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China, Peoples Republic of

Retail Food Sector

North China

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Report Highlights:

China's retail food revolution has been rolling across the country for nearly a decade, replacing traditional wet markets and food stalls with modern hypermarkets, warehouse and convenience stores. At the same time, growing prosperity on the part of top-tier urban consumers has fueled both economic access and desire for high-quality imported food products. Improving distribution and logistics are making it possible for US exporters to supply this extremely competitive and rapidly expanding retail market in North China.

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I. Market Summary: Growth of a Modern Retail Industry

A. Overview of the Retail Food Market in North China

China's retail food industry revolution is reaching into northern China. The most basic infrastructure for providing food to consumers, from production to supply chain to retail outlet, is modernizing. Hypermarkets are replacing wet markets, warehouse stores are supplying restaurants and other businesses, and chain convenience stores are replacing little "mom and pop" stalls. The highway network is expanding, logistics and cold chain are improving, and food can be shipped in better condition over longer distances to market.

This development of the modern retail food industry, which has been accelerating since 2000, is part and parcel of the basic drive for growth and modernization that is transforming China. Driven by rising urban incomes, consumption patterns are changing and expectations are rising. There is for the first time a segment of the population that is: curious about non-Chinese food; can afford imported products; seeks status, and not just nutrition.

These changes came first to the Pearl River Delta, in South China across the border from Hong Kong, and then spread to the Yangtze River Delta around Shanghai. Now the retail revolution is reaching Northern and Northeastern China. Major hypermarkets, including international powerhouses like Carrefour, Wal-Mart and Metro, are extending their reach into the major cities of the north and northeast. Strong local competitors are also fighting for market share. In many once-isolated cities, there are retail stores that view imported food as a profitable niche, and branding has become a feasible marketing strategy.

North China covers an area larger than the eastern half of the United States, but retail development has been focused in a few large cities and two coastal provinces. Beijing has the highest income levels, followed by Tianjin, which has become the focus of multi-national investment. These large metropolitan areas border each other, with Beijing linked to Tianjin's Port by a modern superhighway. Growth of the middle class has been significant in both.

In Beijing, the modern retail market is developing most quickly in the growing suburban residential areas, where car ownership is skyrocketing. Many hypermarkets are locating in an urban-suburban border zone, hoping to appeal to both sides. Parking lots have for the first time become a necessity for stores in these areas. By the end of 2003, there were nearly 100 hypermarkets, warehouse stores or large supermarkets in Beijing, with another 19 in the planning or development stage. In addition, Beijing as the government and diplomatic capital has a significant population of well-off expatriates. This has created enough demand to support small groceries that specialize in imported products aimed at the expatriate community. Department stores also often include a high-end food market.

The government has however tried to limit growth in the convenience sector after watching the Shanghai convenience market spin out of control and become oversaturated. 7-Eleven, which has long had stores in southern Guangdong Province, began opening stores in Beijing in April 2004, but a chain of gas station marts catering to the booming population of drivers has not developed as rapidly as planned.

The modern retail food industry is also highly developed in Shandong Province, a fertile peninsula south of Beijing that juts into the Yellow Sea. The climate and conditions there are ideal for producing a variety of commercial food products, including poultry, beef, fruit and aquatic products. Companies from nearby Japan and South Korea are heavy investors and modern infrastructure including cold chain and container port facilities is well developed.

While no city in Shandong has the per capita income of Beijing, cities like Qingdao, Yantai, Weihai and Jinan are all among the most prosperous in China, meaning there is a developing middle class cohort that is attracted to and can afford imported food products. In addition, Shandong has long been exposed to the outside world, and people there have a good awareness of management innovation, technology and food products from abroad.

Other areas where the modern retail market is taking hold include Dalian, a port in Liaoning Province where Japanese and Korean investment has also been heavy; and Xian, in interior Shaanxi Province. Economic development in many northern cities has, however, lagged because of a legacy of large and unproductive state-owned enterprises, holdovers from the Mao-era command economy that still dominate production and employment. Despite this, elements of modern retail markets have emerged in every large city in North China.

Prosperity and modernization has not, however, reached the rural market, where two-thirds of the population still lives. Imported products are simply too expensive for this sector, where cash income can be as little as \$100 per year. Unless a food product can be sold for an average price of 1 Rmb (about 12.5 US cents) per item, it will be too expensive for this market. Domestic food processors shrink portion sizes or use inexpensive or cheap ingredients to reach these price points. In addition, distribution and retailing infrastructure remain rudimentary in most of China's countryside.

B. Market Drivers

Prosperity and economic development in China is generally located at the contact points between regional, national and global economies. In the north, Beijing, Tianjin, Dalian, and Shandong Province have the strongest connections to the national and global economies. They have the largest share of the growing middle class, and it is also in these areas where the physical elements of the modern retail market – the retail outlets, the cold chain and other logistics – are developing most quickly.

Virtually all market drivers are related to this basic structure of development, in which exposure to the developing national and global economies leads to rising expectations, prosperity, modern concerns and attitudes and ever increasing contact with the outside world. The pattern began with the development of the Pearl River Delta in the 1980s, and is now accelerating in northern China.

The status of overall foreign investment is a good indicator of development, and therefore the presence of modern market drivers, in a particular region or city. Beijing, Tianjin, Dalian and Shandong have all been focuses of investment, but domestic and foreign investment has also spread into secondary cities like Shenyang, Changchun, and Harbin.

Market drivers, all of them related to the thrust for modernization and development, include:

- Aspirations: Following years of poverty and isolation, Chinese want to be part of the modern world, and have their country to take its rightful place in the modern world.
- Status-seeking: Buying imported products, and being seen to afford imported products, confers status and "face."
- Curiosity: Younger Chinese are curious about new foods, both from other regions of the country and from abroad.
- Health consciousness: Consumers are concerned about hygiene and health, concerns heightened by episodes of SARS, avian flu and adulterated food scandals.

