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CHINA UPDATES

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Issue 5

November 16, 2011

Special Consumer Market Issue



China Updates is a service provided by U.S.-China Health Products Association and their media partner Herbridge. The Newsletters will be issued as relevant material becomes available. China Updates will provide news on regulatory environment, new legislation, association activities and any information related to the natural health products industry in China.

China's Consumer Market Continues to Expand

By Richard Zhu (竹子俊)

China's retail industry is expected to surge continuously in the future, fuelled by the strong growth of China's consumption expenditure and the rapid emergence of the middle-class, said a recent report by Deloitte China.

The report, named "China Power of Retailing 2011", estimates that accelerating operating costs, global economic uncertainty, upgrade in consumption pattern along with other factors will prompt more Chinese retail companies to adopt multi-format retailing and internationalization, in order to meet the diversified needs of consumers and to deal with fierce competition.

Steady Growth

China's retail industry continued to grow steadily in 2010, with the strongest growth in sales revenue for companies, which have a multi-regional and nation-wide operation. In terms of sub-sector, department stores achieved the fastest growth, according to annual report, which is based on the top 100 chain retailers ranked by the China Store and Franchise Association. The steady and rapid growth was driven by several factors, including adjustment of the economic growth mode, increase in household income, development of technology, acceleration of urbanization, consumption upgrades and government policies to stimulate consumption.



“Despite global economic uncertainties, China’s retail industry has achieved steady to fast growth, outperforming other countries in the Organization for Economic Cooperation and Development. It has been supported by the changing mode of economic growth, rise in national income, technology innovation, heightened urbanization, upgrade in consumption pattern and the stimulus policies from the government,” said Mr. Eric Tang, Consumer Business & Transportation Co-Leader of Deloitte China.

In 2010, consumption in China maintained steady and rapid quarter-on-quarter growth. The annual retail sales reached RMB15, 455.4 billion, up 18.4 percent over the previous year, and the inflation-adjusted retail sales growth rate was 14.8 percent. In terms of locations, urban retail sales of consumer goods reached RMB13, 368.9 billion, up

18.8 percent over the previous year, while rural retail sales reached RMB2, 086.5 billion with a year-on-year growth of 16.1 percent. In terms of consumption patterns, food and beverage sales were RMB1, 763.6 billion, increased by 18.0 percent over the previous year.

Consumer product sales grew at 18.5 percent, reaching RMB13, 691.8 billion, among which the above-norm enterprises’ retail sales were RMB5, 805.6 billion (per unit) at a growth rate of 29.9 percent. Some retail sectors grew rapidly: 46.0 percent for gold, silver and jewelry products, 37.2 percent for furniture, 34.8 percent for automobiles and 27.7 percent for home appliances and audio/video equipment. Moreover, China Consumer Confidence Index continued to rise and was higher than the global average. Although Chinese consumer confidence fell dramatically as a



result of the global financial crisis in 2008, it has rebounded since 2009, as the global economy recovered and a series of central and local government policies were enacted to stimulate domestic consumption, maintain growth, as well as the restructuring of some industries.

Characteristics of the market

According to the Deloitte report, there are several features of the retail market. First, Expansion became the focus of China retail industry. In 2010, the total number of stores owned by the Top 100 retailers grew at 9.7 percent over the previous year. In addition, the number of stores owned by 52 retailers in the Top 100 list increased above 10 percent. There were three key reasons for such expansion. Second, the third and fourth tier cities have become the focus for retailers' expansion. With intensified competition, now retail markets in the first tier and secondary cities are saturated. In order to maintain high growth, retailers are gradually expanding to the third and fourth tier cities, where the market potential is optimistic. Third, mergers and acquisitions (M&A) activity in the China retail market continues to increase dramatically. Since 2006, there has been an upsurge of M&A deals in the domestic retail industry, which reached a peak in 2008 and 2009.

