imports directly, so exporters must establish a relationship with a distributor.

I.D. Regional Market Profiles

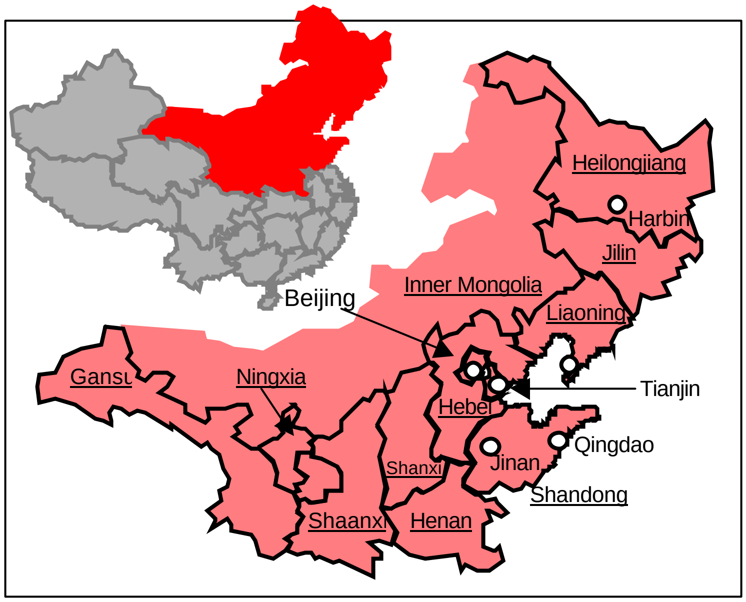
FAS has four offices in China, with Agricultural Trade Offices in Beijing, Shanghai and Guangzhou, and an Agricultural Affairs Office in Beijing. Office coverage is divided as shown on the map below. Each area has its own unique aspects, as noted in the regional profiles that follow.

Figure 3. FAS China At A Glance



Beijing Region – Beijing's retail scene has the most room for future development of China's 'big three' cities, a byproduct of its relatively slow development. Beijing's retail sales growth rate is among the highest in China, at 19.1% in 2003, compared to 12.2% for Shanghai. Unlike Guangzhou or Shanghai, Beijing is not at the center of a wider web of economic development, with Tianjin the only nearby city worth mentioning. The broader region, however, is home to some of China's most dynamic coastal cities, including Dalian and Qingdao, and the major cities of Northeast China such as Harbin. Shandong province in particular, shows signs of becoming a major industrial and commercial center.

Figure 4. Beijing Region



In Beijing proper, the most rapid development is taking place in the rapidly expanding suburbs, where car ownership has skyrocketed. Retail sales for the first quarter of 2004 amounted to $12.9 billion (out of a national total of $304.9 billion). Many **hypermarkets** are locating in the borderline areas between the city and suburbs, in hopes of attracting customers from both. The sudden surge in car ownership means that, for the first time, parking lots have become a major necessity. By the end of 2003 there were nearly 100 large food retail units, including large supermarkets, hypermarkets and warehouse stores, with another 20 in the planning or development stage. Beijing's unique status as the national capital has allowed it to attract an extremely large and varied expatriate community which supports a large number of boutique and specialty grocery stores that carry imported products. In addition to expatriates, these stores target the growing number of upscale Chinese consumers who have lived or studied abroad. The presence of the expatriate community is also felt in department stores, which often include high-end food sections as part of their operations.

As in other areas, hypermarket development has been led by foreign-invested companies including Wal-Mart, Pricesmart, Carrefour and Metro. Other entries include Fu-Mart from Japan, and Trust-Mart, RT Mart from Taiwan and Hymall, which was recently purchased by Tesco. These companies all operate in a similar manner to their foreign parents, and have been a major factor in the rapid improvement of supply chains and distribution. Domestic retailers such as Beijing Hualian and Wu-Mart have been quick to imitate their methods and have become major players in this market. CRC Vanguard, which started in South China, has expanded into the North and hired talent away from foreign-invested competitors. Tianjin-based HomeWorld is also regarded by some as a strong potential competitor in the warehouse/price-club sector. While many domestic chains remain hampered by a state-owned management structure, some have become formidable competitors, cashing in on local knowledge and influence with local political institutions. Chinese regulators routinely favor domestic firms at the expense of foreign operators, and some SOE's continue to receive 'soft loans' from state-run banks to finance retail expansion.

Table 3. Major Hypermarkets/Supermarkets in Beijing

Retailer	Ownership	Total sales in 2003 (Million USD)	% of sales increase compared to 2002	No. of outlets (Dec 2003)
Beijing Hualian Group	China	1642.5 (nationwide)	32	62 (nationwide)
Beijing Wu-mart	China	1027	68	518
Beijing Jingkelong	China	633.2	23	156

Beijing Chaoshifa	China	490.9	3	112
Beijing Shoulian	China	238.5	0	75
Beijing Shuntianfu	China	69	21	17
Carrefour	France JV	1622.8 (nationwide)	25.7	41(nationwide)
Wal-mart	US	706.9(nationwide)	23.5	33

Source: CCFA / ATO Beijing

Despite the strength of its expatriate community, the percentage of imported food in Beijing hypermarkets rarely reaches more than 2-3% of sales. Stores routinely adjust the quantity of imported food in a particular store based on local incomes and the presence of expatriates. Warehouse stores generally target higher-income consumers (who own cars), and thus generally stock more and higher-value imports. Sam's Club stores in Beijing sell three times as much imported food as Wal-Mart Super Centers, but the ratio of imported products is still only 2-3% of sales. Beijing retailers hold US products in high regard for their quality. Shelf surveys reveal special sections devoted to imported beer, fruit and wine. Dairy cases have expanded, and often display imported cheeses. Substantial displays of imported breakfast cereals have also become more common. Although most stores boast extremely large frozen food sections, they remain stocked mainly with frozen dumplings, with the exception of imported frozen mixed vegetables as well as corn and peas.

Hypermarkets in the Beijing area generally expect to make higher profits on imported foods, because the market risk is higher. They also expect promotional assistance for new-to-market items, including in-store demonstrations and sampling, as well as negotiated fees for promotional efforts. Some retailers charge slotting fees, such as Carrefour where the cost can reach as high as RMB 10,000 ($1,200) per slot per store. Other retailers, such as Wal-Mart and Auchan appear to put most of their effort into keeping prices as low as possible. The hypermarket format is expanding rapidly throughout North China, although same store sales fell by 10% nationwide in 2003, largely due to increased competition.

Modern **convenience stores** are just beginning to make an appearance in Beijing and other northern cities. Most are operated by the same state-owned supermarket chains that dominate Shanghai and other parts of China. The stores can be characterized as clean, well-managed and heavily automated, with real-time inventory sytems. In many places they are rapidly replacing the traditional xiaomaibu stands that sell snacks and drinks, but stock few imported products. Initial reports indicate that convenience chains are having to adjust their strategies to match the differences in Beijing's consumer culture, with one noting that 24-hour service is less of an advantage in the cold North than in the southern areas where most of China's convenience chains are based.