- Convenience: People work harder, earn more, live busier lives and have less time to shop and cook. Working couples are the standard. Demand for convenience and ready-to-eat food is skyrocketing.
- Exposure to foreign tastes: US fast food outlets like KFC, McDonald's and Pizza Hut have broadened Chinese tastes, with outlets frequently located at or near hypermarkets. In addition, the growing expatriate community has increased exposure to imported food, and more and more Chinese are traveling and studying abroad, bringing back a taste for the food.
- Olympic Run-up: The run-up to the 2008 Olympic Games is priming development in Beijing and the Shandong port of Qingdao (site of some of the water sports events), as well as reinforcing trends like curiosity and exposure to foreign tastes. In Beijing, new logistical facilities including cold warehouses are under construction.

C. Food Sales (Charts)

There are few detailed government statistics on retail food sales or breakdowns of per capita consumption in China. These statistics can also be inaccurate, since few are gathered by scientific sampling methods. Nevertheless, the statistics do give a general picture of steady economic development and indicate the direction of trends.

| Figure 1: Provinces and Cities of North China Size, Population and Income | | | | | | | | |
|--|-----------------|-----------------------|-------|-------|----------------------|----------------|-------|------------------|
| Provinces | Size (sq miles) | Population (millions) | | | Annual Income (US\$) | | | %GDP Growth 2002 |
| | | Total | Urban | Rural | Urban | Urban Top 10%* | Rural | |
| Shandong | 59,073 | 90.8 | 26.3 | 64 | 923 | 2,437 | 358 | 12.7 |
| Xinjiang | 642,819 | 19.1 | 6.5 | 12.6 | 904 | 2,231 | 226 | 7.6 |
| Shanxi | 60,336 | 32.9 | 12.5 | 20.4 | 756 | 2,165 | 261 | 13.4 |
| Henan | 64,478 | 96.1 | 24.8 | 71.3 | 757 | 2,143 | 269 | 9.4 |
| Jilin | 72,335 | 27.0 | 13.7 | 13.3 | 803 | 2,045 | 286 | 10.5 |
| Inner Mongolia | 456,954 | 23.8 | 10.5 | 13.3 | 733 | 2,015 | 236 | 12.2 |
| Heilongjiang | 175,290 | 38.1 | 20.2 | 17.9 | 740 | 1,959 | 292 | 10.3 |
| Qinghai | 279,001 | 5.3 | 2.0 | 3.3 | 788 | 1,882 | 207 | 13.2 |
| Ningxia | 20,000 | 57.2 | 30.8 | 23.2 | 735 | 1,739 | 232 | 10.2 |
| Shanxi | 79,459 | 36.7 | 29.9 | 6.8 | 767 | 1,627 | 193 | 10.4 |
| Liaoning | 56,371 | 41.4 | 19.2 | 22.3 | 791 | 1,493 | 310 | 8.4 |
| Hebei | 72,468 | 67.0 | 13.4 | 53.6 | 725 | n/a | 316 | 8.6 |
| Cities | | | | | | | | |
| Beijing | 6,489 | 11.4 | 8.1 | 3.3 | 1511 | *2,830 | 654 | 10 |
| Tianjin | 4,602 | 9.2 | 5.4 | 3.8 | 1132 | 2,848 | 644 | 12.5 |
| Qingdao | 4,114 | 7.2 | 2.5 | 4.7 | 1057 | 2,612 | 508 | 15.4 |

Source: China Provincial Statistical Offices

*Provinces and cities are ranked by annual income of top 10% of urban residents; for Beijing, top 20%.

The relative earning power of the top 10% of urban families gives an indication where foreign imported foods may be most likely to find willing and able consumers. (Figure 1).

Figure 2: Per Capita Urban Food Purchases By Income

| Item (kg) | 2002 | | 1999 | |
|----------------------|---------|------|---------|------|
| | Top 10% | Avg | Top 10% | Avg |
| Grain | 71.4 | 78.5 | n/a | n/a |
| Starches and Tubers | 8.2 | 9.0 | 15.8 | 13.7 |
| Edible Vegetable Oil | 7.8 | 8.5 | 7.8 | 7.8 |
| Pork | 22.4 | 20.3 | 20.2 | 16.9 |
| Beef | 2.2 | 1.9 | 2.4 | 1.9 |
| Poultry | 13.3 | 9.2 | 6.3 | 4.9 |
| Fresh Eggs | 11.1 | 10.6 | 13.0 | 10.9 |
| Fish | 14.5 | 9.6 | 5.6 | 4.4 |
| Shrimp | 2.7 | 1.3 | 1.5 | 1.0 |
| Wine | 0.42 | 0.24 | 0.28 | 0.17 |
| Fresh Fruit | 74.7 | 56.5 | 62.6 | 46.1 |
| Cake | 5.6 | 3.8 | 4.4 | 3.1 |
| Fresh Dairy Products | 26.5 | 15.7 | 13.8 | 7.9 |
| Sour Milk* | 3.3 | 1.8 | 1.5 | 0.9 |

*Yogurt, sour cream, etc

Source: China National Statistics Bureau

Figure 2 illustrates the differences in diet between the average-income urban residents and the high-income urban residents, the most likely to target for imported products. Top-tier urban households eat fewer grains, starches and oils, and much more fish, wine, fresh fruit, dairy products and sour milk (mostly yogurt). Consumption of poultry, fish, shrimp, wine, fresh fruit, cake and dairy products has grown sharply since 1999.

