

## **Purchasing strategies of chain retailers in China and implications to wholesale distributors**

### **Introduction**

The rise of chain retailers has brought significant changes to China's distribution sector in the past decade. The relentless efforts by retailers to minimize intermediaries in their supply chains, or put it simply, "cutting out of the middlemen", through initiatives such as increase in direct-to-retail arrangements and centralized purchasing, has brought huge challenges to China's wholesale distributors. There are growing discussions about disintermediation.

Indeed, there is a significant shift in power to retailers and consumers. While we believe the demise of distributors in China is off the mark given the huge complexity of the Chinese market, it is true that retailers' changing purchasing strategies have far-reaching implications for China's wholesale distributors. Hoping to shed light on the latest development in China's distribution sector, the Li & Fung Research Centre has joined hands with the prominent China Chain Store and Franchise Association (CCFA) to conduct a survey to understand the purchasing practices and plans of grocery store chains in China in 2011. In this study, we also conducted face-to-face interviews with some of China's largest wholesale distributors, to seek their views on the development of the sector in the years ahead.

### **I. Overview**

#### **1. China's distribution sector is highly fragmented**

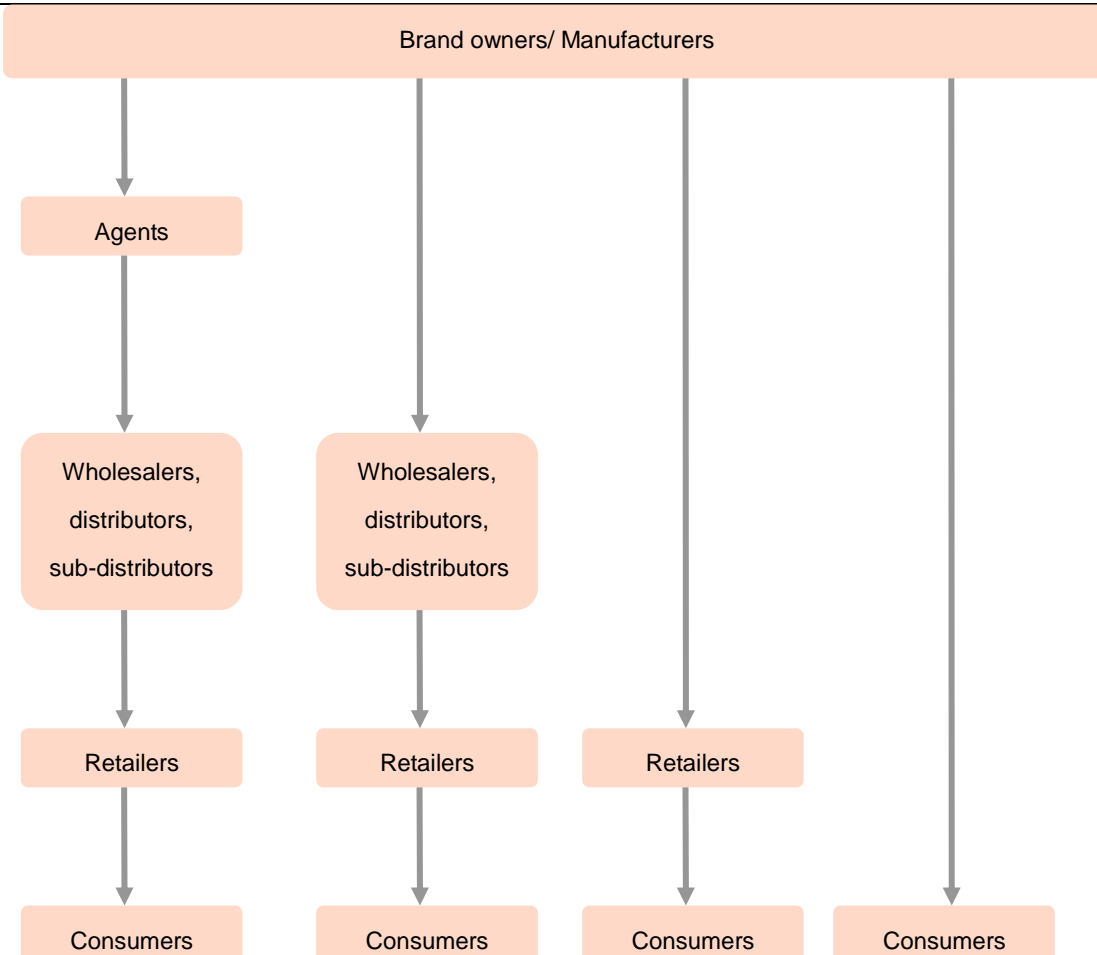
In China's wholesale distribution industry, there are countless number of small-sized players; most of which are with limited distribution reach. Often times, goods have to pass through multi-tiers of distribution players before reaching the hands of consumers in China. There are many different parties involved in the product supply chains, such as agents<sup>1</sup>, distributors, wholesalers<sup>2</sup>, sub-distributors, etc. Given the complexity of the Chinese market, companies in