In the race to develop Beijing and North China, state-owned behemoth Lianhua has moved quickly into the lead with its Quik chain. 7-11, with a strong foothold in South China, began opening stores in Beijing in April, 2004 but has proceeded slowly. The rapid growth in car ownership has created great interest in gas marts, which should be an important source of growth for the sector in the near future. Overall, however, the convenience sector has been relatively slow to develop. Beijing's government has made a concerted effort to limit growth in the sector, fearing both overdevelopment as seen in Shanghai, and the displacement of traditional family-owned stores. The generally unfavorable regulatory climate may also be a factor, as permits and licenses can be difficult to obtain at the best of times.

Beyond Beijing retail growth has been impressive. Of Carrefour's 56 retail stores in China, 25 are located in North China. While hypermarkets in Beijing have begun catering to car owners, this has not been the case in other northern cities, where shoppers most often walk, ride bikes or use public transportation. As a result, the volumes that can be purchased on a single shopping trip are limited. Shoppers at warehouse stores are more likely to drive cars or small trucks, or to arrange for delivery. One variant on the hypermarket in China are department stores with large food sections. Most are older stores, but Malaysian-invested Parkson's is trying to develop a niche in imported food. Stores often measure more than 30,000 square meters. Although the food departments are generally about the size of a domestic supermarket, they stock higher quality products and a higher percentage of imports. This particular format is still important in parts of North China and in inland provinces, although the expansion of modern retailers has placed their long-term viability in doubt.

Shandong, a coastal province to the south of Beijing, is home to a number of growing industrial cities and rising incomes. Climate and soil conditions are ideal for a variety of food and agricultural products such as poultry, beef fruit, peanuts and aquatic products. Companies from nearby Japan and South Korea have invested heavily in the development of the province's modern infrastructure, including cold chain and container port facilities. While no single city has per-capita incomes approaching those of Beijing, the cities of Qingdao, Yantai, Weihai and Jinan are among some of the most prosperous in China, and have developed a significant middle class. In addition, Shandong's long history of trade has made the local culture more open to imported products than most other parts of China. In August, 2004, ATO/Beijing partnered with Carrefour to launch its Shandong American Retail Food Promotion in the cities of Qingdao and Jinan. The promotion ran 15 days and introduced 200 new-to-market consumer-ready products. In Qingdao the event coincided with the International Beer Festival and garnered strong support from the local and provincial governments. Sunkist oranges, California table grapes, U.S. potato products, Alaska Salmon and a number of consumer-ready food products did particularly well in Qingdao, which is home to a large expatriate community.

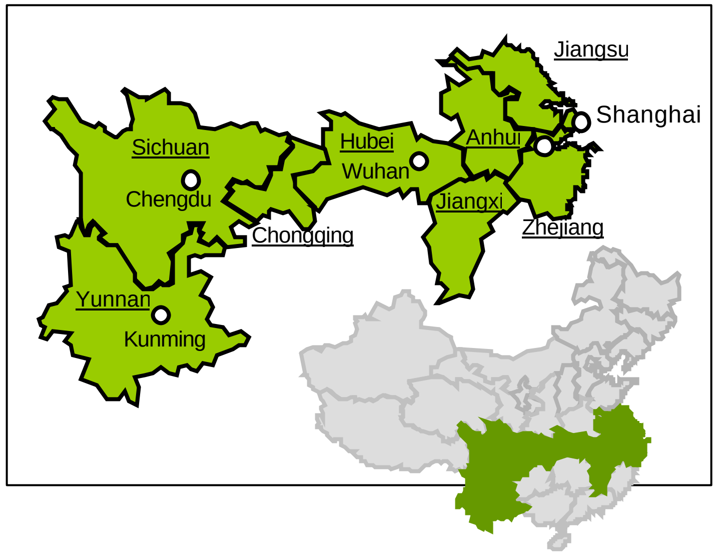
Another standout market is the port city of Dalian, the gateway to China's Northeast. Similar in many ways to Qingdao, Dalian is a trade-oriented city with heavy investment from Japan and Korea. Dalian has excellent infrastructure and high disposable incomes compared to other cities. Harbin, the capital of Heilongjiang province in the far Northeast, is the largest provincial capital in China, and has become a hotspot for retail development. A few short years ago this city of 10 million had no large supermarkets. Last November, it hosted the opening of its third Carrefour store, and will see the opening of its third Wal-Mart store before February, 2005. ATO/Beijing estimates that, by the end of 2005, the greater Harbin area will be home to 20 domestic and JV hypermarket operations.

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

Shanghai Region – The city of Shanghai sits at the center of the Yangtze River delta and, along with Guangzhou, is one of China's two major zones of economic development. Massive infrastructure development has supported the drive for development, and local press reports that Shanghai has now passed Rotterdam as the world's largest container port. Combined with the neighboring provinces of Jiangsu and Zhejiang (greater Shanghai), Shanghai accounts for 20% of China's retail sales and roughly ¼ of GDP. Although there are ports dotted along the coast, the vast majority of imported food products, even those destined for port cities such as Ningbo, enter through Shanghai. Although quite large, Shanghai's expatriate community is not as diverse as Beijing's and is overwhelmingly dominated by Taiwanese (estimates vary widely, placing the Taiwanese population in the greater Shanghai area at as much as 300,000). The Taiwanese bring with them a strong familiarity with U.S.

and Japanese brands and products. Shanghai itself is aggressively cosmopolitan, deriving much of its identity from its up-to-the-second knowledge of international fashions and brands, making it an ideal venue for imports.

Figure 5. Shanghai Region



The **hypermarket** and supermarket sectors in Shanghai are quite well developed. In general, western-invested hypermarkets are receptive to import food promotions, though these often come with strings attached, such as steep slotting fees for new products, which form a serious barrier to the introduction of new products. Taiwanese chains such as RT-Mart and Trust Mart are also important players, and are generally favorable to imports, though some lack experience with western-style promotions. Domestically owned chains are less favorable to imports and less interested in promotions. Although transportation and distribution infrastructure is among the best in China, procurement by chains is still often piecemeal. Although many chains have centralized procurement for some products, many other products, including many imports, are procured through local agents adding to the price and making quality control more difficult. This is beginning to change as hypermarkets build their supply systems and distributors and consolidators team up to simplify the process.

The scale of stores in Shanghai tends to be small, reflecting the crowding in one of Asia's most densely populated cities. Hence what are commonly called supermarkets are often little larger than grocery stores, while many hypermarkets are considerably smaller than their western counterparts. Another common feature in the region are urban hypermarkets that act as both anchor store and mini-shopping mall: the ground floor of the building is rented out to various small shops and boutiques to form a small mall, while the upper floors are taken by the hypermarket. One of the few chains to follow the more traditional 'big box' approach has been Germany's Metro. Metro has targeted Shanghai's 30,000 plus licensed restaurants as its customer base, and thus acts in many ways as a restaurant supply wholesaler, providing bulk sales and even chef training.

