

BRIC Spotlight Report

June 2011

Retail Sector in China: The Next Big Thing?

Fast Facts

- Retail sales increased 16.3% in 2011 Q1, while GDP expanded 9.7%. Retail sales are expected to double in the next three years.
- Retail sales in China amounted to nearly \$2.1 trillion in 2010, nearly 50% of those in the U.S. China's retail sales are expected to grow by around 10% in 2011.
- China's retail sector is showing some signs of consolidation in 2011. The market share of the top 20 retail chains rose to 8.9% in 2011 from 8.4% in 2010
- Over 25 of the world's largest retailers are conducting business in China.
- Five of China's domestic retailers are ranked among the 250 largest global retailers on the Global Powers of Retailing for 2010.
- By 2015, China is poised to zoom to the position of the third biggest consumer market globally, after the U.S. and Japan.
- China slipped to the 6th rank on A T Kearney's Global Retail Development Index 2011, from the top position in 2010.

China's growth story has been one of the most spectacular economic marvels of the new millennium. Over the last 30 years, China has ushered in an era of economic reform, emerged as an export juggernaut, and has experienced unprecedented urbanization. All these factors, backed up by the state's unswerving commitment to development, have vaulted the Middle Kingdom to a venerable position globally in terms of Purchasing Power Parity GDP, second only to the United States (U.S.). Over the past two decades China's Gross National Income (GNI) per capita has expanded 13 times.

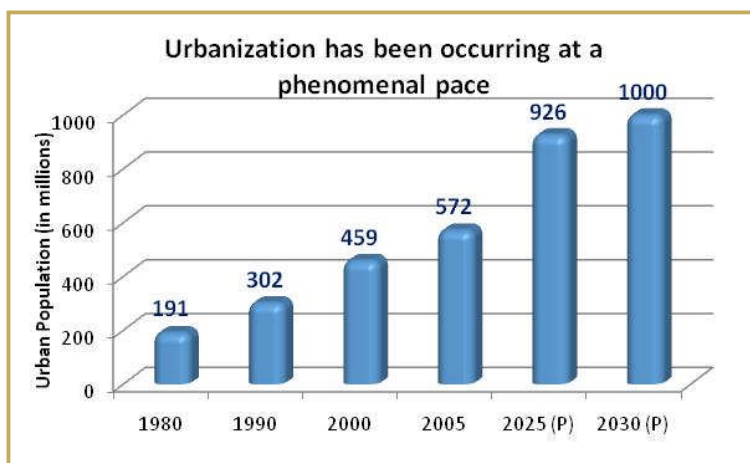
And as incomes have grown, so has the capacity to spend. By 2015, per capita consumption in China is set to increase to 17,000 renminbi (\$2502) from 13,400 renminbi (\$1975) in 2008. Total

urban consumption in 2015 is likely to exceed 13.3 trillion renminbi (\$1.96 trillion), making the country the third biggest consumer market after the U.S. and Japan according to the 2009 Annual Chinese Consumer Study by McKinsey.

These sweeping changes in China's socio-economic framework have also led to the emergence of a buoyant retail sector, which thrives on the progressive Chinese consumer. With this, domestic retailers have come to benefit from the mounting retail appetite, and global retail chains have made a beeline to grab a share in the booming Chinese retail market.

As demand in the developed countries reaches maturity, the lure of the flourishing retail market in China has attracted global retailers since the floodgates of the sector were thrown open to foreign players. With consumption demand in most of the developed world still reeling under the aftermath of the global slump, the bustling Chinese retail market provides greener pastures for retailers looking for growth. Moreover, now that the Chinese government is consciously trying to retool its development model more towards domestic consumption rather than export dependence, retailing in the world's fastest growing economy is poised for exuberant growth.