There were 140 M&A deals in China retail industry in 2010, with a total value of more than \$4.966 billion. As expansion becomes a trend in the retail industry, M&A is one of retailers' first choices to enter new markets, or maintain leading market positions.

Fourth, more and more retailers are operating with a combination of both large and small stores, enabling them to serve consumers with different needs. On one hand, as the Chinese economy maintains high growth, household income of Chinese consumers continues rising. More and more consumers prefer one-time bulk purchases and one-stop shopping experience. Such changes in consumption patterns require retailers to provide a large number of diversified merchandise in one store to meet various consumer needs. On the other hand, diversified and personalized consumer demands stimulate retailers to open more small stores due to several reasons.

Fifth, the specialty chain has become another opportunity for the retail industry due to many factors. As the mass market becomes saturated with increasing competition and reduced average profits, retailers are increasingly focusing on specialized products and services to appeal the customer segments and to avoid direct competition with large multi-sector retailers. However, after rapid expansion, specialty chain retailers have to face the same challenges in corporate management and supply chain construction same as traditional chain retailers. If these problems are not handled properly, future growth of the specialty chain is likely to be hampered.

Sixth, more and more retailers have started expansion to multi-sectors. With foreign retailers' penetration into the retail industry in China, increasing domestic competition and scarcity of retailing posts, local industry players are gradually transferring from traditional retailers to multi-sector retailers.

In addition to expansion and adoption of new operation in different retail sectors, retailers also began investing in commercial real estate and developing private brands, which have also become their new form of profit making.

Seventh, an obvious trend in the Chinese retail market currently is that retailers focus on integration of e-commerce and chain stores. E-commerce helps companies connecting with consumers directly. And consumers now have the power of information at their fingertips, literally enabling them to compare shops and purchases at any time. As online shopping grows rapidly, the real store development has entered into an important phase with both opportunities and challenges.

Last but not least, Chinese retailers usually choose IPO as the first approach in entering the capital market, which has the advantages of lower costs and more adequate capital; hence IPO becomes the optimal option for leading retailers in financing for expansion. In 2009, the launch of the Growth Enterprise Market (GEM) lowered the threshold for listed companies, encouraging the chain retailers to go public. In addition, due to stimulating policies for capital market such as introduction of stock index futures in China, chain retailers, which have leading regional positions are likely to choose the domestic stock market to go public. In 2010, 12 retailers were successfully listed, and 27 retailers announced their plans on IPO. Retail industry has become the focus of venture capital. B2C online retailing has attracted venture capital's attention in the last two years.

The top 100 retailers' strategy

"With reference from the market share of the top 100 retailers, we discover that scale expansion and market penetration are the key development strategies for retailers. This indicates that exploring new markets and taking advantage of the resulting scale changes are retailer's strategic

"In 2010, 12 retailers were successfully listed, and 27 retailers announced their plans on IPO."

priorities, which are also reflected in the average sales turnover of companies with cross-region operations," said Mr. David Lung, Consumer Business & Transportation Co-Leader of Deloitte China.

Average sales turnover of the top 100 retailers in major regions indicates that regional operations are heading to the extremes. The nation-wide operation model in different regions continues to enjoy absolute advantages, taking up 65.73% (equivalent to 27.32 billion yuan) of the total turnover of the top 100 retailers and achieving the highest growth rate of 37.6% in 2010. Companies with operation in a single province achieved the second highest growth rate of 13%. Cross-region companies only recorded a growth rate of 5.6% while companies with single region operations experienced a negative growth rate, said the report.

Growth rate in the number of branches among the top 100 retailers was 9.74% in 2010 – the lowest in the last three years. However, the growth in sales reached 22.43%, achieving a far higher rate than the 13.5% of 2009. This indicates that retailers have turned to more defined and efficient models, which emphasizes on the sales capability of an individual store, more refined industry division, and unique operation characteristics.