Table 4. Selected Hypermarkets/Supermarkets in Shanghai

Retailer	Ownership	Revenue (2003)	No. of Stores
Lianhua	China/SOE	240.31	12 (hypermkt only)
Hualian	China/SOE	180.33	n/a
Nonggongshang	China/SOE	123.81	260
Carrefour	France JV (Lianhua)	32.55	8*
Metro	Germany JV (Jinjiang)	56.21	4*
Auchan	France JV	8.52	4*
RT-Mart	Taiwan JV	104.27	5*
Hymall	Taiwan/UK JV	NA	11*
Jieqiang	China/SOE	16.26	90*

Lotus	Thailand JV	34.07	13*
Homegain	China	14.50	95
E-Mart	Korea JV	3.05	1
Tops	China	2.13	33

Source: Shanghai Statistical Yearbook 2004, ATO/Shanghai research
Note: Store numbers as of December, 2003, except * November 2004.

Supermarket chains, dominated by Shanghai-based giants Lianhua, Hualian and Nonggongshang, are omnipresent not only in Shanghai but throughout most of East China. Lianhua is probably the only food retailer with true nationwide reach (with the possible exception of Hualian). The supermarket industry, however, has lost ground in competition with foreign-invested hypermarkets. In the first quarter of 2004, 53% of consumer goods were sold through hypermarkets. This shift has prompted a sharp response from both supermarkets and the Chinese government. First, China's domestic supermarket chains have launched their own hypermarkets, complete with distinct branding, such as Lianhua's Century stores or Nonggongshang's NGS hypermarkets. Second, the Chinese government has taken a direct interest in supporting China's retail industry. One of their first actions in this vein was to merge the two largest chains, Lianhua and Hualian, into a larger company called Bailian. The merger has been slow to take off however, and both chains continue to operate and report income independently. Part of the reason for this slowness is a third major change: the larger Shanghai-based chains are pursuing a strategy of acquiring smaller local or regional chains outside of the Shanghai area. While there have been difficulties in incorporating these acquisitions into the parent company's management structure, it is giving these chains unprecedented nationwide reach, as well as providing a presence in smaller cities where there is less competition and higher profit margins.

Intense competition is affecting hypermarkets as well, and many are seeking new ways to build foot traffic. Thailand-based Lotus recently extended the hours at its flagship store in Shanghai to 24 hours, in order to attract busy urban professionals and customers seeking to avoid the massive daytime crowds. Lotus has openly admitted that the strategy was designed to raise their profile rather than profits, in anticipation of future expansion. Carrefour's flagship store at Gubei quickly followed suit, announcing extended hours. More recently, Nonggongshang's NGS hypermarkets in Shanghai took a different approach, announcing that they will begin labeling non-genetically modified foods on their shelves. This turns existing regulations, which require labeling of products containing GM material, on their heads, and appears designed to build a following among Shanghai's increasingly sensitive consumers.

Despite the competition, the hypermarket industry is set to grow, both in Shanghai and beyond. After many delays, Wal-Mart announced its entry into Shanghai, and is scheduled to open its first store in the city in mid to late summer, 2005, followed shortly by two more. Lotus has also announced aggressive expansion plans, as has E-Mart (owned by Korea's Shinsegae), which plans to open 10 new stores in the next four years. British retailer Tesco also established a presence this year when it purchased shares in Taiwan-owned Hymall. What impact this will have on Hymall's activities in Shanghai is not entirely clear, but the chain has announced plans to open 10 new stores through 2005. In late 2004, according to press reports Japan's Ito Yokada announced plans to open an office in Shanghai to operate wholly-owned stores in China. Local retailers are also continuing to expand: Lianhua announced it will spend over $100 million on acquisitions in 2005. At the same time, it is continuing to integrate prior acquisitions, converting its Jiayou stores in Hangzhou to the Lianhua and Century Lianhua format. Hualian has undergone a change in management, and appears to have shelved expansion plans for the time being.

In the wake of SARS, concerns over food safety are having a profound impact on food retailing in Shanghai. As in all major cities in China, the Shanghai city government has long been pursuing a policy of shutting down wet markets, with only limited success. City governments generally view wet markets as unsanitary, difficult to regulate, and inferior as sources of tax revenue. Shoppers still prefer wet markets, however, due to their convenience, price, and above all the freshness of meat and quality of produce available. The SARS and avian influenza crises have led to considerable refinement in the government's strategy: rather than focusing on closure of wet markets, Shanghai is now insisting that they meet stricter sanitation standards. Following the avian influenza outbreak, for example, all markets selling live birds have been required to isolate bird pens and slaughter facilities from customer areas.

The other half of this strategy has been to encourage the development of 'fresh' supermarkets to replace wet markets. These are defined as supermarkets that dedicate at least one half of their floor space to fresh vegetables, fruit, meat, dairy and eggs, as compared to the average one-third of space dedicated to these items in conventional supermarkets. If successful, this strategy has a much greater potential for displacing wet markets. It will also have profound implications for the development of supply and distribution channels for fresh produce throughout the area, as supermarket chains taking up this approach will have to become far more active players in the produce markets. Nonggongshang in particular, appears to be committed to this strategy, and has already converted over 100 of its supermarkets to the 'fresh supermarket' format.

The conversion of supermarkets to a 'fresh' format may be hastened by the appearance of **discount stores**. Carrefour has introduced its Dia brand discount stores that feature a limited range of shelf-stable products at deep discounts, and expects to open a total of 300 Dia stores in Shanghai alone. Competition from these stores may create more incentive for supermarket chains to adopt the 'fresh supermarket' format in order to avoid competing head-to-head on dry goods. The discount stores are also leading the way in the development of house brand products. High-profile retailers are hoping to capitalize on consumer fears and cash in on their reputations by offering products carrying their own logos. Dia stores are leading the way, with roughly 30% of their 1,000 SKUs being house brands. Chinese chains are following suit, and Lianhua has developed four in-house brands covering 2,000 SKUs. The appearance of house brands may not be a particularly favorable development for food imports. Some chains appear to be using house brands as a way of cashing in on their reputation as a guarantor of quality. Since imports tend to sell on the basis of perceived high quality, this may place them in competition with the house brands.

The **convenience store** industry in Shanghai remains by far the most developed in China. The largest players by far are all local chains, with deep-pockets parents in the food retail or food processing industries. Management at all is exceptional, with real-time inventory tracking and heavily automated management systems. The largest chain, Quik, is owned by Lianhua, while Alldays is owned by Nonggongshang, and Kedi by Bright Dairy group of Shanghai (which is, in turn, owned by Nonggongshang). Other major players include Shanghai Buddies (formerly Liangyou), which grew out of the old state-owned grain and oil stores; Mei, which is owned by food and beverage manufacturer Aquarius; Lawson's, a joint venture between Lawson's Japan and Hualian; 21st Century, recently sold by supermarket chain Jiadeli to Maya; and C-Store, owned by Taiwan-based RT-Mart. No exact figures are available for the total number of convenience stores in Shanghai proper, but estimates put the number at over 4,100.