Urbanization is driving the retail boom



China has experienced unparalleled levels of urbanization since the onset of economic reforms begun in 1978. Compared to 1980, today China's urban population has increased by over 200%. According to a McKinsey research study, by 2025, two-thirds of the Chinese will be living in urban areas. By 2030, China's urban centers will be inhabited by 350 million more people, this

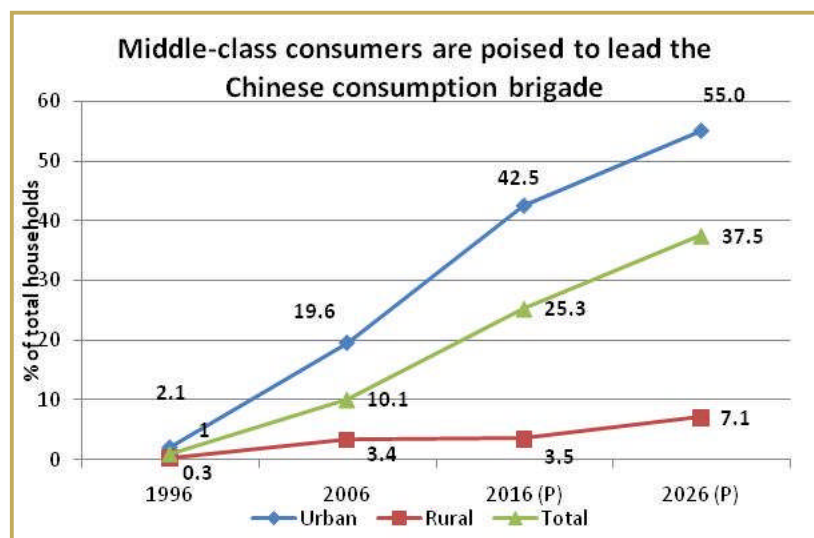
increase itself beating the entire population of the U.S. today. Also by 2025, 221 Chinese cities will boast of a population of over one million, with 23 cities registering over five million. In comparison, Europe has just 35 cities with a population of over one million currently. The urban economy is expected to generate 90% of China's GDP by 2025, with its aggregate consumption and disposable incomes twice those of Germany.

While the 1990-2005 period saw the emergence of two mega-cities in China with a population of over ten million, namely Beijing and Shanghai, by 2025 the number of mega-cities is expected to climb to eight, adding Tianjin, Shenzhen, Wuhan, Chongqing, Chengdu and Guangzhou to the group. These mega-cities are fast emerging as urban retail hubs in China.

The power of the aspiring middle-class

World over, the resurgent demand from the growing middle-class has been instrumental in driving global growth. The World Bank estimates that the global middle-class will grow from 430 million in 2000 to over 1.15 billion in 2030 (incomes ranging from \$3650-\$7300 annually). More importantly, while the developing countries accounted for 56% of the global middle-class in 2000, this figure is expected to zoom to 93% by 2030. China and India together will account for a phenomenal two-thirds of this expansion. In China, the process of economic growth led to fast-paced urbanization and improvements in the standards of living, and with this, more and more urban migrants were propelled to the emerging middle-class.

The middle-class has become the face of the contemporary and aspiring Chinese consumer, who is now being wooed by domestic and foreign retailers alike. Defining the middle-class as people with incomes ranging from \$6000-\$25,000 a year, Song and Cui estimate that this virtually non-existent category of consumers in 1995, will boast of over 340 million people by 2016 (*Understanding China's Middle-Class*,



Source: 'Understanding China's Middle-Class', Kheehong Song & Allison Cui, chinabusinessreview.com, January-February 2009.

chinabusinessreview.com, January-February, 2009). Constituting about 23% of the Chinese population today, the middle-class is raring to grow to 25% in 2010 and 33% by 2020. The urban middle-class will lead this explosive expansion, with over 60% of urban households estimated to join this group by 2016, compared to 39% in 2006. Needless to say, the power of the rapidly expanding middle-class in China will be a moving force in driving the Chinese retail boom.

