China's Retail Revolution

Market Brief – 2014

SOVEREIGN™

SovereignGroup.com

MARKET INSIGHTS

- China is positioned to overtake the US as the **world's largest retail market by 2018**, with a market value expected to exceed US$4 trillion.
- China's upper-middle class will be a key driver of China's retail sector's growth; China's **upper-middle class will account for over 50% of the urban population by 2022.**
- Retailers are refining their customer-centric strategies as companies start matching product offerings to an **increasingly more sophisticated consumer.**
- China is still an emerging market; in many categories, consumers continue to be fickle, which poses a challenge for foreign brands.

THE MARKET LANDSCAPE

Economies of change

China's economy has been growing at a phenomenal rate for the past three decades, with the country's GDP increasing on average 10% each year from 1978-2013. In 2010, China's GDP surpassed Japan's and China became the world's second largest economy. China's current nominal GDP exceeds US $9 trillion[1] and although growth has slowed to 7%, China is still expected to overtake the United States as the world's largest economy by 2020 in nominal terms and will likely overtake the US by the end of 2014 if purchasing power parity is taken into account.

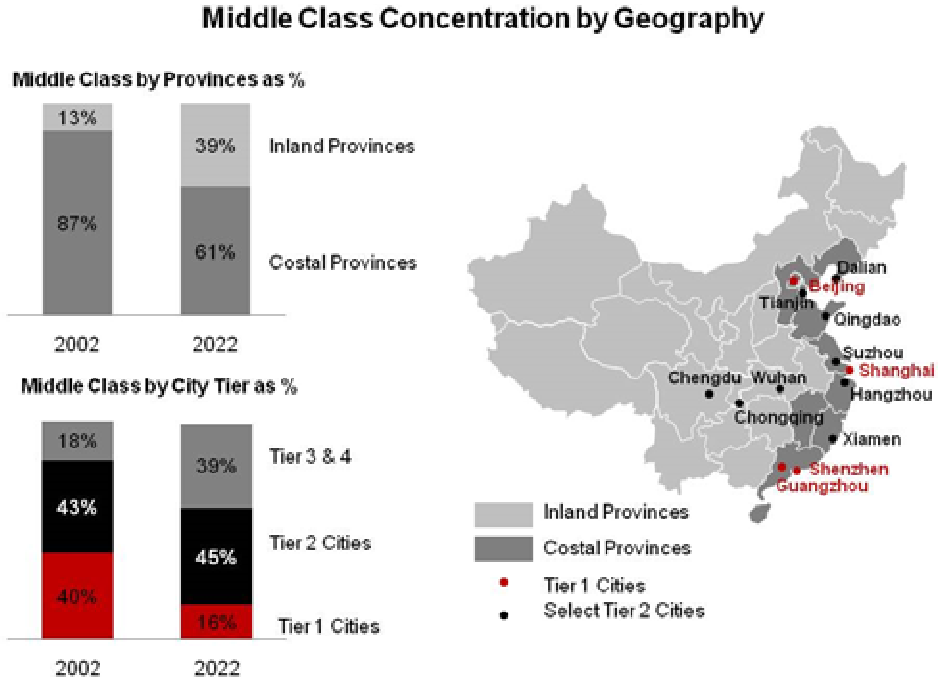
China is likely to overtake the US as the world's largest economy in 2014.

China's astonishing development is primarily the result of an investment-led growth model, with a focus on building the country's infrastructure and industrial manufacturing base. Industry still accounts for over 46% of China's GDP, while services (including retail) account for about 43%, and agriculture accounts for about 11%.

As the country has grown economically, so too has the wealth of Chinese households. Millions have been lifted out of poverty over the last 30 years. China's middle class[2] now accounts for more than 476 million people, which is roughly 68% of the urban population and larger than the entire population of the United States. The upper-middle class[3] accounts for 14% of urban households and is expected to increase to 54% by 2022[4]. It is the middle class, especially the upper-middle class, that will drive domestic consumption of goods and services in China. Much of the middle class is concentrated along the coastal provinces in Tier 1 and Tier 2 cities, although this will begin to equalise in the next few years.