Table 5. Major Convenience Store Chains in Shanghai

Company	Ownership	Number of Stores	Locations
Quik	China/Lianhua	1,500	North China East China South China
Alldays	China/Nonggongshang	1,000	Shanghai
Kedi	China/Bright Dairy	1,000	Shanghai Jiangsu Zhejiang Guangdong
Shanghai Buddies	China/Liangyou	500	Shanghai
Lawsons	Japan JV/Lawson's, Hualian	210	Shanghai
Mei	China/Aquarius	300	Shanghai
21 Century	China/Maya	576	Shanghai
C-Store	Taiwan JV/RT-Mart,	NA	Shanghai Jiangsu
Family Mart	Japan JV/Ito Yokada, CITIC	40	

Source: ATO/Shanghai research

Growth has continued despite declining per-store revenues and cutthroat competition. Japan's Family Mart entered the crowded field this year, opening 40 stores in Shanghai. Competition has led to greater efforts by existing chains to carve out new markets. Quik and Kedi have pursued deals with gas station operators to open convenience stores in gas stations throughout China. China's rapidly growing freeway system, combined with concerns about the quality of products carried in mom-and-pop stores may make this a winning strategy. Lawson's has moved in the other direction, targeting high-end malls and other shopping venues. Since these traditionally house plenty of high-end sit-down restaurants, but lack options for shoppers or office workers, Lawson's has taken to stocking Japanese-style box lunches. Another convenience chain, 21st Century, was purchased by a well-known chain of music stores, Maya, and is now offering music and movies at their convenience stores and opening combined-format stores. Alldays is bucking this trend, announcing that it will open no new stores, after doubling in size last year.

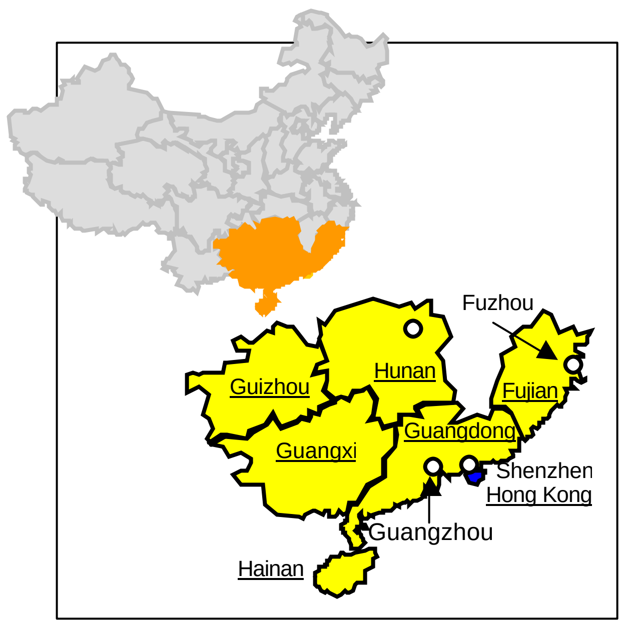
Many chains are also showing increased interest in carrying high-value products in order to raise per-store sales. ATO/Shanghai partnered with Lawson's to conduct a first-ever U.S. food promotion in 55 stores in Shanghai. The remarkable success of this promotion led to a follow-on promotion with the Alaska Seafood Marketing Institute, which featured Alaska Salmon in Lawsons' box lunches. Box lunches have traditionally been viewed as a price-driven market in which imported products had little chance: most box-lunch makers target a total cost of well under $1 per lunch. This promotion has made clear, however, that even traditionally difficult market niches may contain lucrative sub-niches. Another emerging trend is the use of franchising to support expansion. Both 21st Century and Shanghai Buddies are relying on franchise stores for most of their new store openings in Shanghai.

Beyond Shanghai is the Yangtze River delta, with a huge number of fast-growing cities and tremendous market potential. Retail development is likely to be fastest in those areas near Shanghai that are connected to its web of transportation and logistics. Retailers have already spotted this potential, and nearly every major city within 3 hours drive of Shanghai is host to both foreign-invested and Chinese hypermarkets and supermarkets. Beyond this, foreign-invested hypermarkets have moved into nearly every major city of China's interior, and some now boast multiple outlets. Yunnan in particular has been a hotbed of retail development despite relatively low per-capita incomes. At last count the capital, Kunming, was home to three Wal-Mart, two Carrefour, two PriceSmart, two Trust-Mart and one Parkson hypermarket, though this number has probably grown. Most recently, Wal-Mart announced plans to expand into smaller cities beginning with Yuxi in Yunnan province. Precisely why Yunnan has been the focus of so much development is unclear, but other cities have also seen remarkable growth. Chengdu, in Sichuan province, is home to multiple Ito Yokada, Carrefour and Wal-Mart stores, and is one of the few cities of the interior to show consistent growth in retail revenues.

ATO/Shanghai recently carried out a major multi-level promotion in Chengdu in cooperation with Ito Yokada. Consumers showed remarkable enthusiasm for the imported products, which included seafood, pork, poultry and dried fruit and nuts, and several products (particularly pork) sold out several times during the course of the promotion. Logistics and distribution constitutes one of the largest obstacles in these interior markets. Most imports are sourced through local agents, who in turn source from a nearby transportation hub, which in turn sources from Shanghai. The large number of hands that products pass through raises not only prices, but significant concerns about the quality of the product by the time it reaches the far end of the distribution chain. ATO Shanghai has found that one of the most valuable outcomes of its promotions in interior cities is to help build links between retailers and distributors, smoothing out this long supply chain.

For convenience chains, these logistical limits are an even more serious issue. In the Shanghai area, most development has been limited to cities that fall within Shanghai's web of transportation and distribution services: Suzhou and Wuxi, and to a lesser extent Hangzhou and Nanjing. Quik, Kedi and C-Store have been the quickest to expand into these nearby markets. Interviews with Kedi indicate that they rely entirely on their Shanghai distribution network to supply stores in Suzhou.

Figure 6. Guangzhou Region



<u>Guangzhou Region</u> – Located in South China, Guangdong has the highest GDP of any single province in China, with retail sales of consumer goods increasing to 560.6 billion RMB in 2003, accounting for 12% of China's total sales. At the heart of Guangdong's economy is the Pearl River Delta (PRD) Economic Zone, which accounted for 80% of the province's GDP in 2003. Like Shanghai, the city of Guangzhou sits in the center of a web of development that spreads well beyond Guangdong and into neighboring provinces. Also like Shanghai, retail development in Guangzhou itself is approaching saturation point, with the strongest growth opportunities likely to take place in nearby cities such as Shenzhen. The Chinese government has targeted the Pearl River delta and several adjacent provinces for future investment as a means to offset the growing influence of Shanghai. Rapid expansion of the freeway system has helped to extend Guangzhou's influence throughout southern China by cutting shipping times to interior cities like Changsha (Hunan province) down to a single day.