China's wealthy consumers are also making their mark

While the wealthy currently constitute about 1% of China's urban households, they are experiencing a strong growth of 16% annually according to a McKinsey research report. The number of wealthy households in China is set to rise from 1.6 million recorded in 2008 to about four million in 2015, making the Dragon home to the fourth largest pool of wealthy consumers globally, after the U.S., Japan, and the U.K. The wealthy are concentrated in the East and Central South regions of the country, and over 30% live in the four largest Chinese cities of Shanghai,

Beijing, Shenzhen and Guangzhou. A remarkable characteristic of wealthy consumers in China is that on an average they are about 20 years younger than their counterparts in the U.S. and Japan, giving retailers a much wider window of opportunity to capitalize on the purchasing power of this segment. The average Chinese millionaire is only 39. The predominantly young and fast growing affluent Chinese consumers are increasingly making their presence felt in a wide array of industries, such as consumer electronics and consumer luxury goods, as well as the automotive, real estate, banking, and services sectors.

No wonder that sales of luxury goods are expected to outpace the growth of any other product in China. Over the next five years CLSA, a financial services firm, estimates that China's luxury goods market will grow at the pace of 25% a year, almost twice as fast as the broader retail sector. A large number of upscale luxury brands such as Louis Vuitton already count China as their single largest market. The Asian giant's share of world luxury market is also expected to triple by 2020. By the end of this decade, China's share of luxury market is predicted to be around 45%, higher than that of the U.S.

Unleashing the retail dragon through reforms and foreign investment

While by now most prominent global retailers have forged an entry into the thriving retail industry in China, the framework of rules and regulations governing this sector have remained largely ambiguous and fraught with contradictions. Prior to 1992, foreign retailers were prohibited from setting up joint ventures or wholly-owned subsidiaries for wholesale or retail trade in China. Loosening its tight regulations somewhat, in July 1992 the State Council permitted foreign investment in retailing on a trial basis in Beijing, Shanghai, Tianjin, Guangzhou, Dalian, Qingdao, as well as the five Special Economic Zones (Shenzhen, Zhuhai, Shantou, Xiamen, and Hainan). By 1997, about two dozen foreign-invested stores in China had been approved by the central government to conduct business. However, hundreds of foreign-invested retailing as well as wholesaling enterprises had already established themselves in Chinese cities, having sought approval from the provincial or municipal authorities.

In order to curb the mushrooming of foreign-invested retail enterprises, the central government ordered a moratorium on local approvals, revoking many approvals made in 1997 and 1998 as well. The ownership structure of many of these enterprises was also restructured, making them Chinese majority-owned. Despite these interventions, the tussle between the local and the central government persisted, as many foreign-invested retail enterprises continued to be approved by local authorities.

WTO accession powers foreign investment in retail

China's accession to the World Trade organization (WTO) in 2001 marked a new, liberalized era for foreign investment in retail. Under the WTO's *Accession Protocol*, the opening up of the retail sector was phased over a period of five years to December 2006. The framework of rules however, left much to be desired in terms of clarity and transparency. On the issue of equal ownership between the domestic retailer and the foreign investor, the *Commercial Sector Measures* brought out in April 2004 by the Chinese government were in contradiction with the *Accession Protocol* as well as the *2007 FDI Guidance Catalogue*. While the *Commercial Sector Measures* restricted foreign investment to 49% equity for foreign-invested retail chains with more than 30 outlets, the *Accession Protocol* as well as the *FDI Guidance Catalogue* of 2007 allowed for equal ownership. However, providing some clarity, the Chinese government's *Administrative Measures for Foreign Enterprises or Individuals Establishing Partnership Enterprises*, brought out in 2009, now permits foreign investors or individuals to set up retail enterprises in partnership with domestic entities in China.

The Chinese Ministry of Commerce has also been gradually delegating the authority to approve all foreign-invested retail businesses to provincial commerce branches, facilitating the expansion of foreign retail players within the country. However, the authority to approve retail businesses involving items controlled by the state, as well as enterprises using the channels of direct selling, including, mail order, the internet, franchises, commissioned operations or commercial management, remains centralized.