[1] Source: International Monetary Fund
[2] Middle class is defined as an annual household income of RMB60,000 - 106,000 (US$10,000 - 17,000)
[3] Upper-middle class is defined as an annual household income of RMB106,000 - 229,000 (US$17,000 - 38,000)
[4] Source: Sovereign analysis of multiple sources

In addition to households' increased wealth driving consumption, the central government is attempting to shift the overall economy to a consumption-led growth model – as was made evident in the priorities of China's 12th Five-Year Plan[5] – which is more sustainable in the long run. One of the top priorities of the 12th Five-Year Plan is the promotion of domestic consumption through setting economic targets for growth in the services and consumer industries.



Source: Sovereign analysis on multiple sources

China's Retail Market

In 2013, China's retail market grew 13% compared to the previous year, reaching US$2.6 trillion, and is expected to grow 10% annually for the next 4 years. At this rate, China will overtake the US as the world's largest retail market, and will be worth around US$4.2 trillion, by 2018. China is ranked number two in terms of overall retail expansion potential and is already set to replace Japan as the most dominant market for luxury products.[6]

China is expected to overtake the US as the world's largest retail market, worth around US$4.2 trillion by 2018.

Growth in the retail market will be driven by a number of factors, including increased urbanization, higher disposable incomes (i.e. a rising middle class), and the relaxation of the one-child policy. Smaller cities (Tier 2 and Tier 3) will be at the forefront of retail growth due to increasing proportion of middle class consumers, new shopping venues and ecommerce sales providing greater access to consumers.

On 11 November 2013, also known as "Singles Day", sales on Tmall.com reached a record high of over US$5.7 billion; nearly US$1 billion in the first hour.

Online and mobile sales platforms are rapidly growing in China. From 2003 to 2011, China's online retail market grew at a compound annual growth rate of 120%, making it the fastest growing ecommerce market in the world. China became the world's largest ecommerce market in 2013. With over 302 million shoppers and nearly US$300 billion in online transactions, ecommerce now accounts for about 10% of all retail sales[7].

Holidays, both official and unofficial, are significant drivers for growth in retail sales. There are 10 holidays that are particularly important for retail sales. For example, 11 November has become an unofficial day to celebrate being single, and retailers promote discounts on this day to boost sales. On Single's Day in 2013,Chinese-language online business-to-consumer retailer Tmall ran special promotions resulting in single day sales exceeding US$5.7 billion.

[5] The Five-Year plans are a series of social and economic initiatives set by China's central government, which indicate key areas where the government intends to focus developmental efforts; currently, China is in its 12th Five-Year plan, which runs from 2011 to 2015.
[6] Source: Sovereign analysis of multiple sources
[7] Source: Sovereign analysis on multiple sources, including the Ministry of Commerce

The following table lists ten holidays in China, both official and unofficial, that are drivers for retail sales.

Table: 10 Holidays Driving Retail Sales

Holiday	Date	Holiday	Date
Chinese New Year	1 January (Lunar Calendar)	Chinese Valentine's Day	7 July (Lunar Calendar)
Lantern Festival	15 January (Lunar Calendar)	Middle Autumn Festival	15 August (Lunar Calendar)
Valentine's Day	14 February	Chong Yang Festival	9 September (Lunar Calendar)
Women's Day	8 March	Single's Day	11 November
Children's Day	1 June	Christmas	25 December

Source: Sovereign analysis of multiple sources

Trends and market dynamics

- Anti-corruption – The anti-corruption and austerity campaign implemented by President Xi Jinping has made headlines on multiple occasions due to the high profile of the officials that are being targeted. The austerity measures, intended to curb the free-spending habits of civil servants, military leaders and provincial party bosses, have had a significant economic impact and are estimated to have shaved nearly RMB1 trillion off of the economy in terms of fixed asset investments and luxury retail sales. The impact on the retail sector has primarily been in the luxury goods sector, including luxury foods and alcohol such as Maotai, a Chinese liquor favoured by government officials.