Positive growth of foreign retailers

The report indicates that foreign retailers maintained positive growth in their Chinese operations in 2010. Overall sales of foreign retailers in the Top 100 increased from RMB307.1

billion to RMB362.7 billion, but their composite sales growth (18.09 percent) was lower than that of the Chinese retailers (25.3 percent), resulting in a decline of their market share in China retail industry from 22.6 percent in 2009 to 21.8 percent in 2010.

As Home Depot (China) dropped off the Top 100 list, American retailers' share in Top 100 total sales fell close to Hong Kong and Taiwan retailers; European retailers experienced declining sales share from 2008 to 2010; Asian retailers' share in total sales increased, as a result of Lotte Mart (Mainland China) expanding its coverage in the mainland China, but their share remained as the smallest.

European and American retailers in the Top 100 operated in a wider range of sectors (Home Depot dropped off the Top 100 which caused a reduction in the range covered by American retailers), whereas Asian, Hong Kong and Taiwan retailers focused primarily on supermarket and department store. American retailers took a lead in sales and number of stores, with average annual sales of RMB26.925 billion, far above the Top 100 average, and an average number of stores of 1,299 (of the four American retailers, Yum and McDonald's had 3,500 and 1,200 chain stores respectively), followed by Hong Kong and Taiwan retailers with average sales of RMB17.547 billion and an average number of stores of 199.17. European retailers ranked the third. Average sales of Asian retailers was RMB8.9 billion only, and their average number of stores was only 38.14, which ranked the lowest.

“American retailers took a lead in sales and number of stores, with average annual sales of RMB26.925 billion”



The report points out, however, Asian retailers had the strongest operational capacities in terms of their average single-store sales, with above-average composite retail sales (RMB189 million) of RMB362 million. Retailers from Europe, Hong Kong and Taiwan ranked the second and the third respectively. The single-store sales of American retailers was only RMB74 million, far below the Top 100 average. It was relevant to the retail sectors and sizes of the stores opted by the foreign retailers in China. For instance, Asian retailers usually operated supermarkets and department stores in China, with a small number of stores in larger sizes; American retailers, such as Yum and McDonald's, these fast-food chain retailers operated a larger number of stores in much smaller store size than those of supermarket and department store, therefore, to a certain extent, their average single-store sales were diluted.

Foreign retailers in the Top 100 had composite sales growth of 18.09 percent in 2010, twice that in 2009, but it was still lower than the Top 100 average of 22.42 percent and the domestic average of 25.3 percent. Overall store number of foreign retailers in the Top 100 increased more than 25.64 percent, far above that of Chinese retailers (11.49 percent) and that of foreign retailers in 2009 (13.6 percent).



Hong Kong and Taiwan retailers demonstrated the most rapid growth in number of stores in 2010, of 227 percent. It was mainly due to Watson's entry into the Top 100 list.

Asian and European retailers posted rapid sales growth, while American retailers maintained steady growth. Lotte Mart joined the Top 100 in 2010. Except Ito-Yokado, sales growth rates of the other four Asian retailers were all above 20 percent, significantly boosted the overall sales growth of Asian retailers (43 percent). Five European retailers maintained double-digit growth in 2010, resulting in an average sales growth of European retailers rising from 4 percent in 2009 to 17 percent. Although Home Depot dropped off the Top 100 list, Wal-Mart and Yum had double-digit growth, and thereby the composite sales growth rate of American retailers (11 percent) was not much lower than that in 2009 (14 percent).

Outlook of the industry

Over the next five years, China retail industry will enter into an important period with both opportunities and challenges, such as uncertainty in the global economic recovery, rising inflationary pressures, consumption upgrades and changes in consumption structure, said the report. It will be inappropriate for chain retailers to continue

adhering to their original strategy of developing single channel. Although the single-sector retailers will remain dominant in retail industry in the next few years, more and more companies will try to diversify their operations in order to sustain growth and outperform their competitors.