International retailers, including Wal-Mart, Carrefour, Metro, Jusco, Park 'N Shop, and Trust-Mart have all opened stores in major cities such as Guangzhou, Shenzhen, Dongguan, Zhuhai and Fuzhou, and have plans to further expand their operations in South China in the next few years. For example, Wal-Mart and Carrefour are currently establishing large purchasing centers in Shenzhen.

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

Regional supermarkets and hypermarkets purchase products from local importers, wholesalers and distributors, with many facing various difficulties in obtaining and/or transporting imports to the mainland. For example, some lack sufficient information on where to source imported food and beverage products. However, many directly and indirectly purchase foreign products that have been transshipped to the mainland from Hong Kong. This allows importers and distributors to avoid paying VAT and customs duties, and exposes the market to some products currently banned from the mainland. The gray channel trade makes it difficult for US exporters and most western-style supermarkets that insist on using proper channels to be competetive with contraband products.

South China consumers have a strong preference for U.S. food products in part due to the reputation for high quality, but also for health reasons since many locally-produced foods are alleged to have high concentrations of pesticide residues. Nonetheless, consumers are very price-sensitive, and many buy domestic products because they cannot afford higher-priced imports. The most popular imports include baby foods/infant formula, chocolates, dried fruit and nuts, fresh fruit and vegetables, potato chipa, popcorn and canned foods such as soup.

Table 6. Selected Hypermarkets and Supermarkets in Guangdong Province

Retailer	Ownership (Base)	Sales in Guangdong (RMB)	Number of Outlets 2003	2004	Locations
CRC Vanguard	Chinese-Shenzhen	10.3 billion	321	346	Throughout Guangdong
A. Best (Xin Yi Jia)	Chinese-Shenzhen	5.9 billion	26	30	Guangzhou Shenzhen Jiangmen
Minren	Chinese-Shenzhen	2.2 billion	21	111	Throughout Guangdong
Renren	Chinese-Shenzhen	3.2 billion	7	12	Shenzhen Huizhou Jianmen Zengcheng
Park'n Shop	Hong Kong	5.9 billion	8	27	Thoughout Guangdong
Trust-Mart	Taiwan	N/A	11	17	Guangzhou Shenzhen
Wal-Mart	U.S.	2.4 billion	10	13	Shenzhen Dongguan

Lotus	Thailand	11 billion	4	6	Guangzhou
Carrefour	French	N/A	5	6	Guangzhou Zhuhai Shenzhen
Metro	German	1.6 billion	1	1	Dongguan
Jusco	Japan	438 million	5	6	Guangzhou Shenzhen
Homecity	Chinese-Guangzhou	4 billion	25	50	Guangzhou
Sources: ATO/Guangzhou Telephone Interview All listed hypermarkets and supermarkets rely on agents and distributors for purchasing products.					

Convenience stores and mini-marts at foreign-owned gas stations such as Esso, BP and Shell have a strong presence in the Guangzhou area. While convenience stores place a greater emphasis on ready-to-eat foods, snacks, newspapers and magazines, gas station mini-marts have not become western-style one-stop-shops, offering only a very limited range of soft drinks and local products. 7-Eleven, the most competetive convenience chain in Guangdong, has plans to open ten additional stores by the end of this year. Circle K (OK), Kedi and Quik have recently challenged 7-Eleven's dominance in South China, and have plans to aggressively expand their presence there.

The most interesting item to note about convenience stores in the region is their price competetiveness with hypermarkets. The market is so price sensitive that convenience stores are forced to keep their prices in line with larger retailers, definitely a point of divergence with their western counterparts. As incomes rise and more consumers own cars, state-owned gas stations that currently only sell gasoline are rapidly being converted into full-service stations with mini marts. For example, BP only had some 25 gas station mini-marts at the end of 2002, but now has over 170 such stations and is continuing to refit older ones.

Table 7. Convenience Stores and Gas Mini-Marts in Guangdong Province

Retailer	Ownership	No. of Outlets (2004)
7-Eleven	President / Taiwan (franchise holder)	185
Kedi	Shanghai / Chinese	17
Quik	Lianhua (Shanghai) / Chinese	100
Meiyijia	Dongguan / Chinese	300
C-Store	Taiwan	54
Jiadeshi	Hong Kong	42
Esso	US / Petrol China	6
BP	BP / Petrol China	176
Circle K (OK)	Ya Li Group / Hong Kong	16

II. Road Map for Market Entry

Ground Rules

China is not a single amorphous market, but a kaleidescope of small 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 being targeted. Nonetheless, there are some basic guidelines that can be applied in most cases.

1) Understand the importance of relationships. China's legal system is developing, but remains inconsistent. Enforceability of contracts varies widely. In lieu of a strong, consistent legal system, business in China relies heavily on personal contacts and influence (referred to as 'guanxi'). For companies with a serious interest in the China market, no investment will be more important to their success than the network of relationships that they establish in China. For more pointers on this, please see ATO/Shanghai's report CH 4835, Chinese Business Etiquette.

2) 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 you in China. Chinese buyers are often unfamiliar with U.S. product sources, quality standards and contract practices, while many U.S. exporters are not familiar with China's sales practices, distribution channels and consumer preferences. Visits to China give exporters the chance to assess the market, establish relationships and determine where their greatest difficulties and opportunties will be.

3) Find a local partner and/or distributor. An exporter's success in China often hinges on his local partner, distributor or representative. Business in China is based on relationships: regular contact with buyers, distributors, consumers and government officials is crucial to success. For larger companies and companies with a long-term commitment to China, establishing a representative office or a joint venture partnership may be worthwhile. Smaller companies, however, are likely to rely on a local importer/distributor to handle marketing and regulatory issues, which makes the choice of a good partner absolutely critical. Hastily made partnerships are perhaps the most common cause of business failure in China. It is also important to ensure that the incentive structure of your partnership is designed to keep you and your partner working in the same direction.

4) Keep an open mind. Things don't always work as expected in China. This can sometimes be a good thing, provided you are poised to take advantage of opportunities as they arise. Time and time again, ATO promotions have turned up unexpected opportunities. A few examples: At a mall promotion in Shanghai, high-end beef cuts, long regarded as too expensive and inappropriate to Chinese cooking methods, was the hot item. Two years later, at the exact same venue, fresh pears and cherries sold out within hours of opening. Another promotion in Wuhan, deep in the interior, saw Mexican foods sell out in short order. In Chengdu, at the center of one of China's largest pork producing provinces, U.S. pork sold out several times during a promotion. By the same token, a product may find its niche in an unexpected place. Washington apples have shown remarkable strength in China despite brutal price competition from domestic apples, because their excellent appearance makes them ideal for the gift market, where price is less of a consideration.

5) Invest (wisely) in market research. From the perspective of an outsider, 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 ultimately to test their products directly. Be careful how you invest research money, however. Due to a dearth of reliable government statistics and laws that limit their activities, the quality of research by international market research firms is often not significantly better than that of much less expensive local companies.