- Government support – In order to counteract some of the effects of the austerity measures, China's central government has introduced a variety of subsidy programmes to boost the retail sector. One example is the government's 2013 attempt to increase domestic consumption by introducing a household appliance trade-in subsidy. It offered a 10% discount to those purchasing newer, more environmentally friendly household appliance models, if they also traded in their old appliances. '农超对接 Nong Chao Dui Jie' is another government programme that is expected to impact the retail market by putting systems in place to help supermarkets establish supply chains directly with the local farmers, increasing supply chain efficiency and traceability.

- Highly fragmented – China's retail industry is highly fragmented, with thousands of small retail stores populating the sector. The top 100 retailers in the market – such as Suning Home Appliance, Carrefour, RT Mart – only account for about 11% of overall retail sales. This has led to fierce competition but also offers opportunities for new market entrants due to the absence of dominant players.

- Limited brand loyalty – China is an emerging market with few specific product categories, such as infant formula, that have garnered strong brand loyalty. Chinese consumers are easily swayed by promotions, price and advertising. Even top brands with high penetration can lose approx. 30-60% of their customer base every year. Brands must therefore continuously attract new customers to grow and manage consumer churn.

- Fading bias for foreign brands – Chinese consumers were known to prefer international brands due to the perception that these products offer a higher standard than local brands. However, in the last few years, perceptions of domestic brands have improved in many product categories. Consumers are becoming more sophisticated and often no longer choosing products just for their international cachet; instead, they focus, in many product categories such as mobile phones and electronics, on value.

> *Tier 2 cities are expected to become more important in driving retail growth in China.*

- Expanding geographic footprint – Tier 1 cities have already reached saturation point in many retail segments, such as luxury and fashion goods. Tier 2 cities can therefore offer fresh opportunities to foreign retail companies, as disposable incomes continue to grow and costs are typically lower than in Tier 1 cities. Many companies – such as Mango, Cartier, Wal-Mart, Carrefour and Coach – have already expanded beyond Tier 1 cities to drive their China market growth.

- The rise of omni-channel retailers – As it is in developed countries, omni-channel retailing in China is picking up rapidly. Retailers are aggressively adopting this approach to deliver an integrated retail experience, both by better integrating their online and offline platforms, and by creating multiple touch points for the customer. Uniqlo, Gillette and Mango, for example, are utilising both their own websites and Tmall store to drive offline sales. With the prevalence of smart phones and continued growth in China's ecommerce market, omni-channel marketing will also grow in importance as a means for retailers to attract consumers and grow their brand.

- Corporate rigidities lead to failure – International retailers often fail to adapt and succumb to their own corporate rigidities by relying on past success in other markets to develop their China strategy. This can manifest itself in a number of ways; recent examples include Best Buy and Home Depot, two large US retailers, who failed to adapt their business model successfully to suit the China market.[8]

In the case of Best Buy, operational rigidities led to the withdrawal of their brand name stores from the market. With both operational costs and prices higher than local competitors like Suning and Gome, which keep costs down by simply renting space to electronic brands, Best Buy was unable to achieve margins sufficient to justify its presence in China.

Home Depot, on the other hand, narrowly focused on the same Do It Yourself model that has brought it great success in the US. This rigidity led it to ignore the fact that the Chinese consumers it was targeting to buy its products perceived manual labour as being below their status. Without addressing this fundamental difference in home renovations from the beginning, its strategy was doomed to fail.

Despite the abundance of advice offered by specialist advisors in China and the number of high-profile examples of foreign failures in the China market over the past two decades, a remarkable number of new China entrants are still failing to heed the lessons of those who have come before them. China's dynamics do not concede to success in other markets.