Figure 3: Per Capita Annual Food Spending of Urban Residents by Region

| Province | 2002 (RMB) | | | | | | 1999 (RMB) | | | | | |
|---------------|------------|------|----------|------------|-----------|------|------------|------|----------|------------|------------|------|
| | Total Food | Meat | Aqua Tic | Vege table | Cond' mnt | Bev* | Total Food | Meat | Aqua tic | Vege table | Cond' ment | Bev* |
| Liaoning | 2075 | 386 | 173 | 213 | 41 | 122 | 1731 | 355 | 122 | 252 | 29 | 96 |
| Shandong | 1928 | 332 | 121 | 159 | 24 | 126 | 1676 | 312 | 112 | 142 | 23 | 115 |
| Xinjiang | 1913 | 421 | 54 | 166 | 21 | 92 | 1609 | 391 | 49 | 162 | 20 | 62 |
| Qinghai | 1851 | 382 | 49 | 170 | 31 | 119 | 1655 | 312 | 42 | 162 | 25 | 133 |
| Shaanxi | 1833 | 254 | 49 | 166 | 31 | 90 | 1473 | 233 | 36 | 150 | 26 | 67 |
| Jilin | 1809 | 334 | 101 | 198 | 34 | 99 | 1562 | 307 | 83 | 198 | 26 | 79 |
| Hebei | 1795 | 330 | 96 | 207 | 30 | 153 | 1496 | 280 | 71 | 177 | 24 | 102 |
| Ningxia | 1774 | 308 | 41 | 191 | 26 | 75 | 1375 | 252 | 42 | 162 | 22 | 62 |
| Heilong. | 1585 | 304 | 80 | 156 | 27 | 87 | 1410 | 277 | 66 | 156 | 23 | 75 |
| I.Mong. | 1532 | 305 | 40 | 139 | 24 | 88 | 1304 | 263 | 38 | 115 | 20 | 79 |
| Shanxi | 1531 | 225 | 35 | 171 | 24 | 81 | 1406 | 203 | 29 | 173 | 24 | 86 |
| Henan | 1517 | 294 | 38 | 169 | 27 | 98 | 1428 | 263 | 36 | 140 | 26 | 100 |
| Cities | | | | | | | | | | | | |
| Beijing | 3472 | 566 | 163 | 249 | 61 | 242 | 2959 | 540 | 131 | 248 | 57 | 190 |
| Qingdao | 2974 | 528 | 374 | 223 | 36 | 181 | n/a | n/a | n/a | n/a | n/a | n/a |
| Tianjin | 2607 | 427 | 232 | 210 | 48 | 148 | 2460 | 452 | 220 | 215 | 48 | 129 |

*Liquor and other beverages

Source: China Provincial Statistical Offices

Figure 3 shows trends in urban food sales. Slight deflation in China from 1999 to 2003 suggests that consumption increases are actually larger than they appear in this chart. Spending on meat, aquatic products, condiments and beverages has increased, while consumption of wheat and rice (not shown) has fallen. Residents of cities like Beijing, Qingdao and Tianjin spend much more on meat, condiments and liquor. Spending in Qingdao is much higher than for other cities in Shandong Province.

| Figure 4: Kitchen Appliances Per 100 Urban Households | | | | |
|---|---------|---------|---------|---------|
| Item | 2002 | | 1999 | |
| | Top 10% | Average | Top 10% | Average |
| Refrigerators* | 103.5 | 87.4 | 89.8 | 77.7 |
| Freezers | 8.4 | 6.8 | 8.1 | 5.4 |
| Microwaves | 67.9 | 30.9 | 22.5 | 12.2 |
| Other cooking** | 132.4 | 96.0 | n/a | n/a |
| Water heaters | 44.9 | 26.7 | n/a | n/a |
| *Most but not all refrigerators have a small freezer compartment | | | | |
| **Other electric cooking devices: mostly rice cookers, also toaster ovens, etc. | | | | |
| Source: China National Statistics Bureau | | | | |

Figure 4 shows that by 2002 most urban households had a refrigerator, which usually included a small freezer compartment. However, standalone freezers were unusual even among well-off urban households. Meanwhile, microwave penetration is soaring. Chinese kitchen equipment is an important marketing consideration.

D. SWOT Analysis for US Food Imports

| STRENGTHS & OPPORTUNITIES | WEAKNESSES & THREATS |
|--|--|
| US products reputation for consistent hi-quality among local retailers, consumers | Many other imported products are vying for the Chinese market |
| Increased awareness and curiosity about imported food encouraged by Olympics | High price of US products limits market |
| US companies understand the importance of brands and how to build them | Brands take time and money to build; need education along entire value chain |
| Importance of 'face' encourages purchase of aspirational, branded, hi-status items | Domestic replacement if brand or status differential isn't established |
| Gift giving culture encourages purchase of impressive, branded, hi-status items | Fake products may take market share, damage brand image |
| Major urban areas are developing sizable populations of hi-income consumers | Tremendous pressure on price in fragmented rural market |
| Improving infrastructure supports more distribution of frozen foods and produce | Distributors may not provide good sales & marketing support |
| Higher living standards, education drive demand for quality, safety, dietary variety | Chinese food manufacturers-distributors are responding to this pressure |
| WTO-required tariff reductions make US imports more competitive vis-à-vis local | Protectionist impulses and abrupt policy shifts raise non-tariff barriers |
| Busier lifestyles has created opening for convenience food | Small initial shipments may not make money due to high transportation costs |
| Young consumer generation has created opening for fad foods | Long lag-time from order to delivery due to Trans-Pacific shipment |

II. Road Map for Market Entry

A. Rules of the Road

The first rule for successful marketing in China, according to experienced retailers and distributors, is to take the time and spend the effort to research and develop the market step-by-step, just as you would with a new product or market in the United States. It is all too easy to think that the target is so big you can't miss. But even though China has more than 1.3 billion people, the bull's eye for your product is probably very small. The country is huge, modern logistics are still in the development stage, and even in urban centers the percentage of people willing and able to buy imported products is still relatively small. The biggest mistake you can make is to spread yourself too thin. It is best to pick a target city or region where top tier urban income earners are concentrated, develop a market position and then spread into new areas as you gain experience. With a solid plan, you will be positioned to expand along with China's economic development and prosperity.

Other important principles of a China entry strategy include finding a good distributor to work with; educating the whole value chain about your product, including distributors, retailers and, not least, consumers; and establishing your product as a high-quality, high-status product worth the import premium.

- **Finding A Good Distributor**

Your most important relationship in China will be with your distributor, so take time to find one you're comfortable with. The best distributors are in demand, but they are also most likely to have the experience and savvy to distribute your product. Even the best distributors, however, probably won't provide the kind of sales and marketing effort that US companies expect, and many find it necessary to take the sales initiative themselves, while the distributor handles logistics.

A good distributor should be able to coach you on import requirements and handle the burden of Customs and health paperwork, either by themselves or through a licensed import agent. They should also have an extensive catalogue and an established network of customers. Equally important, your importer or distributor must be able to make or arrange payment in hard currency. The Chinese RMB is a controlled currency not freely convertible into US dollars. Although gradual liberalization is likely, and some is required by China's World Trade Organization accession agreement, currently companies need special licenses or status to convert RMB into US dollars.

