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North China Retail Update

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Report Highlights: North China's retail food sector continues to undergo dramatic change, with traditional wet markets rapidly being replaced with supermarkets, hypermarkets and convenience stores. Rising incomes has enabled mid-upper class consumers to try and use high quality imported food products on a continuing basis. Improved distribution and logistics are providing greater access for suppliers to penetrate this lucrative retail market.

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I. North China Retail Market Overview

With the national economy growing at more than 9 per cent annually, China's retail market is expected to expand 8-10 percent yearly and reach US \$2.4 trillion by 2020. North China's retail food sector continues to change dramatically with traditional wet markets now rapidly being replaced by supermarkets, hypermarkets and convenience stores. Rising incomes have empowered middle class consumers to not just try, but use high quality imported food products on a continuing basis. Improved distribution and logistics have made access less complicated for supplies to enter this highly fragmented and competitive retail market.

Overseas retail giants continue to aggressively pursue this market and account for 40% of total retail supermarket sales in Beijing, compared to 70% in Shanghai. Based on a recent China Chain-store & Franchise Association (CCFA) report, in the first three quarters of 2005, wholly owned retail businesses operated by foreign investors increased significantly in China. Wal-mart currently operates 56 stores in 28 cities throughout China, including 51 Wal-mart Supercentres, 3 Sam's Clubs and 2 Community Stores with plans to open 18-20 new stores in 2006. French retail giant Carrefour, the largest overseas player in China with sales of more than US \$2.4 billion in 2005, plans to open 20 new stores in 2006 on heels of 14 newly established retail stores in 2005. As of February, Carrefour operates 71 stores nationwide and those 24 are in North China. Rapid retail expansion by overseas retailers poses a challenge to domestic companies trying to expand although Chinese regulators routinely favor domestic over foreign firms. Some State Operated Enterprises (SOEs) continue to receive 'soft loans' from state-run banks to finance local retail expansion, if not survival.

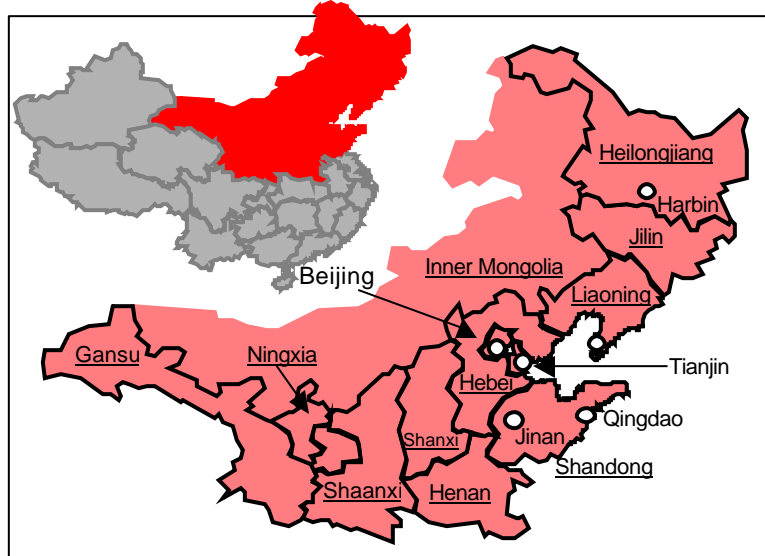
China's recent retail industry can best be described as one of acquisition and consolidation. Tesco invested \$260 million to acquire a 50 percent stake in Hymall, a domestic chain operating 25 hypermarkets nationally in China. This should enable Tesco, the world's third-largest retailer and largest in the UK, to challenge Wal-Mart and Carrefour here. Tesco plans to open a 20,000 square meter shopping mall in Beijing in early 2007. In January 2006, Wu-mart, the 10th largest chain store operator in China and largest retail chain in Beijing, took control of competitor Merry-Mart, Beijing's fourth largest retailer. The acquisition signaled increasing competitiveness in the domestic retail sector that continues to expand via consolidation. The bold Wu-mart move should result in greater efficiencies and purchasing power, and the company claims to be the fastest growing consumer goods seller in Beijing. Wu-mart predicts it will become the major wholesale channel for all of Beijing this decade.