[8] Note: Best Buy still operates and owns a local company it acquired called Five Star; however, the company intends to sell the brand or enter into a partnership

Flexible Strategies and Perseverance: UNIQLO

UNIQLO is the flagship brand of Fast Retailing, one of Japan's largest clothing retail groups. There are more than 1,300 UNIQLO stores worldwide, with the majority based in Asia. UNIQLO entered China in 2002 and is an example of a company whose initial poor performance led to an overhaul of its China market strategy. When UNIQLO first entered China, the firm attempted to apply the same positioning as a mass-market brand that it had employed with success in Japan. However, the company's prices were too low and its target market was too broad, resulting in poor performance.

After several years of struggling to gain traction, the firm changed its pricing strategy and aggressively adopted an omni-channel approach to the market. UNIQLO partnered with Tmall for its ecommerce sales and developed an App for mobile platforms to promote online-offline interaction. As a result, the company has been able to grow its brick and mortar stores and, as of July 2014, has 294 retail outlets in China; a further 80 new store openings are planned for 2014.

UNIQLO is an example of how difficult China can be for retailers entering the market, regardless of size. However, through a nimble approach to strategy development and quick adaptation to market conditions, the company has become successful in the China market.

APPROACHING THE MARKET

Foreign brands need to consider two mission-critical factors, when developing their China market entry strategy. The first is determining which entry model or models to deploy. Second, they need to devise a "beachhead strategy" that focuses on a particular city or region in which to target initial penetration. China's sheer scale means that it is simply too big for most brands to implement a successful country-wide strategy from the outset.

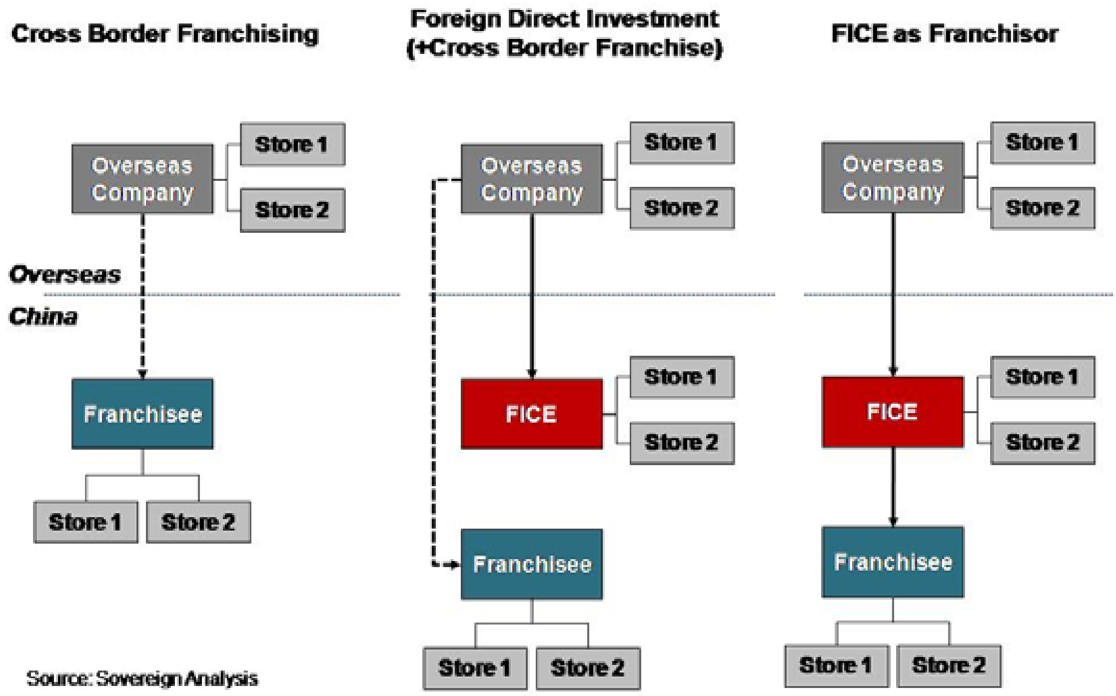
Entry Models

Foreign firms have several alternatives available for entering China's retail market. These will depend largely on the company's target market and business model, but can be divided into four principal options for entry into the market:

1. Distributor model – Utilizing a distributor model[9] is practical for foreign companies looking to enter the China market quickly and with minimal financial risk. It is however crucial to select the right partners because the market is highly fragmented and contains significant regional differences. With this model, growth can be limited or challenging because distributors often carry more than one brand and your partner may be unable or unwilling to give sufficient attention to selling your products.

2. Franchising – This can be effective because the costs are lower than direct investment and geographic coverage can occur rapidly. There are three general franchising models, illustrated in the chart to the right. The model used will depend primarily on a client's available resources and overall China market strategy[10]. Franchising is an especially good option for small and mid-sized retailers; however, support to franchisees may be necessary in terms of marketing and brand building.

Three Options for Franchising



Source: Sovereign Analysis

[9] Note: Generally speaking, it is important to have partners/distributors that have the appropriate licenses to both import and distribute goods in the China market.
[10] For more information regarding China's franchising industry, please review Sovereign's Franchising Industry Report.

3. Direct investment – Establishing a Foreign Invested Commercial Enterprise (FICE) will be at the core of any company 's entry into China's retail sector if it plans to open retail stores. Setting up a FICE can take six-months to a year, depending on the complexity of the structure and location, before it is fully operational. Retail stores will need to be opened concurrently with the FICE or after the FICE setup is completed.[11]

4. Ecommerce Platforms – Ecommerce platforms are a viable way to gain access to the Chinese consumer. Companies can utilise a mixed approach, where they sell through both traditional channels as well as online, or can test the market with minimal risk by focusing on eccommerce alone. The two most typical ways for companies to exploit China's ecommerce market are via:

   - **Stand-alone websites** – Companies can utilise their offshore web site platform although it is crucial to have the website translated into Chinese and prices adjusted to RMB for ease of use; however, there could be problems in respect to compliance with the local regulatory environment and connectivity if the site is not hosted in China. To have the website hosted in China, companies must have a legal presence in China (WFOE, JV or Representative Office) and obtain an ICP[12] licence.

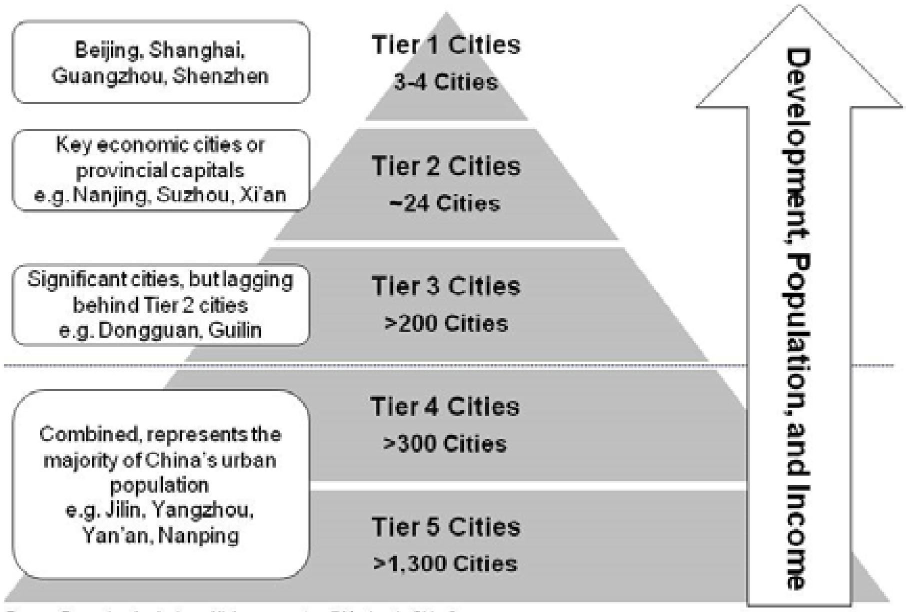
   - **Third-party platforms** – Third-party platforms such as Tmall, the largest business-to-consumer (B2C) website platform in China, are excellent ways for companies to create or expand their footprint in China's retail sector. The ability to utilise a third-party platform has made access to Chinese consumers easier, especially since some have developed solutions for selling products without the need for the vendor to have a legal presence in China. For example, in September 2013 Tmall set up a platform known as Tmall. HK or overseas direct purchases, which does not require company to be registered in China to have a Tmall presence.[13]