China has a relationship-based business culture, so face-to-face meetings with distributors and retail clients are important. Most distributors and retailers simply won't buy from somebody they haven't met face-to-face. If they don't meet you or an employee of your company, they will suspect you are not committed to the market.

- **Educating the Value Chain**

A Western store manager wondered why Chinese consumers wouldn't buy any of his imported premium US canned soup. Spot interviews revealed the main problem: consumers had no idea how to prepare canned soup. There are no similar Chinese products and there were no Chinese instructions on the can.

The point: the most basic assumptions about your product may not apply in China. Consumers are curious about imported food, but they need to know exactly what it is and how it's prepared before they'll try it. For this reason, distributors and retailers unanimously say in-store product tasting and preparation demonstrations are key to introducing new food products to the retail market.

For some products, education needs to extend all along the value chain – what is it, how to handle it, where to stock it, how to sell it. One hypermarket manager describes listening to one of his Chinese buyers talk to a distributor's salesman, also a native Chinese. They had a sample, but neither knew exactly what it was. They decided finally it should be stocked with the jams and jellies. The product? Garlic paste.

- **Adapting to the Market**

In addition to educating the value chain, suppliers need to consider how to adapt both their products and their practices to the Chinese market. Every aspect of a product, from packaging to flavor profile to preparation and use, needs to be considered. A few examples: many Chinese find US food too sweet, because the overall US taste profile is sweeter than that of the Chinese; baking products should be pitched to expatriates because few Chinese kitchens include a convection oven; Chinese do not like to buy economy sizes, so packages should be small, which cuts the risk of experimental buying for consumers.

There are also regional differences that need to be considered. People in North China generally prefer strong flavors, but not as hot or peppery, as in Sichuan or Hunan. Shandong Cuisine is saltier than elsewhere in the north. Fresh fruit suppliers say northerners prefer oversize fruit that can be given as gifts, compared to southerners who often prefer more standard size fruit for their personal consumption.

- **Marketing and Branding**

Food importers must learn to use marketing and branding to battle the price challenge from domestic products. An imported product must establish that it is worth a premium – you won't succeed if your product is perceived as nothing more than a more expensive version of a domestic product. But if you can establish that brand premium, then price becomes a much less significant factor (see Section II. D, Sam's Club case study).

The biggest market for imported food in China is made up of younger urban middle-class Chinese, and marketers say these people are attracted to imported food products for three basic reasons:

1. Their reputation for consistent quality, safety and hygiene;
2. Curiosity about foreign tastes; and
3. As modern, progressive, aspirational products that confer status.

All of these factors can come into play in marketing a product, although they must be handled carefully. Many Chinese are skeptical about the safety of domestic products, and there are periodic scandals, so emphasis on mode of production and prominent display of US government approvals may help underline quality and safety values. Neat, attractive packaging, unusual on domestic products, can lure the curious and reward the status-conscious although domestic producers are catching up. And, the fact that imported products are more expensive can itself be used to confer status – and give high-end Chinese consumers an opportunity to display both their sophistication and wealth.

Western branding techniques can be an advantage for imported products, because very few Chinese companies have mastered the concepts. If you establish a brand edge, it will be more difficult for competitors, imitators and China's infamous "copycats" to steal your market. Imitators rarely produce a truly equivalent food product, and if you can make aspirational Chinese consumers aware of the differences, they will be unable to gain status without buying the real thing.

Just as in the US or Europe, you need to consider exactly which segment of the population your product appeals to, who will actually buy your product, where they will make the buy, and how they will use the product. Imported foods are frequently used as high-status gifts, for instance, and if that is your target then packaging and appearance are key marketing elements. A health product for seniors may need to be pitched towards a housewife who would buy the product for parents or in-laws, since the more senior and frugal generation here is much less likely to spend on a premium product.

- Some other market-entry tips and pitfalls:
 - Have some key target clients in mind before you enter the market. If a retailer is a client in the US or Europe, try to use them as an entrée to the China branch. Since these large retailers like to buy direct from suppliers, this may enable you to avoid the problem of finding a distributor at first.

- If you have minimum order requirements, waive them at first. Most likely you won't be able to ship full container loads for a while – even retail giant Wal-Mart consolidates shipments.
- Ship “last in, first out” to China. Shelf life is a major issue for Chinese retailers, and many US products arrive too late in the cycle. Consider shipping younger or newer product to make up for shipping and distribution time.
- The payment dilemma: Some US suppliers require full payment in advance from distributors, but distributors don't like to take ownership of products that haven't proved themselves in the market. Easier terms may expand volume, but suppliers say the risk of nonpayment is high.
- Many imported-product distributors also service the HRI market. High-end hotels and restaurants can be a way to introduce products, because they are willing to buy premium ingredients, and also work to inculcate imported tastes among their clientele. Sam's Club sees this as a market niche (see Section IV. C, products not in the market).

B. Distribution and Logistics

For decades China followed a policy of provincial self-sufficiency, so distribution and logistics were given short shrift. It is only in the last few years that a national food market has begun to develop, with more and more food products moving across regional and provincial boundaries. International hypermarkets like Metro, Carrefour and Wal-Mart, along with fast food companies like YUM and McDonalds, have led the way in efforts to achieve fast, high-quality and transparent shipment. Domestic poultry, dairy, fruit and aquatic products companies have also helped create a market for better logistics.

However, cold chain logistics are still considered unreliable and in some cases even dangerous outside large urban areas. Although the situation is improving, insiders say no outside company should consider shipping on the China cold chain. Metro Cash 'n Carry says it has built its own network using heavily supervised third-party providers, and can guarantee the cold chain from Shanghai to all its outlets in northern and central China. But most others admit they still can't ship perishables to all their outlets in China.

Hypermarkets and warehouse clubs handle imported products via central offices, which take care of buying and distribution. For example, although Carrefour, Wal-Mart and Metro all have northern regional offices in Beijing, most imported products come through a single gateway, Shenzhen for Wal-Mart, Shanghai for Carrefour, Metro and Shanghai Lianhua.