With the onset of a liberalized framework for foreign investment in the retail sector, more than

Top Retailers in China 2010 According to Sales		
Ranking	Retail Player	Overall retail sales (\$ million)
1	Suning Home Appliances	11,103
2	Gome Home Appliances	7,486
3	Belle International	3,486
4	Dashang Group	3,579
6	RT Mart Shanghai	7,445
7	Carrefour China	5394

half of the top 50 global retailers such as Wal-mart, Carrefour, Tesco and Metro, have entered China and are conducting business. While Wal-mart runs 146 stores spread across 89 cities, Carrefour boasts of 156 stores. Foreign investment in retail has ushered in a new era, with modern management techniques and brand recognition becoming the mainstays of the Chinese

retail sector.

Retail formats in vogue

China's retailing sector remains highly fragmented, housing many small and medium-sized retailers unlike the U.S. where the big retailers have a dominating presence. China was home to over 549,000 retail enterprises. Despite the fact that the number of chain stores has grown in recent years, cross-provincial retailers remain less common because of local market access barriers.

However, China does flaunt a wide array of retail formats, each at a different level of evolution and development:

- **Department stores:** These stores were popular earlier on, but are facing intense competition now and are battling to stay ahead. (Golden Eagle, Parkson, Beijing Cuiwei, Shenzhen Suibao)
- **Hypermarkets:** The development of hypermarkets has been led by international retailers, who are now spreading their wings to tier 2 and 3 cities, as markets in tier 1 cities reach saturation. (Wal-Mart, Carrefour, Vanguard, Tesco, Metro, RT Mart Shanghai, Trust-Mart)
- **Supermarkets:** This highly fragmented market dominated by domestic players, is witnessing cut-throat competition, often leading to weeding out of the weaker players coupled with strategic consolidation. (A-Best Supermarket, Baijia Supermarket)
- **Convenience stores:** Though still in the development stage, this format is witnessing increasing competition, mostly among domestic chains. (Quick of LianHua, Alldays & Kedi of NGS)
- **Specialty stores: Electronics/Appliances:** This segment is clearly dominated by domestic players, with limited foreign investment. (GOME, Suning)
- **Discount stores:** Still evolving, this format remains concentrated in tier 1 cities. The first discount store was introduced by Carrefour in 2003.
- **Franchising:** Constituting about 3% of China's total retail market, franchising seems to have tremendous potential for future growth. (KFC, McDonalds, 7-eleven, Pizza Hut)

Chinese Retailers Ranking among the top 250 Global Powers of Retailing 2011	
Retail Player	Global Rank
Brilliance Group	70
Gome Home Appliances	86
Suning Home Appliances	104
Dashang	145
NGS Group	221

- **Direct selling:** With direct selling rules introduced in 2005, providing the much needed legal framework, the potential for further growth remains immense. (AMWAY, Mary Kay, Avon)
- **Online retail:** Online shoppers grew 68% between 2009 and 2010 to 185 million. Online retail sales have been predominantly consumer-to-consumer transactions. However, with over 29% of its population using the internet, online retail sales are poised to grow over 30% per year. (Taobao, Alibaba, eBay)

Retail sales in 2010: Online retail and e-commerce expand strongly

China's retail sales, which rose nearly 17% in 2009 amidst the economic downturn, expanded strongly in 2010 as well. China's National Bureau of Statistics reported that retail sales during the year jumped 18.4% to 15.5 trillion yuan (\$2.34 trillion). Sales of the top 100 retail chains in the country grew 21.2% to 1.66 trillion yuan (\$253 billion). With China witnessing increasing internet penetration, a number of retail giants expanded their online operations. According to the China Chain Store & Franchise Association (CCFA), nearly 34 of the top 100 retail chain owners started offering online shopping services in 2010. This helped e-commerce turnover in the country rise 22% to 4.5 trillion yuan. Online retail sales in the country almost doubled to nearly 513 billion yuan.

However, despite the current growth in online retail, the segment accounts for a relatively tiny portion of the entire retail market in China. Although overall online retail sales in the country are expected to touch nearly one trillion yuan by 2014, it will just account for only 6% of the country's 16 trillion retail market.

A snapshot of prominent Chinese retailers in terms of investment potential

Several prominent Chinese retailers are registered on the Hong Kong Stock Exchange with investment potential for global investors with an interest in China's retail sector.