Tier 1 or Tier X Cities

China is a massive country in terms of both its geography and its population. Nearly 50% of the population is now urbanised, living in cities of highly varied socio-economic development. To reflect the level of development, China's cities are often divided into different tiers, with Tier 1 cities being the most developed, followed by Tier 2 cities, Tier 3 cities, and so on.

Although the criteria for categorisation can vary, there are generally five broad economic and social criteria that determine which tier a city is categorised in:

1) Population
2) GDP
3) Economic growth rate
4) Political and/or economic hub
5) Historical or cultural significance



Source: Sovereign Analysis on Nielson report on "Winning in China"

[11] For more information on the setup process for a company, please download Sovereign's China Market Entry Handbook found at www.jljgroup.com.
[12] ICP – Internet Communications Protocol
[13] Note that companies must meet the specific requirements set out by Tmall, which include: having a legal entity overseas, being able to engage in overseas trade and being either the brand owner or an authorised dealer.

There is no official classification of cities into tiers; businesses often use the term as shorthand when discussing the opportunities and challenges of China's incredibly diverse landscape. Tier 2 cities, for instance, typically have populations greater than five million people and are an economic and/or political hub. Xi'an, for example, only has an urban population of six and a half million people but is the political and economic hub of Shaanxi province. While the concept of city tiers pushes back at the myth of a monolithic China, it does fail to take into account regional differences.

Tier 1 Cities. There are four Tier 1 cities in China – Beijing, Shanghai, Guangzhou and Shenzhen. They are typically richer and possess better infrastructure relative to lower tier cities, and their consumers tend to be trendsetters. In the past, Tier 1 cities were the beach heads for many foreign invested retail companies because residents have relatively high levels of disposable income, are open to foreign products and enjoy an established infrastructure in terms of supply chain and retail space.

However, Tier 1 cities are highly saturated and competition is fierce, with large retailers from Europe, the US and elsewhere already well established in the market. Retail space costs also pose a significant challenge. For example, the average price in Shanghai exceeds on average of US$5,400 per square meter per year; in some cases it can be significantly higher. Shortages of retail space in the downtown areas are expected to drive the price of retail space up further.

Tier 2 Cities. Although Tier 2 cities are not as developed as Tier 1 cities, they still have populations and disposable incomes rivaling large European and US cities. For example, Suzhou has a population of over five and a half million people with a per capita income of approx. US$27,000 per year.[14] The majority of Tier 2 cities are located in the coastal provinces but there are also a number of important Tier 2 cities in central China (e.g. Chengdu and Chongqing). Due to their population and disposable income levels, Tier 2 cities are becoming more and more important in terms of driving growth in China's retail sector.