Most distributors for international food products are based in Shanghai, Hong Kong or Beijing. They bring containers to their own warehouses, then ship to other regions and cities. Even for port cities like Dalian and Qingdao, most imported food enters the country through the gateways of Shanghai or Beijing/Tianjin, except for imports from Japan and Korea. Local retailers say these patterns will change as the volumes increase, and several major players are already developing direct imports in the north.

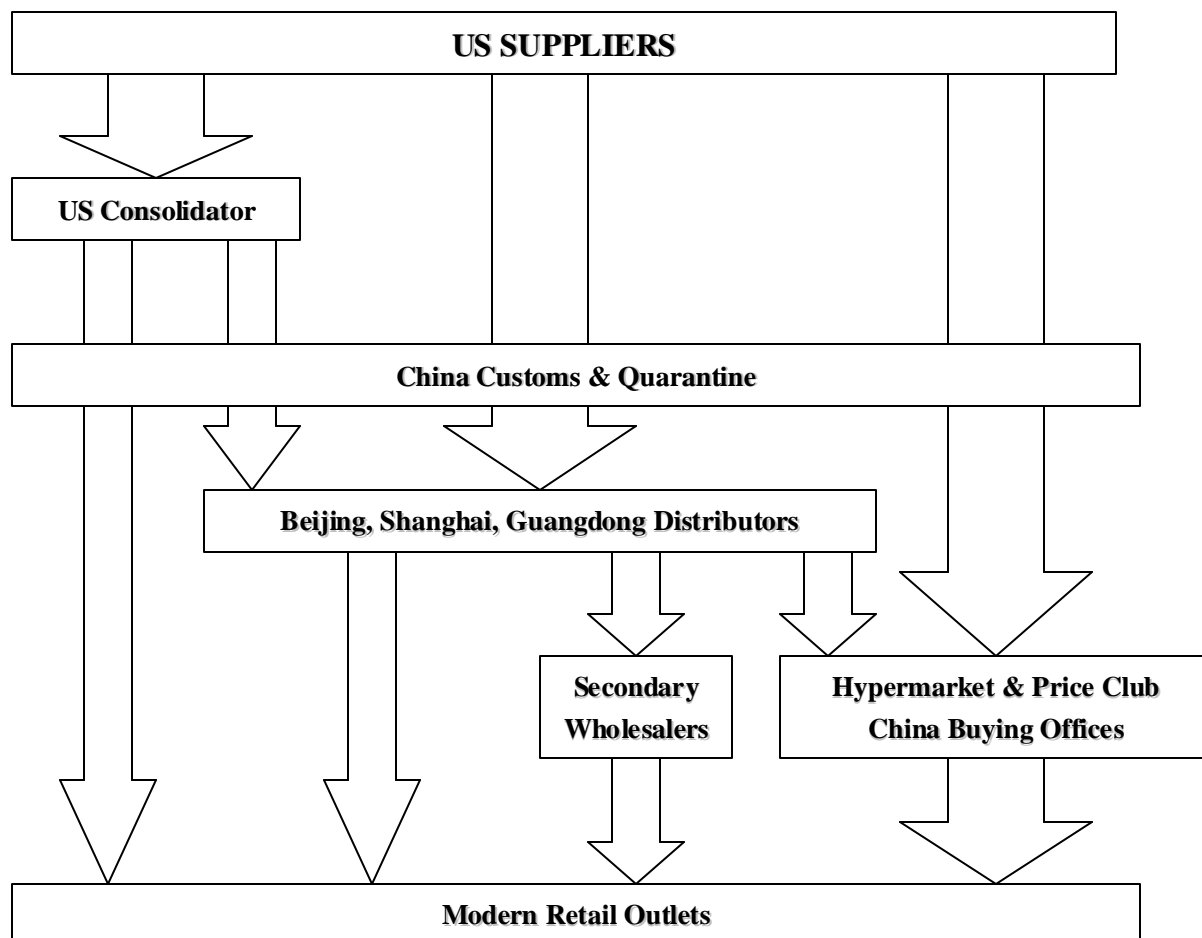
Distribution of food products is generally by truck, as shipping by rail is slow, unreliable and opaque. Domestic producers and exporters ship large volumes by rail, but only if a firm delivery date is not important. Even then they may employ special staff to shepherd shipments through railway stations and major switching points. For example, most “temperature controlled” shipment uses railcars fitted to hold giant blocks of ice, which must be replaced by the shipper's representatives at major rail junctions.

Distribution options for foreign suppliers include:

- Private distributors, some of them foreign-invested. The best are based in Shanghai and Beijing. Those with a Hong Kong connection tend to bring products through Hong Kong and southern China, which may raise costs for northern distribution.
- Direct sales to retailers. Chinese retailers who buy a lot of imported products send representatives to US food fairs on buying expeditions, while multinational retailers like Carrefour, Wal-Mart and Metro frequently use their global procurement systems to buy products for the China market. This leapfrogs the problem of finding a distributor, but may leave you at arm's length from important developments in the China market.
- Third Party Logistics: A small group of foreign-managed companies has developed in ports and free trade zones, offering customs clearance, foreign exchange conversion, bonded warehousing and shipment. Typically, the supplier hires a local representative to handle sales and promotion. This route is becoming more viable as the logistics sector opens wider as a result of domestic reforms and the WTO.
- "Gray channel." Product is shipped into Guangdong from Hong Kong, under-invoiced to slash tariffs. Quarantine inspection is swift or non-existent. This route may be less effective in reaching North China markets, since tariff savings are eaten up by transit costs: Beijing is more than 1,200 miles to the north of Hong Kong, with Harbin another 660 miles to the northeast in Heilongjiang Province. The central government has been trying to crack down on the gray channel to reduce tariff losses, and some supermarkets now require full Customs, VAT and quarantine paperwork that may not be available via the gray channel.
- US consolidators: US consolidators work in two ways: filling direct orders for Chinese retailers, and filling orders for China-based distributors. As a supplier, you still need to make a pitch to the distributor or end-user. The efficiency of US consolidators is an advantage for US exporters, and this channel has been growing slowly but steadily.
- Small individual distributors: A large number of entrepreneurs have set up small offices and deal in a narrow product line or a few SKUs. Their assets frequently run to no more than an office, a desk and a fax machine. Some are effective when they understand the product and the market they are trying to sell.
- Repackaging: Some products are imported in bulk, then repackaged or bottled for sale in China and elsewhere in Asia using less expensive Chinese labor, often in a free trade zone. Products like nuts, dried fruit, frozen vegetables; candy, chocolate and wine lend themselves to this method.