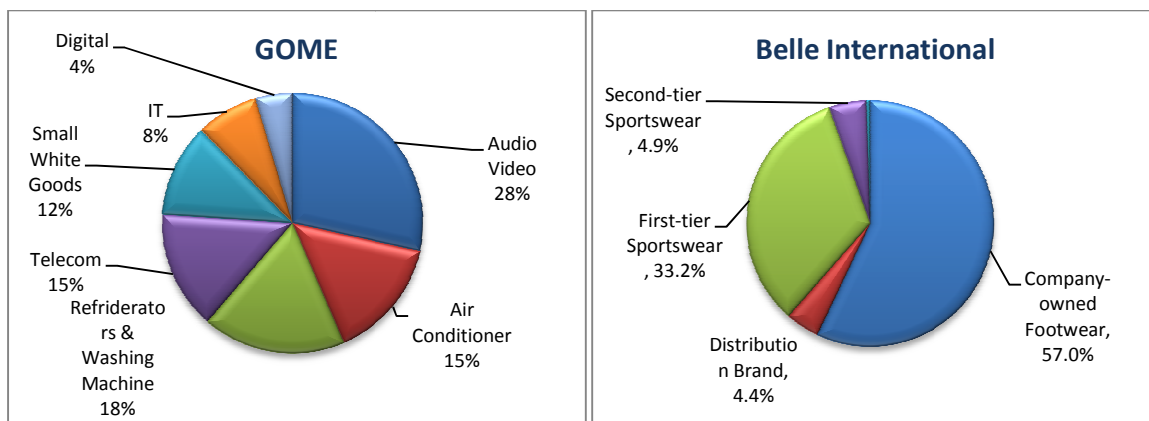
GOME HOME APPLIANCES: Established in Beijing in 1987, GOME is a leading retailer in home appliances and consumer products in China. It is the largest Chinese electronics retailer by number of stores. By the end of December 2010 GOME Group had a presence in 336 large and medium-sized cities through 1320 stores. Listed on the Hong Kong Stock Exchange in August 2004, it is a pioneer of the retail chain model in China.

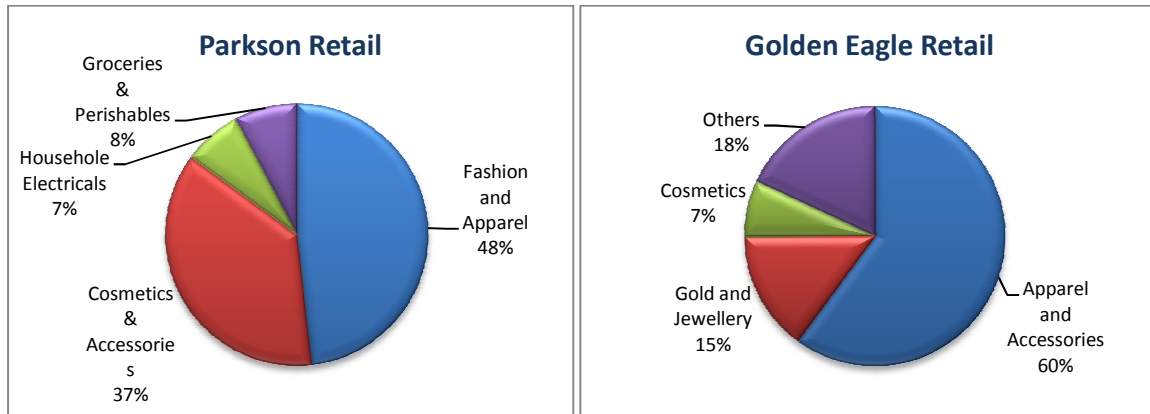
While it derives the lion's share of revenues from from Shanghai, Beijing, Guangzhou and Shenzhen, second-tier cities account for a fourth of its total revenues too. GOME has undertaken a series of strategic mergers and acquisitions which include China Paradise, Dazhong Home Appliances, and Shaanxi Cellstar. In order to maintain its margins and remain competitive, the company closed down 39 underperforming stores in 2010. In a strategic move, GOME restructured its operational model, transitioning from a "shopping mall model" to a "retail shop

merchandise management model”, with added emphasis on the product-mix, in-store layout and product display.