<sup>1</sup> Typically, agents are not obliged to the buyout of the products; thereby they take no inventory risks. They are paid a certain amount of commissions from business transactions.

<sup>2</sup> Distributors and wholesalers would take ownership of the products. They make profit from merchandise mark-up. Generally speaking, distributors are perceived to play a more active role in product distribution and offer better ranges of services, whereas wholesalers are often viewed as more passive.

China often adopt a combination of distribution modes (see Exhibit 1).

### Exhibit 1: Product distribution in China



Source: Compiled by Li & Fung Research Centre

## 2. Wholesale distributors in China face increasing challenges

### 2.1 Fierce competition

Competition is fierce in China's wholesale distribution sector, particularly in the lower spectrum of the market; those players who cannot offer higher value-added services to clients often have to resort to price cuts, eroding their profitability. Besides, business costs such as labor, energy, raw materials and logistics costs have also been rising rapidly over the past years. Indeed, many players just have razor-thin margin and this further hurts their ability to invest in upgrading.

## **2.2 Growing pressure of disintermediation**

Disintermediation refers to the removal of intermediaries in a supply chain, i.e. the cutting out of the middlemen. To streamline their supply chains, some big-name retailers such as Wal-Mart have leveraged on their scale and set up their own merchandizing and sourcing departments in China to source directly from manufacturers. They source mainly daily necessities, consumer durables and foodstuffs. In recent years, direct purchase of fresh agriculture produce is also becoming more popular as well. On the other hand, some established suppliers such as Haier have also taken initiatives to setting up their own retail outlets, in order to reduce their reliance on retailers. Disintermediation threatens the survival of distributors, especially those traditional players serving solely as a middleman between manufacturers and retailers without much value-added services.

The rapid development of e-commerce is also posing increasing threats of disintermediation. E-commerce now offers consumers wider product choices and the opportunity to make considerable savings in terms of time and money. Take China's apparel market as an example, today, the rising popularity of online players such as VANCL (凡客誠品), MasaMaso(瑪薩·瑪索), Vsnoon(維思諾), Moonbasa(夢芭莎), 9 Dadao (第九大道), M18 (麥考林) and James King is bringing new pressures to wholesalers and retailers.

## **2.3 Retail chain operators continue to gain power over distributors; information sharing along the supply chain is a major concern**

Unlike in the early days of reform, product distribution today is no longer supply-driven. We witness a significant shift in power in China's retail supply chains. Retail chain operators in China have been expanding rapidly in scale and gained power over their distributors. Today, the majority of wholesale distributors in China remain fairly small in size with narrow product lines. Besides, many wholesale distributors in China are serving in limited localities i.e. in single province and city only. Few have a national distribution network.

Gaining the upper hand in the retail supply chain, retail chain operators are placing more stringent requirements upon their distributors. For instance, to reduce inventory costs, many retailers now request suppliers to deliver the products in smaller batches at a higher frequency. As a result, distributors need to keep higher level of safety stocks.

Moreover, many retailers have taken advantage of their strong market power by introducing cumbersome charges<sup>3</sup> to suppliers as well as extending payment period frequently, causing a lot of tension between retailers and distributors. The mistrust between retailers and distributors has affected information sharing among the retail supply chain partners leading to bullwhip effects and posing major barriers in enhancing supply chain efficiencies.

### **3. Specialty wholesale markets play a distinctive role in China's wholesale distribution sector**

Wholesale markets are often regarded as a distinct feature of distribution landscape in China. Manufacturers in China are generally smaller in scale and more scattered, when comparing with their counterparts in the United States and Europe. Hence, wholesale markets have played a critical role in channeling products from manufacturers into the hands of consumers.