Any distributor should be able to deal with government paperwork and procedures, including quarantine and health approvals. Many of these procedures are deliberately designed as non-tariff barriers that increase costs and reduce convenience. Proper classification of imported products for tariff purposes has become another source of conflict, but the situation is improving as the Customs service becomes more professional.

C. Distribution Flow Chart For Northern China



D. Retail Sector Profiles

1. Hypermarkets, Warehouse Outlets, Department Stores

Foreign joint ventures have led developments in the hypermarket and warehouse sector. Multi-national companies like Wal-Mart, Pricesmart, Carrefour and Metro and have all established outlets in northern China. Other entries include Japanese companies like Fu-Mart, as well as Trust-mart, RT Mart, and Hymall from Taiwan. These companies operate like their domestic parents, applying modern marketing and inventory control techniques, and have been a major force in improving supply chains and access to imported food.

Domestic retailers like CRC Vanguard and Shanghai Bailian have been quick to imitate the hypermarket format, but many remain inefficient state-owned enterprises that have difficulty

bringing modern management to bear. Nevertheless they are formidable competitors, due to local knowledge and large networks. They are also often favored by Chinese regulators and in many cases can obtain "soft loans" from state banks to finance expansion.

China's WTO accession agreement calls for an end on current limits to foreign participation in the retail market after 2004, and there has been some consolidation among Chinese companies girding themselves for the anticipated competition. Shanghai Bailian, which now includes Lianhua hypermarkets, Hualian supermarkets, Quik convenience stores and some non-food outlets, has become the largest retailer in China. CRC Vanguard, which began in the south but has spread into northern China, has hired some highly experienced personnel from foreign JVs. Foreign operators consider Homeworld, which is expanding from its base in Tianjin, as a formidable competitor in the domestic warehouse/price club sector.

The percentage of imported food products found in the hypermarkets and warehouse stores varies greatly, but rarely reaches even 5% of sales. Hypermarkets routinely calibrate the amount of imported food in a store according to both local income and presence of expatriates. Warehouse stores, which target higher-income local businessmen and women, generally stock more and higher-value imports. Sam's Club sells three times as much imported food as Wal-Mart Super Centers, but that is still only 2-3% of sales.

Generally hypermarkets expect to make a higher profit on imported items, partly because the risks are higher. Hypermarkets will expect promotional assistance on new-to-market items. This can include demos and samples and negotiated fees for other promotional efforts. Some companies charge slotting fees, with French JV Carrefour the richest at up to RMB 10,000 per slot per store. Others, such as Wal-Mart and French JV Auchan, put most of their effort into keeping prices as competitive (low) as possible.

In Beijing, hypermarket shelf surveys reveal special sections devoted to imported beer, fruit and wine. Dairy cases have expanded and often display imported cheeses. There are also substantial displays of imported breakfast cereals. Beijing retailers hold US products in high regard for quality. However, frozen sections are huge, stocked mostly with Chinese dumplings and other similar products, although imported frozen vegetables are present.

The hypermarket sector is expanding rapidly throughout north China and same store sales were down almost 10% nationwide in 2003 as a result of multiplying competition. While hypermarkets in Beijing have begun catering to car owners, that is not the case in most cities, where patrons most often walk, ride bikes or take the public bus, limiting the amount of food they can take home at one time. Some hypermarkets provide neighborhood bus service. Warehouse store patrons are more likely to drive cars or small delivery vehicles, or use a tricycle delivery cart to get purchases to their home or business.

Department stores with large food sections make up a variant of the hypermarket segment. Malaysian-invested Parkson's is trying to develop a niche in imported food. The stores often measure more than 30,000 square meters of floor space, but the food departments are generally about the size of domestic supermarkets, although with higher quality food and higher percentage of imports.

Fig II. C (1): China's Top Retail Food Chain Stores, 2003

| Rank | Chain name | 2003 Sales (mn USD) | 2002 Sales (mn USD) | % Rise | Out-lets 2003 | % of Food Import |
|------|---|---------------------|---------------------|--------|---------------|------------------|
| 1 | Shanghai Bailian (Brilliance) | 5,859.5 | 4,807.1 | 21.9 | 4357 | 1-2% |
| 2 | Dalian Dashang | 2,195.9 | 1,544.4 | 42.2 | 96 | 1-2% |
| 3 | Beijing Hualian Group | 1,642.5 | 1,243.9 | 32.0 | 62 | 2-3% |
| 4 | Carrefour Corporation | 1,622.8 | 1,291.5 | 25.7 | 41 | 1-5% |
| 5 | Shanghai Nonggongshang | 1,495.2 | 1,054.3 | 41.8 | 1213 | 1-2% |
| 6 | China Resources (CRC) Vanguard | 1,246.8 | 1,037.6 | 20.2 | 467 | 5% |
| 7 | Suguo Supermarket Co. | 1,157.0 | 851.9 | 35.8 | 1162 | 1% |
| 8 | Beijing Wu-Mart | 1,027.1 | 611.9 | 67.8 | 518 | 1-2% |
| 9 | Xinyijia Supermarket Co. | 712.6 | 459.1 | 55.2 | 46 | n/a |
| 10 | Wal-Mart China Corporation | 706.9 | 572.4 | 23.5 | 33 | 1-4% |
| 11 | Jiangsu Wenfeng Great World Chain Development Corporation | 690.5 | 527.0 | 31.0 | 326 | 2% |
| 12 | Metro Cash & Carry Co., Ltd. | 678.8 | 641.3 | 5.8 | 18 | 5-7.5% |
| 13 | Home World Commercial Grp | 636.7 | 531.9 | 19.7 | 49 | 0.1-0.3% |
| 14 | Beijing Jingkelong | 633.2 | 531.7 | 19.1 | 156 | n/a |
| 15 | Trust-Mart Co., Ltd. | 567.7 | 647.6 | -12.3 | 27 | 3-5% |
| 16 | Beijing Chaoshifa | 490.9 | 475.8 | 3.2 | 112 | 1% |

Source: Department of Commercial Reform and Development, Ministry of Commerce; CFAS Survey. MOC figures show nationwide sales for all products. Food makes up more than half of sales in most listed stores. Individual stores vary greatly in % of food that is imported, depending on location.