Saturation and costs pose significant challenges in China's Tier 1 cities, making Tier 2 cities highly attractive alternatives

The Tier X Cities. Tier X Cities – or Tier 3 Cities and beyond – encompass the majority of China's urban population and many have populations of between one and five million people; however, incomes can range from as high as US$14,000 per year to less than US$5,000 per year. Tier 3 cities, as well as lower tier cities, may offer opportunities to foreign invested retail companies, because they account for a significant portion of China's economy; however, there may be significant challenges in penetrating the market. Disposable income is not at the same level as in higher tier cities and the overall business culture and environment may be more challenging to navigate.

[14] Source: CIA world fact book; figure based on Purchasing Power Parity.

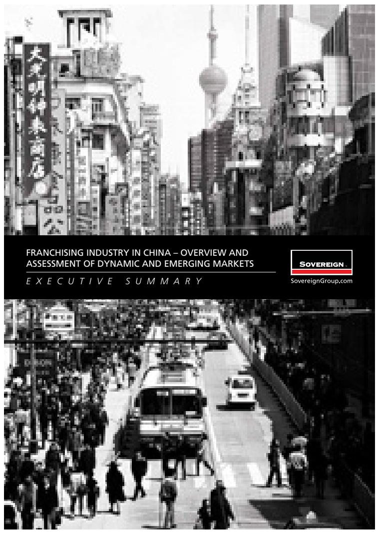
CONCLUSIONS

With a middle class larger than the population of the United States and a market size for retail goods reaching US$2.6 trillion, China offers substantial opportunities to foreign retailers looking to expand internationally. However, understanding Chinese consumer motivations and having an appropriate localisation strategy is essential to a successful market launch. Without understanding the specific market dynamics, the possibility of failure increases significantly.

Companies need to have a detailed knowledge of the market, especially the opportunities and challenges, before determining how they will enter the market. Furthermore, a blanket approach to China will not be feasible in most cases because China's economic development is vastly uneven, with the majority of wealth concentrated in the coastal regions and in Tier 1 and Tier 2 cities. However, the Tier X cities should not be overlooked in a company's long term strategy because it is estimated that they will account for 40% of middle class households by 2022.

Related publications include:

2014 China Market Entry Handbook



Franchising Industry in China

For more information on how Sovereign China can assist you with understanding the market or establishing a presence in China, please contact us at china@SovereignGroup.com.

About Us

With offices in Shanghai and Beijing, Sovereign China was formed by the merger of Sovereign's existing China operations and The JLJ Group in 2013. The JLJ Group was established in 2003 to accelerate international clients' ability to understand and operate in the China market and has successfully assisted more than 600 companies from over 60 countries with their China market entry.

Sovereign China provides a suite of services designed to lead investors through the market entry process and stay with them to develop long-term success in China. From assisting with understanding the market, developing a market entry strategy to establishing their operations and finally providing back office and compliance support services, we are with our clients from planning to execution.

Shanghai Office
Suite 805, Tower A,
Guangqi Culture Plaza,
2899 Xietu Rd.
Xuhui District,
Shanghai 200030, China
Tel +86 21 5211 0068
Fax +86 21 5211 0069

Beijing Office
Suite 2002, Building 1,
Blue Castle International Center,
3 West Dawang Road,
Beijing 100026, China
Tel +86 10 6582 0268
Fax +86 10 6582 0251

www.sovereigngroup.com
china@SovereignGroup.com

Sovereign China's consulting services address investor's China market needs:

- Market research and assessment
- Market forecasting and business intelligence
- Competitive intelligence
- Customer satisfaction surveys
- Growth strategy
- Site location analysis
- Corporate structuring and setup

Shanghai Office
Suite 805, Tower A, Guangqi Culture Plaza
2899 Xietu Road, Xuhui District
Shanghai, China 200030
Tel +86 21 5211 0068 | Fax +86 21 5211 0069

Beijing Office
Suite 2002, Building 1, Blue Castle International Center
3 West Dawang Road, Chaoyang District
Beijing, China 100026
Tel +86 10 6582 0268 | Fax +86 10 6582 0251

china@SovereignGroup.com
www.SovereignGroup.com