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

7) Find your market niche and focus on it. China is a very, very big place. A common mistake made by exporters is to spread themselves too thin by trying to cater to the entire market spectrum. The mass market is driven by price, and China's fragmented logistics systems make it difficult to service more than one geographic area at a time. Exporters with limited resources are well advised to identify the best market niche for their product, and serve it faithfully and consistently until they are sure of success before moving on. Examples of potential market niches might be along the lines of 'young mothers in Shanghai' or 'affluent teens in Guangzhou' or 'business travelers in Beijing.'

8) Pursue gradual but sustainable growth. Another 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.

9) 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 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 trade shows and trade shows focused on your particular market segment is a good way to start. In-store promotions are also a cost-effective way to support your product while building your relationship with distributors and retailers. Above-the-line media advertising should be carefully planned, as TV and radio time is expensive and has limited reach. Exporters are advised to explore joint marketing opportunities with local Agricultural Trade Offices or with a State and Regional Trade Group (such as NASDA, WUSATA, MIATCO, SUSTA or EUSAFEC).

Market Structure

Distribution and logistics channels vary significantly within China and across all sectors. As a general rule, the 'big three' cities of Shanghai, Guangzhou and Beijing have the best infrastructure. All sectors have certain things in common, however.

- China is still subject to import licensing and currency exchange restrictions. Although import licensing is due to go away in 2005, the reality is likely to take somewhat longer, and currency exchange restrictions will continue. Since most import transactions rely on the licensed importer to handle currency exchange as well, the effect on transactions is likely to be limited. Few distributors or traders hold import or currency exchange licenses and very few licensed importers act as distributors, so the import licensing and currency exchange is primarily a legal convention, adding paperwork (and fees) to the process. Even if payment is made on delivery, the entire foreign exchange process can take several weeks from the time the goods arrive.

- Good distributors, especially those with significant geographic reach, are in extremely short supply. The most important task for an exporter is to identify a distributor they can work with. This company must be able to handle all the import formalities (including finding a licensed importer, customs clearance, logistics, warehousing, quarantine and inspection), and have a network of retail customers. Some products, such as wine and poultry, have a community of specialized distributors with a wealth of experience in those products.

- Indirect sales through Hong Kong still take place, but are declining in importance. In this case, exporters sell to an agent in Hong Kong, who then resells the product into China. Exporters who lack the tie or resources to become directly involved in China often take this route, as business practices in Hong Kong are more familiar, language barriers less of an issue, and risks are generally lower. In doing so, however, exporters lose control of their products, which may be adulterated before reaching the final consumer. This can undermine the product's reputation if it causes problems with quality. Exporters also lose the opportunity to make contact with their ultimate buyers.

- Gray market channels, an extralegal version of indirect sales, persist although their importance has declined in recent years. Gray market sales evade tariffs and VAT taxes, as well as bans or quotas on certain products. They are also notoriously opaque and subject to frequent crackdowns. Declining tariffs and increased openness in direct trade with the mainland have reduced the incentives to move products through this channel.

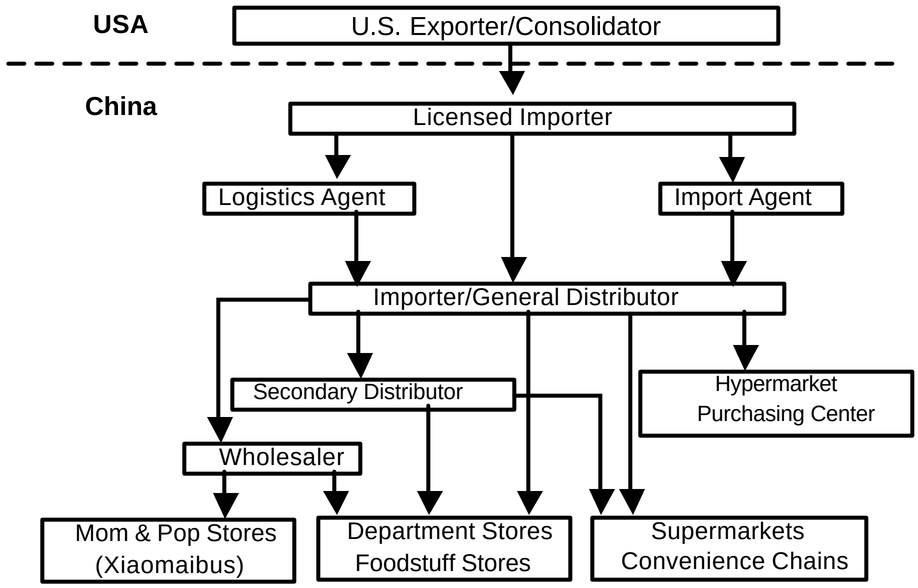
- Once a product clears customs, it is usually stored in a warehouse rented by the distributor, with the storage costs borne by the exporter. As a result, most shipments arrive as consolidated containerloads ordered by one or more retailers.

- Port services in China are becoming more sophisticated. Most major ports now include free trade zones and companies that provide comprehensive logistics services. Free trade zones provid bonded storage that allows exporters to avoid paying VAT and duties until the product ships out of the FTZ. Many also allow value-adding (such as repacking or processing) to take place in the FTZ, with VAT paid only on the original import value of the product. Logistics service providers operating in the FTZs can provide warehousing, inventory control and shipping. Some offer temperature-controlled storage and on-line inventory.

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

Although China's logistics infrastructure is developing rapidly, integrated supply and distribution networks are rare outside the three major cities, and must be peiced together one component at a time. ATO and cooperator promotions often do much of this work for you, making these promotions an excellent opportunity to build distribution networks in new areas. The following chart provides a simplified overview of the flow of goods from a U.S. supplier to a Chinese retail outlet.

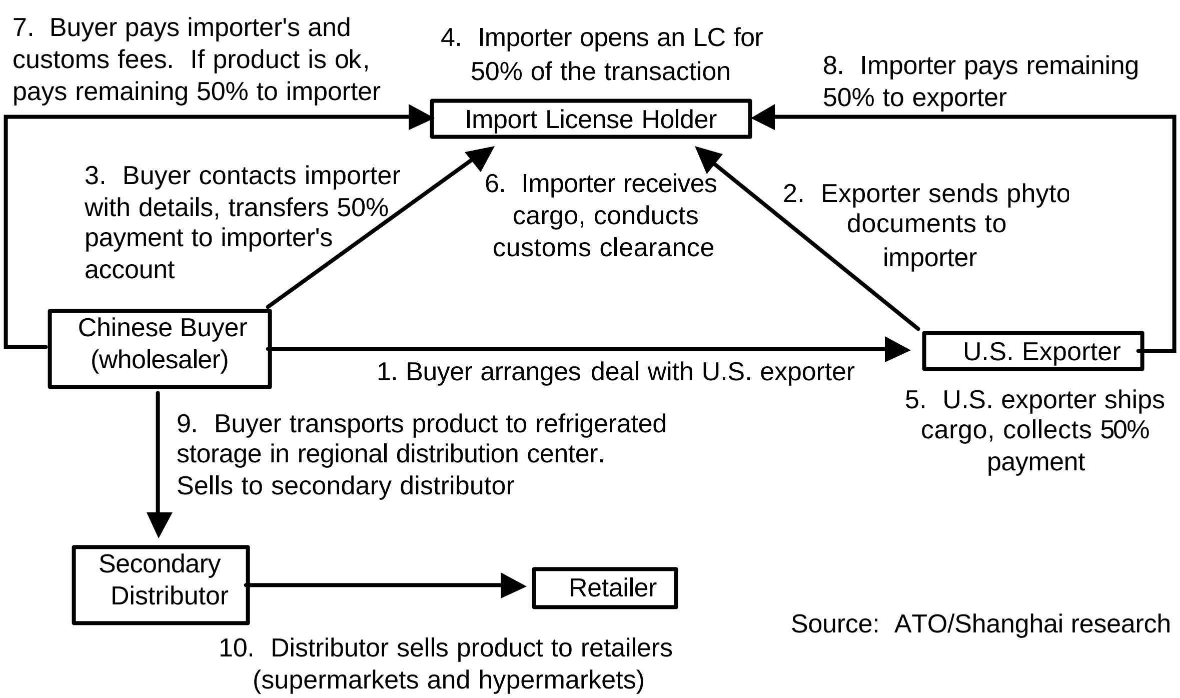
Figure 7. Imported Goods Marketing Chain