Current development trends indicate existing transportation and infrastructure bottlenecks are being significantly relieved, with previously difficult to access northern cities becoming more attractive for domestic and foreign players. As industrial development in these cities takes hold, demand for more and better retail is expected to follow. While foreign retailers have strengthened their presence in large cities, increasingly the focus has turned to small and mid-sized cities, where retail space is more available, and competition less. "We see surging demand for consumption in small and mid-sized cities, offering good opportunities to expand for our investment in China," says Dong, Yuguo, a spokesman for Wal-mart China.

With the above said, small northern retailers are going bankrupt in unprecedented numbers, battered by intense competition and consolidation in the sector. Small retailers have begun to consider practical solutions such as organizing purchasing consortiums or voluntary chains. The largest independent retail chain in Europe, SPAR, entered China in 2004 by partnering with Shandong retailer Jiajiayue. The agreement calls for the opening of 15 new SPAR Supermarkets in Shandong Province over the next three years, many with floor space in excess of 10,000 square meters. Managing Director Gordon Campbell of SPAR, says his company's role is to organize operations, make store improvements, establish purchasing systems, train staff and help Jiajiayue compete in the marketplace with the multinationals.

The following map indicates area coverage for ATO Beijing in the North China Market.

Figure 1. ATO Beijing Region



II. Beijing Retail Market Update

Beijing's retail scene has the most room for future expansion among China's 'big three' cities (Beijing, Shanghai and Guangzhou) given slow development in the past. In 2004, consumer goods retail sales grew by 14.4% and retail food sales 22.7%. Unlike Guangzhou or Shanghai, Beijing is not at the center of a wider economic development web, with Tianjin the only nearby urban area worthy of mention. However, the broader region of North China is home to some of the country's most dynamic coastal cities, including Dalian, Qingdao, and the major cities of Northeast China such as Shenyang, and Harbin. Shandong Province in particular continues to develop into a major industrial, trade and transportation center.

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

Despite the strength of its expatriate community, the percentage of imported foods in Beijing hypermarkets rarely reaches above 3-4% of sales. Stores routinely adjust quantities of imported food for particular stores based on neighborhood income, number of expatriates, etc. Warehouse stores generally target higher-income consumers or those who own cars, and

generally stock more and higher-value imports. Sam's Club in Beijing sell three times as much imported food as Wal-Mart Super Centers, but the ratio of imported products is still only 3-4% of sales. Beijing retailers hold US products in high regard for quality although European, Korean and other suppliers are increasingly popular as well. Shelf surveys reveal special sections devoted to imported beer, fruit, wine, etc. Dairy cases are expanding often displaying imported cheeses, and displays of imported breakfast cereals, biscuits and beverages are also not uncommon. Although most stores boast extremely large frozen food sections, these mainly consist of frozen dumplings, mixed vegetables, corn and peas, etc.

Hypermarkets in Beijing generally expect to make higher profit margins on imported food, because the market risk is much greater. Imported food retailers also expect promotional assistance for new-to-market items, including in-store demonstration, sampling, and negotiated fees for promotional effort. Some retailers charge slotting fees such as Carrefour where costs can reach RMB 10,000 (\$1,200) per slot, per store. Other retailers like Wal-Mart and Auchan appear to put most of their effort into keeping prices as low as possible.

Table 1. Major Hypermarkets/Supermarkets in Beijing

Retailer	Ownership	2004 Total Sales (Million US\$)	% of Sales Increase Over 2003	No. # Outlets (Dec. 2003)
Beijing Hualian Group	China	2000 (nationwide)	25	70 (nationwide)
Beijing Wu-mart	China	1660	61	608
Beijing Jingkelong	China	655	3	140
Beijing Chaoshifa	China	267	13	43
Beijing Shoulian	China	245.4		56
Beijing Shuntianfu	China	76	8	18
Carrefour	France JV	2,400(nationwide)	21	71 (nationwide)
Wal-mart	US	954.4(nationwide)	30	56 (nationwide)

Source: CCFA / ATO Beijing

Modern convenience stores are just beginning to make an appearance in Beijing and other northern cities with many operated by the same state-owned chains dominating Shanghai, and other parts of China. These stores are characterized as clean, well managed, heavily automated, with real-time inventory systems. In many places they are rapidly replacing the traditional 'xiaomaibu' stands that sell snacks and drinks, but stock few, if any, imported products. Initial reports indicate convenience store chains are re-thinking their Beijing strategy where current consumer culture is figuratively, if not literally, driven by automobiles. In addition, 24-hour service is less of an advantage in the cold North than in the warmer South where most of China's convenience chains are currently located.