2. Expatriate Specialty Stores

A small group of stores has developed in Beijing that caters specifically to the expatriate niche, which includes numerous Japanese, Taiwanese and Hong Kongers in addition to Americans and other Westerners. The outlets are small, located in expatriate heavy neighborhoods and suburbs, but the percentage sales of imported food products run from 60% to 90%. The stores stock cheeses, breakfast cereals, canned goods, snack foods, candy and wine. CRC Vanguard, a major retailer, runs four such small specialty stores. In other cities, there is usually at least one store that caters to expatriates. In Beijing and Dalian, state-run Friendship Stores also fill this niche.

3. Supermarkets, Wet Markets

Chain supermarkets actually make up a relatively new sector, having developed significantly in most cities over the last decade, but they are already being superceded by hypermarkets. The supermarket sector is dominated by large state-owned chains, stores are generally crowded; display is poor and management somewhat unsophisticated. Fresh meat and produce is substandard due to poor supply chain practices, and supermarket patrons would usually go to wet markets for these items.

Beijing supermarkets offer a fair sampling of imported products, including special sections for imported beer, wine and water. Frozen sections are usually small, frozen products include US peas and corn, as well as a huge and diverse assortment of dumplings. In other cities, however, supermarkets display very little imported product.

The number of urban traditional or “wet” markets has fallen since 2000 due to competition and stricter hygiene requirements. These markets usually consist of a hall housing stalls owned by individual family businesses. They stock very few imported products, but remain an important source of fresh meat and produce for consumers.

4. Convenience Stores

Modern convenience stores are making their appearance in Beijing and other northern cities. Most are operated by state-run hypermarket and supermarket chains, and are clean, well managed and heavily computerized. In many places they are replacing small “mom-and-pop” stands that stock soft drinks and snack foods but very few imported products.

Shanghai Baillan is moving aggressively into Beijing and other cities in the north with its Quik chain, and 7-Eleven opened in Beijing in 2004 via a Japanese-owned subsidiary. Gas marts located at service stations are a new entry, and may be ideally placed to sell imported products because their target customers are wealthy enough to own cars. However, in 2003 the sector did not develop or grow as quickly as projected.

E. Case Study: For Sam’s Club, A Growth Business in Imports

Wal-Mart China opened its first two stores, a Super Center and a Sam’s Club, in the southern city of Shenzhen on the same day in 1996, and ever since has followed a slow and steady growth policy as it developed its understanding of the Chinese market and consumers. The company expanded in southern China, then in selected cities in the north. By the end of 2003 it was operating 27 Super Centers and four Sam’s Clubs. Its first store in Beijing, a Sam’s Club, didn’t open until the middle of 2003.

Sam’s Club and the Super Centers target very different market segments, and as a result treat imported products very differently. Super Centers target the mass market and carry very little imported product – less than 1% by overall sales, although the percentage in food is higher. Sam’s Clubs, on the other hand, target small business owners. The owners buy product for their businesses, but Sam’s Club also caters to them as consumers because they form an important part of the high-income population and can afford higher-priced consumer goods for themselves and their families. At Sam’s Club, therefore, imports account for 2-3% of overall sales, with a much higher percentage in certain categories – about 50% of fresh produce by value, for instance.

“For Sam’s Club, we view imported products as very much a growth business,” says Ned Irving, Senior Director for Sam’s Club Merchandising in China. “Sam’s Club is very much up-market, that’s where the people with the most disposable income are. Affluent Chinese people are interested in new and different experiences as they relate to cuisine from outside China. For Sam’s Club, that’s our customer.”

Irving advises US suppliers to make sure they are not just providing a higher-priced version of something that is produced in China. “If an item is new and different, though, or conspicuously higher quality, then the item-price is not that relevant,” he says. “The main question is, are there the logistics to get it here?”

For instance, Wal-Mart buys US cherries in coordination with US Wal-Mart and flies them in to China. The cherries are far more expensive than anything domestic, but Sam's Club consumers bit because the quality was so much higher than domestic Chinese cherries that it was really a different product.

In North China, Wal-Mart has a regional office in Beijing, which is responsible for buying local products and keeping track of local tastes. The supply chain is still the basic bottleneck, especially for perishable items, but a new distribution center in Tianjin should ease the problem in northern China. Wal-Mart likes to deal directly with producers and manufacturers when possible, but also buys from imported-product distributors in China.

A tour of a Sam's Club outlet demonstrates the marketing strategy. The outlet feels very much like a store in the US, except that the familiar blue logo has been tweaked to red, because blue is an unlucky color in some parts of China. Sam's includes a cosmetic department, expensive high-tech electronic gear, and a liquor department featuring huge bottles of prestige cognac with a diamond in the stopper, selling for around US\$6,000. There is about 80 feet of display for cooked and prepared food, and a large bakery selling breads, cookies and cakes – an area where future expansion is planned.

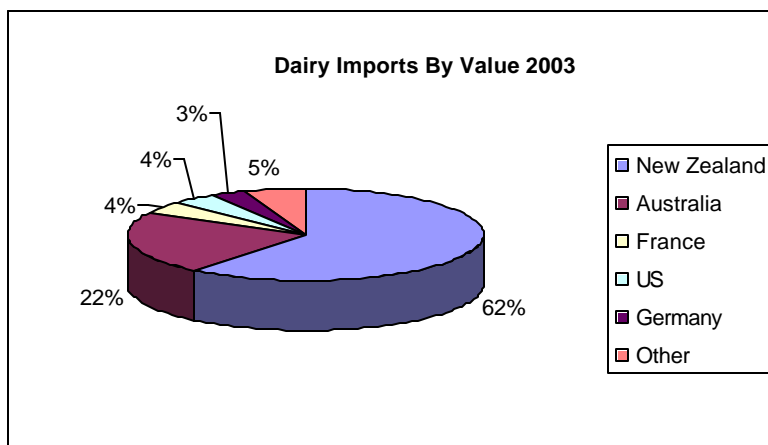
Imports, marked with a small "Imported Product" placard, include chocolate, fruit, cereal and pastries, including a big hit, South Korean Orion chocolate pies. There are often in-store imported product tastings, with young women demonstrators handing out samples. Tastings and demonstrations are the major product support that Wal-Mart China asks from its vendors and distributors for imported products in China.