Source: ATO/Shanghai research

In addition to the difficulty of peicing together a distribution chain, Chinese regulations on import licensing and currency exchange can make financial transactions quite complex. Payment terms and specific arrangements vary according to the product. The following chart follows an actual transaction for a shipment of celery. While every transaction is unique, it provides some notion of the complexities involved in doing business in China.

Figure 8. Import Transaction Flow: Case Study (U.S. Celery)



Source: ATO/Shanghai research

Exporters working with a reliable distributor can avoid getting involved in these details. Experienced distributors can handle currency exchange, import licensing and product registration requirements, and inform exporters of the export documentation and labeling requirements. Nonetheless, knowing how the transaction works is important, should problems crop up later. Certain items peculiar to the above transaction are also worth note. Payment of 50% on shipment is not typical of sales to retailers, most of whom do not pay until after they receive the shipment, and many of whom will demand 90-180 days' credit. Also, first shipments of new products will require additional time and paperwork for product registration and registration and approval of product labels.

II.A Hypermarkets, Supermarkets and Warehouse Outlets

Hypermarkets and warehouse outlets are one of the fastest growing sectors, and offer the best opportunities for U.S. exporters. Dominated by chain stores, this sector has more centralized purchasing than most others. Foreign-owned or managed chains are prominent in this sector, and have solid experience in dealing with and promoting imported products. Leading hypermarket chains such as Carrefour and Wal-Mart owe part of their success to the fact that they have managed to bypass China's inefficient wholesale system and are ordering some products directly from suppliers and manufacturers. It is important to note however, that these buyers often rely on local agents or distributors for logistics and import formalities, and an exporter may still find it necessary to line up a distributor before the chain will agree to carry their products. Although supermarket chains have wider reach than the hypermarkets, the largest chains are state-owned and suffer from a lack of integrated management. Supply and distribution chains for supermarkets tend to be localized, giving them less purchasing volume than the biggest hypermarket chains. In addition, their focus tends to be on lowest price rather than quality or novelty.

Exporters interested in this market segment are advised to familiarize themselves with their prospective buyers, as purchasing practices vary between different chains. Since most of these chains rely on distributors to some extent, it is also useful to become familiar with them as well. In some cases, the more aggressive distributors will actually market new products to the retailers, who may be reluctant to stock items with uncertain prospects for success. Support from the distributor can make a tremendous difference, since hypermarkets often charge exorbitant slotting fees to carry new products. These fees are usually covered by the distributor, making their support critical to success. Both hypermarkets and distributors are generally supportive of promotional campaigns, as they both have a stake in the product's success. However, retail chains often attach a number of strings to promotions, charging numerous fees for use of their space and requiring that the supplier buy back any products not sold by the end of the promotion.

II.B Convenience Stores

The convenience store industry is quite new to China. As a result, it remains geographically concentrated in the coastal areas around Shanghai and Guangzhou, with a growing presence along China's freeways and in the Beijing area. At the same time, it is the most modern in terms of management and distribution networks, with centralized procurement for most chains. Convenience stores also act as service centers, selling phone cards and providing bill-paying services. Until recently, penetration of imported products was limited primarily to dried fruit and nuts. However, fierce competiton has led many chains to diversify their product lines, especially in the direction of higher-value and ready-to-eat products. Ice cream, including premium brands such as Haagen Dazs, have become a staple for many stores. Promotional activities, once based almost exclusively on price-cutting or two-for-one offers, have become more sophisticated. Most recently, Lawson's stores in Shanghai participated in a first-ever U.S. Food promotion organized by ATO Shanghai, following which the chain worked with the Alaska Seafood Marketing Institute to feature Alaska Salmon in its boxed lunches.

Movement of convenience stores into niche markets is creating more opportunities for U.S. exporters. The aforementioned promotion of Alaska Seafood, for example, was made possible by Lawson's recent movement into high-end retail venues with large numbers of white collar workers but few fast-dining options. The growing number of gas-mart convenience stores, for example, raises possibilities such as products aimed at traveling businessmen, while combined music-convenience stores in Shanghai may offer possibilities for product tie-ins.

Exporters seeking to work with these chains should keep several points in mind. First, they are very strongly focused on consumer demographics. Most chains have a very clear idea of who the customer base for a given store is, and proposals that focus on key demographic groups will get a better reception. Key groups include working parents, young urban professionals and schoolchildren. Products will have to be adapted to suit impulse buyers: single-serving portions will do best. Customers at these stores are brand-conscious (otherwise they'd be shopping at the xiaomaibu), but also price-sensitive. Key price points are 1 and 10 RMB/unit. At least one importer has built success on repacking U.S. prunes into single-serving packages that are sold to schoolkids for 1 RMB apeice. Convenience chains are also extremely sensitive to their own standards and store layouts. Promotions are likely to require quite a few meetings in order to work out a program that all participants are happy with.

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

Wet markets are on the decline, but remain dominant in smaller cities and still retain a significant presence in even the most developed big cities. Freshness and price are the key reasons for the persistence of wet markets. Chinese consumers prefer to buy the freshest products possible, and often purchase chickens and fish live, to be butchered on the spot. This is in part an effort to ensure quality, as meat processed out of sight is not always regarded as trustworthy. Vegetables are generally of higher quality at the wet markets as well, since supermarkets often have cumbersome supply chains and products are not well handled. Hypermarkets are a poor alternative for most consumers, who rely on public transportation or bicycles, and do not have the space to store large quantities of perishable foods. Government efforts to clean up wet markets took on a more serious tone following the SARS and avian influenza outbreaks. A recent effort by Shanghai to create a serious alternative to wet markets may succeed, provided traditional supermarkets are able to make the transition to the 'fresh supermarket' format.