In the race to develop Beijing, and North China, state-owned behemoth Lianhua has moved quickly into the lead the pack with its ubiquitous Quik convenience store chain. However, 7-11, with a strong foothold in South China began opening Beijing outlets in April 2004. To date, the stores have never made money. Rapid growth in car ownership has created great interest in 'gas marts' that now appear to be the future direction of the retail convenience sector here. However, the convenience store has been relatively slow to develop. The Beijing Municipal Government made a concerted effort to limit growth in this sector, fearing over development as in Shanghai, and displacement of traditional family-owned stores. The generally unfavorable regulatory climate here may also be a factor, as retail licenses and permits can be difficult to obtain even in the best of times in Beijing.

III. Major North China Retail Market Updates

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

Shandong Province & Qingdao: This coastal province south of Beijing is home to a number of growing industrial cities there. Companies from nearby Korea and Japan have invested heavily in the province's modern infrastructure development, including cold chain, agricultural production and container port facilities. While no single city has per-capita incomes approaching Beijing, the cities of Qingdao, Yantai, Weihai and Jinan are among the most prosperous in China, and have developed a significant middle class. Shandong's long history of trade has made the local culture more open to imported products than many other parts of China. In 2005, retail sales of the top 10 Qingdao retailers experienced growth of near 40%. According to one local trader in Qingdao, Mr. Zeng, " In addition to supplying big retailers such as Jusco and Carrefour, I decided to open my own imported food store in 2006 due to the expanding numbers of expatriates and the rising incomes of local consumers in Qingdao." Zeng was part of an ATO Beijing sponsored buyer mission to FMI in 2005, and has imported nearly US \$5 million in food products from the US. In March 2005, ATO Beijing partnered with Qingdao Jusco to organize an American In-store Food Promotion soon after Jusco's completion of a new 30,000 square meter store space expansion. Nearly 350 U.S. food and beverage items including U.S. Pork, Alaska Seafood, Washington Apples, Sunkist Citrus and processed products including Salsa were featured during the 2-week promotion. To our pleasant surprise, the majority of shoppers for U.S. food products turned out to be local consumers and not expatriates.



Picture 1: ATO Beijing Jusco In-store Promotion

Dalian: The port city is one of the fastest growing cities in China and gateway to the large yet relatively untapped Northeast China market. Similar in many ways to Qingdao, Dalian is a trade-oriented city with heavy investment from Korea and Japan. Dalian has excellent infrastructure, high disposable incomes and a vibrant lifestyle. During the last few years Dalian's food retail sector has undergone a radical transformation given the rapid increase of supermarkets, hypermarkets and shopping malls. These retail formats have extensive dry and frozen goods, fresh and frozen meat, seafood, fruit, vegetables, prepared food, and food service sections. Many of these outlets are located in shopping destination or mall formats the whole family can utilize with restaurants, theatres, fashion boutiques, sporting goods stores, and other specialty shops. Relative to domestic supermarkets, imported food has a

significant presence in foreign operated supermarkets and hypermarkets even if imports account for no more than 3-4% of total sales. However, local retailers should not be ignored either as Dalian's very own 'national' retail food chain Dashang recorded the second highest sales in all of China in 2003, well ahead of Carrefour (4th) and Wal-Mart (10th), not to mention a 42.2% increase over 2002 sales. Most retailers state the main reason they do not stock more imports are the high prices. While Dalian residents consider U.S. food to be equal or superior to most other imports, price is large and highly significant constraint.

Harbin: Capital of Heilongjiang Province in China's Northeast, Harbin is the largest provincial capital in China, and has become a hotspot of retail development. A few short years ago this growing city of 10 million had no large supermarkets. Today, by contrast, Carrefour, Metro, and more recently Wal-Mart have all set up shop. Local supermarkets, convenience stores and other retail formats have a complex ownership, yet are somewhat consolidated. Newly built residential communities likely hold the key to meeting consumer's expectations for higher quality, consistency, sanitation and convenience. At the end of 2005, Dashang, with 120 stores in 26 cities in Northeast China, announced its merger with Harbin's No. 1 Department Store, one of largest department stores in China. The venture preserves the Harbin No.1 Dept. Store brand, and creates on its original site, a special Daoli Shopping District, complete with a New-Mart Plaza in front of the newly refurbished store.

In other parts of North and Northeast China, retail development has lagged due to a legacy of large and mostly inefficient state-owned or operated enterprises. These holdovers from the economic command economy era still dominate much of the production and employment in this part of the country, and have impeded development and reform. However, 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 for U.S. and other suppliers.

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