Retailers with Investment Potential			
Company	Retail Business	Market Capitalization (\$ million)	Stock Exchange Listing
Gome Home Appliances	Electrical appliances	7,544.1	Hong Kong
Belle International Holdings	Footwear, sportswear	19,764.7	Hong Kong
Golden Eagle Retail	Apparels, accessories, Jewelry	5,617.6	Hong Kong
Parkson Retail	Fashion and apparels, accessories, electrical goods, groceries	4,352.9	Hong Kong
Anta Sports	Sportswear, apparel, accessories	4,348.7	Hong Kong
China Donxiang	Sportswear	1955.8	Hong Kong

Revenue by Segment for Prominent Chinese Retailers in 2010





SUNING HOME APPLIANCES: Although domestically listed on the Shenzhen Stock Exchange, it is worthwhile to mention Suning as it was ranked the largest retailer by sales revenues in 2010. Established in 1990, the company was listed in July 2004, and now operates about 1000 stores spread across 300 cities. It follows four chain formats: flagship stores, neighborhood stores, specialized stores and boutique stores. Suning has adopted an aggressive strategy to expand its markets in Mainland China, while eyeing overseas markets as well. In a well-planned strategic move, it acquired a 51% stake in Laox, a Japanese retailer last year, and stands to benefit from the Laox Japanese technology as well as standards of service. Suning plans to open over 110 Laox outlets in China over the next three years, and will revamp the Laox Japanese stores to cater to Chinese tourists. Suning also acquired Citicall in 2010, a leading consumer electronics retailer in Hong Kong, gaining access to 22 stores and facilitating its overseas expansion.

BELLE INTERNATIONAL HOLDINGS: Primarily engaged in the women's footwear and sportswear business, Belle International Holdings has an overwhelming presence in Mainland China, operating about 11,967 retail outlets with another 172 outlets in Hong Kong and Macau. While company-owned brands contribute substantially to total revenues, the company follows the brand licensing and the retail distribution policy for other brands. Sportswear is restricted to retail distribution of brands like Nike, Adidas, Reebok, PUMA and Converse. The company covers product research and development, procurement, manufacturing, and distribution as well as retailing for in-house brands, with Mainland China contributing about 94% to the total revenues. Listed on the Hong Kong Stock Exchange in May 2007, Belle has undertaken strategic acquisitions, acquiring the Mirabell and Millie's business in China, Hong Kong and Macau, as well as the Senda Brand in China.

GOLDEN EAGLE RETAIL: Established in December 1995 in Nanjing, Golden Retail has 20 self-owned stores and one management store in China. The stores are spread across 11 cities in the three provinces of Jiangsu, Shaanxi and Yunnan. Jiangsu remains the major market for the group. Situated in prime shopping locations in cities, the group boasts of 70.7% self-owned properties, with the balance of properties on long-term leases. It focuses on its VIP Customer Expansion Plan, which already has 826,000 enrolled loyal customers.

PARKSON RETAIL: The retailing arm of the Lion Group in Malaysia, Parkson Retail was established in 1987 and started operations in Beijing, China in 1994. Positioned in the middle and upper-middle end of the retail market, the company focuses on fashion and lifestyle products. Listed on the Hong Kong Stock Exchange in November 2005, it has a network of 46 stores spread across 30 cities in China. On average, the group aims to build up its portfolio annually with about 15% additional operating area. Parkson is now focusing on acquiring a controlling interest in its existing subsidiaries operating its stores in China, as well as third-party managed stores. It also plans to purchase the property of current as well as potential flagship Parkson stores, in order to eventually own about 20-25% of its operational retail space. Toward this end, Parkson has completed the acquisition of the Parkson branded managed stores in Nanning, Tianjin and Kunming. The company has also bought the Anshan Parkson property, and acquired controlling stakes in Xi'an Lifeng Parkson apart from the Xi'an Changan and Xi'an Shidai Parkson stores. The Jiangxi K & M store in Nanchang city, as well as the Anshan and Beijing Parkson stores have also been completely acquired.