The traditional variety store, the xiaomaibu, continues to hold on, even in convenience store saturated Shanghai. These family-owned stores are typically smaller than convenience stores, and stock a heterogenous mix of drinks, snacks, household items, hardware, bicycle parts and whatever else the owner thinks to stock. In Shanghai these shops have found their niche by marketing to areas that are ignored by the convenience stores, which tend to focus only on high-traffic areas such as schools and subway stops. Most apartment complexes have at least one xiaomaibu on site. Xiaomaibus also have found an advantage in marketing to micro-niches, sometimes carrying utterly obscure products that, for one reason or another, are in demand in that specific neighborhood, or even by a single customer. Like convenience stores, many xiaomaibus also sell telephone calling cards and provide bill-paying services and the like.

Fruit stands are a distinct variant of the xiaomaibu. Like the xiaomaibu, these are very small, family-owned shops. Unlike the xiaomaibu, they typically stock only fruit, and often carry imported products. Most also offer gift baskets, which can be custom ordered, assembled and wrapped on the spot. Counterfeits are also commonplace in these shops. Like xiaomaibus, promotions are non-existent in the fruit stands, and small size and dispersed ownership makes promotional campaigns virtually impossible.

Supply and distribution channels for wet markets, xiaomaibus and fruit stands are primitive, with store owners making daily trips to nearby wholesale or wet markets to stock up. Preserving the identity of imported products is nearly impossible, and many consumers tend to assume that all products are local, regardless of packaging or claims on the part of the seller. Packaged products are often broken up for resale in smaller units, regardless of whether they were intended to be sold that way.

III. Competition

The most serious competition for U.S. food exporters are local and joint-venture producers and processors. On the one hand, the quality of fruit, vegetables and processed foods in China is improving rapidly. On the other, many international companies have established processing plants in China to take advantage of low labor costs. While supermarket shelves are often stocked with famous foreign brands such as M&Ms and Coca Cola, close inspection will reveal that most of these products are manufactured in China or in Southeast Asia. These local products often have the additional advantage of being formulated specifically for the Chinese market. This, along with omnipresent counterfeiting, has made Chinese consumers somewhat cynical. While they generally associate imports with high quality, it may be difficult to convince them that a product is genuinely imported. Domestically manufactured products have completely cornered the market in several broad categories, including soft drinks, beer, processed meat and low-end confections. Competition is becoming quite serious in other areas as well, including low-to-mid-range wines, confectionery and pet food. Chinese products have traditionally competed on price alone, but improvements in quality and efforts to develop recognizable brands have made these products increasingly competitive at all levels. It should be noted that in any category, niche markets exist. Hence, while domestically manufactured beer dominates the overall market, a strong niche market exists for high-quality imported beer. The fact that this particular 'niche' amounted to $50 million in 2003 (UN data) gives an idea of just how important these niches can be.

In product categories where imports are prominent, competition tends to be strongest with Pacific Rim neighbors such as Thailand, Australia, New Zealand and the Philippines. Competition from EU countries tends to be strongest in high-value niche markets, such as wine, cheese and premium chocolates. For certain products, specific countries have maintained a strong market presence. (Based on UN data for 2003: note that US exports of poultry and beef fell during 2004 as a result of sanitary barriers).

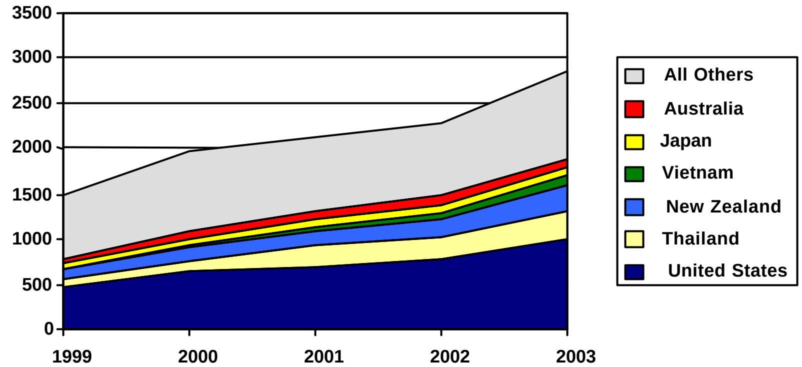
- Oranges: U.S., New Zealand, South Africa
- Grapes: U.S., Chile
- Apples: U.S., Chile, New Zealand
- Cherries: U.S.
- Lemons and Limes: New Zealand, U.S.
- Red Meat (fresh/chilled/frozen): U.S., Canada, Denmark, New Zealand, Australia
- Breakfast Cereal: United Kingdom, U.S., Philippines
- Cheese: New Zealand, Australia, EU, U.S.
- Frozen Processed Potatoes: U.S., New Zealand, Canada
- Frozen Corn: U.S.
- Dairy (other than cheese): New Zealand, France, Australia, U.S.
- Poultry: U.S., Brazil

- Tree Nuts: Korea (chestnuts), Russia, U.S. (almonds, pistachios, walnuts, hazelnuts), Iran (pistachios), Turkey (hazelnuts)
- Premium Chocolate: Switzerland, Belgium, Italy, France
- Premium Ice Cream: France
- Seafood: Russia, North Korea, U.S., Japan, Canada, Norway
- Wine: Chile, France, Australia, U.S.
- Ginseng: U.S., Canada

The U.S. remains the largest overall exporter of consumer oriented food products to China, with a 30% share of total imports in the category. China is attracting considerable attention from other countries, however, and many have established trade promotion offices in China, including Australia, Canada, France, Great Britain, Italy, the Netherlands, New Zealand, Thailand, Malaysia and the Philippines. In addition, China has concluded bilateral or multilateral trade agreements with many of its neighbors, particularly in ASEAN. The fastest growth in exports has been seen with Vietnam and Chile, and Vietnam is now the fourth largest exporter of consumer-oriented agricultural products to China.

Figure 9. China's Direct Imports of Consumer Oriented Agricultural Products

$Million, (UN Data)

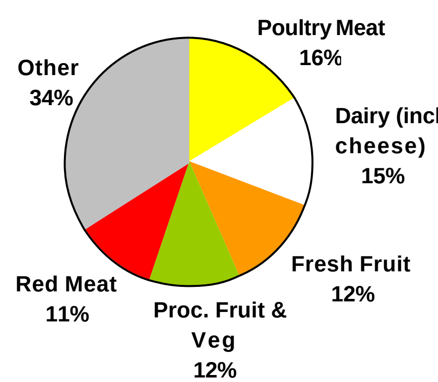


IV. Best Product Prospects

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

- Nuts and dried fruit
- Seafood
- Poultry meat
- Red meat
- Frozen vegetables (esp. sweet corn)
- Infant formula
- Baby food
- Dairy products (esp. ice cream)
- Frozen potato products
- Fresh fruit (oranges, apples)

Figure 10. China's Direct Imports of Consumer-Oriented Ag. Products by Type



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

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

V. Post Contact and Additional Resources

FAS has four offices in China:

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