“Like other industries, the retail sector is also facing the problems of rising operating costs. On one hand, continuous increase in property prices has given rise to higher rental costs; on the other hand, inflation has jacked up import prices and labor costs. Retailers also need to tackle other challenges from talent recruitment and development, logistic efficiency improvement, shortening of the supply chain, the increase in outsourcing services and innovation in business models,” said Mr. Lung.

As the global economy gradually recovers, consumer spending in China is expected to continue growing rapidly. The number of middle-class consumers will continue to increase rapidly, especially in the big coastal cities, which leads to the increase in discretionary spending, as well as spending on home-related products and the awareness of global brands (but local high-quality brands will still dominate the local markets). Moreover, in the next decade, there will be a need of more sustainable patterns not only for production and food consumption, but also for all products and services.

Chinese consumers will pay more attention to the sustainability of consumption. The changes in consumer attitudes and consumption patterns are influencing, and will continue to influence the growth path of retail industry. Consumers are becoming more active participants in the creation of a more sustainable economy and increasingly aware of the broad sustainability challenges in the world. Over the next 10 years, more consumers will prefer sustainable behavior in their daily life, such as routine recycling or looking for sustainable



products. More and more consumers will advocate for sustainability, and demand it in products and corporate practices. However, the report points out there are still some challenges in dealing with consumers. Sustainable consumption over the next 10 years, will not be primarily driven by consumers. Rather, it will be up to the retail industry to take the lead in engaging consumers to change their consumption patterns and to innovate aiming to meet future demands. Externally, retailers can play a critical role in stimulating governments and regulators to guide consumer behaviors. It will not be enough to react to consumers' needs and demands. Top companies will lead consumers to accelerate changes toward the more sustainable behaviors.

Foreign retailers have gradually penetrated into the consumer market in China. Due to economic

recessions in North America and Europe, consumer spending there becomes conservative, and retail growth has been slowed down. As the world's second largest economy, China has the largest population and fastest economic growth. As more and more foreign retailers recognize the importance of the China market, there are likely to be more foreign entrants and increasing investment in China. Besides, competition among local retailers is increasing and changes in consumer demand also bring challenges to retailers.

Given both opportunities and challenges, it is likely for an increasing number of large domestic retailers wishing to expand their operations in emerging markets, setting internationalization as the goal for their future development.

“In the face of future challenges and opportunities, companies will develop multi-format retailing to meet the diversified needs of consumers, to distinguish themselves from others and to deal with pressure from competition. With the global economic integration, China will become stronger and its retail market will also become saturated. To achieve business expansion, retail companies can consider exploring the consumer market in other emerging countries,” said Mr. Tang.



Natural Health Products: Promising Growth Industry in China

Commentary by Jeff Crowther

The above report is a great analysis and example of why not to wait on your China entry plans. The increasing middle-class across China is becoming more and more interested in buying products and foods that are beneficial to their health. Over the last couple of years, I have seen an increase in conferences, forums and expos dedicated to natural health products in China. Also, sales channels are beginning to pop-up on the Internet as well as in traditional retail. Other industries that are expanding such as fitness, specialty children stores and sports are encouraging natural health products sales. Domestic companies that were traditionally ingredient suppliers are now looking to begin producing their own finished products for the market. This is a growing trend I'm hearing about within industry circles.

The time to begin exploring China's natural health product industry is now while the industry is still developing. Entering now is not going to shower money on you, but it should generate some steady income and give your business that valuable time to iron out any issues before the industry really develops. At that point, market entry will be difficult, costly and competition will be fierce.

The U.S. – China Health Products Association is working towards the development of China's natural health product industry by advocating for a more open and transparent regulatory environment. The association is committed to increasing the trade and availability of its member's products as well as working to safeguard the industry's supply chain, which will benefit the health and wellbeing of both industry and consumers alike.

To learn more about China's developing natural health product industry visit the rest of the association's website www.uschinahpa.org or contact us directly: info@uschinahpa.org



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