China Donxiang and Anta Sports are two other prominent sportswear enterprises operating in China. While China Donxiang has held all rights to the internationally recognized Italian brand Kappa in China and Macau since 2006, it also acquired Phenix, a renowned Japanese ski brand in 2008. Since the Phenix company manages the Phenix and Kappa brands in Japan, now China Donxiang owns rights to the Kappa brand in Japan as well. Similarly, Anta Sports is engaged in the design, development, manufacture and marketing of branded sportswear in China, and has also acquired the business for the Fila brand, Italy's largest sportswear company, in Mainland China.

Earnings Growth			
	2008	2009	2010
Gome Home Appliances	-7%	34.4%	37.6%
Suning Home Appliances	48%	33.2%	37.4%
Belle International Holdings	1.6%	26%	35.4%
Golden Eagle Retail	60.1%	-59.1%	282.1%
Parkson Retail	24.4%	8.3%	9.3%
Anta Sports	66.4%	39.8%	24.0%
China Donxiang	86.4%	19.5%	0.3%

Challenges on the horizon but opportunities galore

While the Chinese retail sector holds tremendous potential and seems poised for phenomenal growth, it must confront a few challenges.

CONSOLIDATION: In order to promote efficiency as well as reap economies of scale, consolidation is a top priority for the Chinese retail industry. Currently, China's retail segment is highly fragmented. Competition is especially cut-throat in the supermarket and the hypermarket segment of China's retail segment. The largest player in the supermarket segment, the China-based Shanghai Bailian Group, enjoys only 11% market share. Even Walmart which dominates the retail market in the U.S. commands only around 6% market share in China, despite the fact the big-box retailer set up shop nearly 15 years ago in the country.

LEASING VERSUS OWNING PROPERTIES: As competition in the retail sector intensifies, there is an acute need to manage costs and improve margins, especially when it comes to real estate costs. While acquiring property often proves to be an expensive proposition, retailers can exercise the option to operate from leased properties, which often is an economical option. For instance, leading electronics retailer GOME owns only about 8% of the floor area for its stores, with the remainder of its retail business operating on leased property. However, even leasing floor space is getting progressively expensive in the country. In 2010, leases and rental costs jumped nearly 30% year-over-year.

OUTSOURCING NON-CORE OPERATIONS: Moreover, retailers can also consider outsourcing some of their non-core functions like IT infrastructure, and other back office activities, focusing on their core competencies in retailing and customer orientation. This could play a major role in driving down costs.

BRANDING AND DISPARATE CONSUMER PREFERENCES: While brand positioning is clearly an important aspect of the retailing business, the extremely diverse and dissimilar consumption patterns of Chinese consumers makes branding a formidable exercise. On the one hand, while China is emerging as the fastest growing market of premier luxury brands worldwide, there is also a large category of consumers who are price sensitive and are attracted to value offerings. While brand awareness has been on the rise, the same cannot be said about brand loyalty among Chinese consumers. Hence, while the scope for developing brands by domestic retailers is immense, cultivating brand loyalty remains a challenge.

ENCOURAGING FOREIGN RETAILERS: All said and done, while many global retailers have made their presence felt in the Chinese retail arena, they still face restrictions and lack of clarity in rules. This is evident in the fact that only 5% of China's retail enterprises are foreign-invested. Foreign retailers have played an instrumental role in providing impetus to organized retail in the country as well as modernizing the sector through best practices and state-of-the-art technology.

In the best interest of the Chinese retail industry, it may be beneficial to support and encourage joint ventures and partnerships between domestic and foreign retailers. Currently, some of the foreign retail giants contend that prime retail real estate space always goes to a local player, which puts them at a disadvantage.

Challenges and hurdles notwithstanding, continued urbanization and a prosperous middle-class will continue to be the drivers of the booming Chinese retail sector. Not surprisingly, the world is bracing to witness the emergence of China as one of the largest global retail markets in the next decade. 🌐

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