Wal-Mart is so sure imports will be a growth center that it has designated a vice president, Divisional Merchandising Manager Ricky Wong, to help foreign suppliers solve problems and achieve success in the China market. Irving thinks it helps to have a sense of adventure to succeed in China.

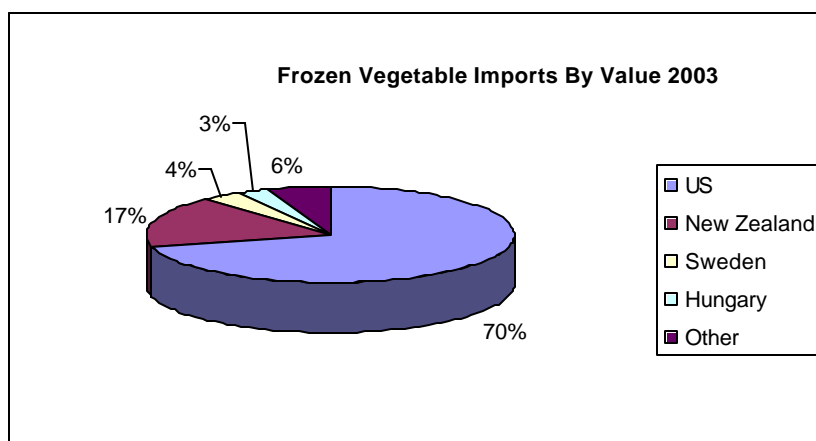
"There are a lot of things that nobody's ever tried here. We try a lot of things that don't end up working out," says Irving. "You bring something in and you really don't know if it can sell. There's a big range of possible results. It's fun, entrepreneurial in a sense, exploring. I would tell potential suppliers not to be intimidated by the small numbers of sales in some items. We are interested in developing all categories."

III. Competition

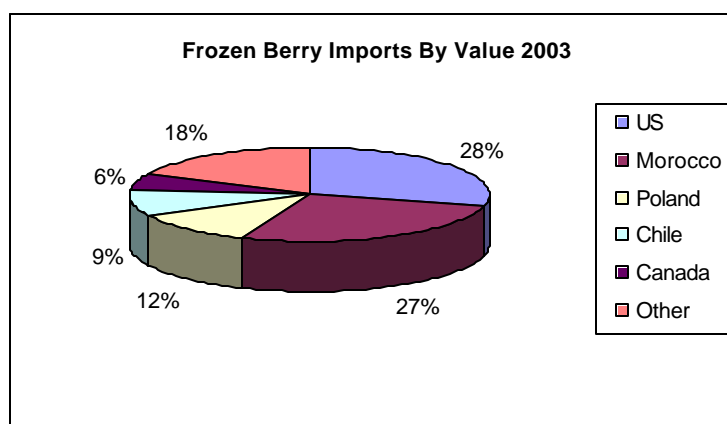
The fast-developing Chinese retail market is attracting competitors from all over the globe, and anyone entering the market must evaluate rivals carefully. Australia and New Zealand use their relative proximity to dominate dairy products; Chile and South Africa are strong in counter seasonal fresh fruit; Southeast Asia exports large amounts of tropical fruit, and Morocco in frozen strawberries. Some detailed product import splits for 2003, according to China Customs statistics:



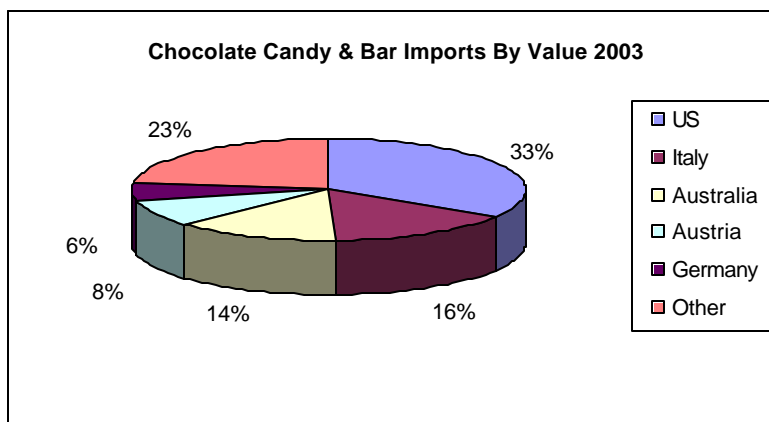
Total Value: \$12,153,654



Total Value: \$16,618,584



Total Value: \$21,245,353



Total Value: \$20,482,442

IV. Best Product Prospects

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

- Fish and other seafood, fresh, frozen or chilled
 - Fresh fruit
 - Meat, especially premium beef*
 - Breakfast cereal
 - Confectionary
 - Premium chocolate
 - Premium cheese
 - Premium wine
 - Frozen vegetables
 - Frozen berries
 - Frozen foods
 - Health food
 - Baby milk powder
 - Pet food
 - Nuts and dried fruit
- *Note: US Beef imports are currently banned by China

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

- Ready-to-cook and ready-to-eat foods
- Sam's Club believes there's a market gap in availability of Western and other foreign food for retail consumers. The number of restaurants that offer non-Chinese food is growing fast, and top-tier urban consumers patronize those restaurants. Western, Indian, Japanese, and Southeast Asian food. Consumers would like to be able to cook the same food at home, but it's not available, either in terms of ingredients or in frozen, microwavable or other easily prepared form.
- Microwavable RTE snacks
 - Baby food
 - Nutritional supplements
 - Food targeted at seniors
 - Premium ice cream
 - Non-native berries and berry products

C. Products Which Are Present, But Have Poor Potential

- Beer
- Soft Drinks
- Canned meat and fish
- Extruded snacks
- Yogurt
- Prepared food for restaurants (in warehouse or club stores)

V. Post Contact and Additional Resources

For further information about the North China market, as well as upcoming events and activities, please contact the *Agricultural Trade Office in Beijing.

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