Wholesale markets are usually located in the vicinity of manufacturing clusters, serving mainly manufacturers of the region. Yiwu Commodities Market (義烏小商品城), Shandong Shouguang Vegetable Wholesale Market (山東壽光蔬菜批發市場) and Beijing Dahongmen Apparel Wholesale Market (北京大紅門服裝商務區) in China are some better-known examples.

Many people view that wholesale markets in China are disorganized and that most of them are selling low-price, poor quality and unbranded products. In recent years, however, we do observe some large-scale wholesale markets putting a lot of efforts to upgrade themselves with centralized management, modernized hardware, better brand positioning, etc. It is believed that more and more sophisticated, well-equipped, specialized wholesale markets will be established and continue to play a distinctive role in China's wholesale distribution sector.

## **II. The survey**

The survey aims to collect first-hand quantitative data on the purchasing practices of grocery store chains in China. Between March and May 2011, a total of 18 supermarket and hypermarket chain operators, including state-owned enterprises, solely-owned foreign enterprises, Chinese private enterprises, joint ventures, and shareholding companies were interviewed. 50% of our surveyed

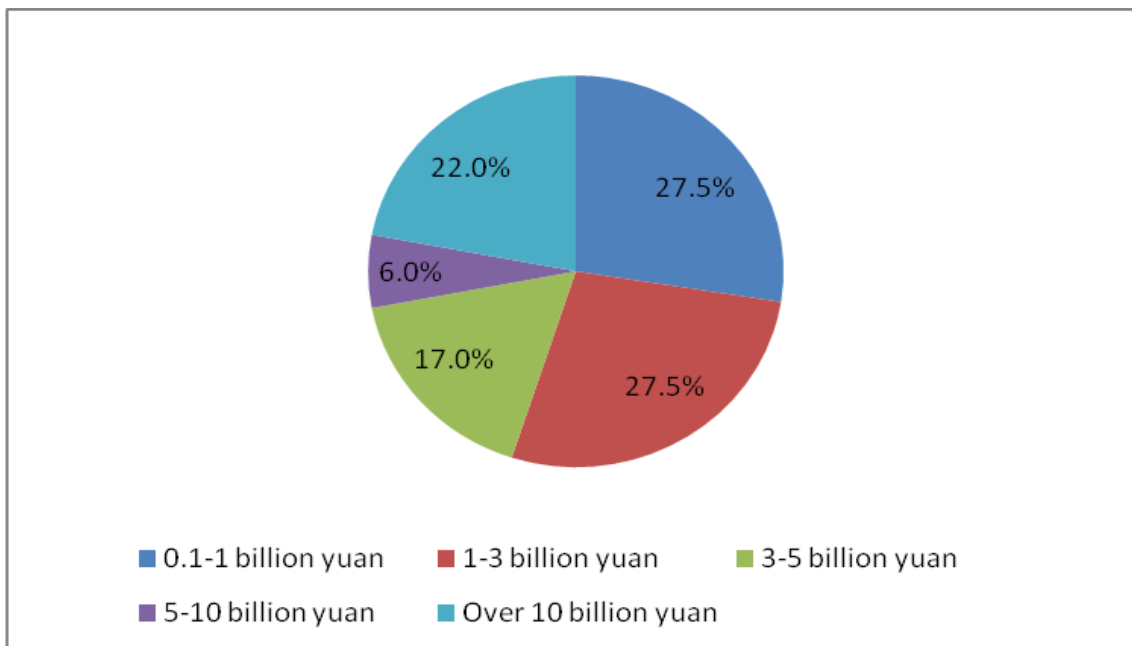
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<sup>3</sup> Retailers in China tend to levy heavy slotting fees from suppliers ranging from entrance fees, bar-code fees, festival fees, promotion fees to advertisement fees.

retailers operate in single city or province, while another 28% and 22% are regional<sup>4</sup> and national retailers.

Exhibit 2 demonstrates the breakdown of the surveyed chain operators by sales revenue in 2010.

**Exhibit 2: Breakdown of the surveyed chain operators by sales revenue in 2010**



Source: the CCFA and Li & Fung Research Centre

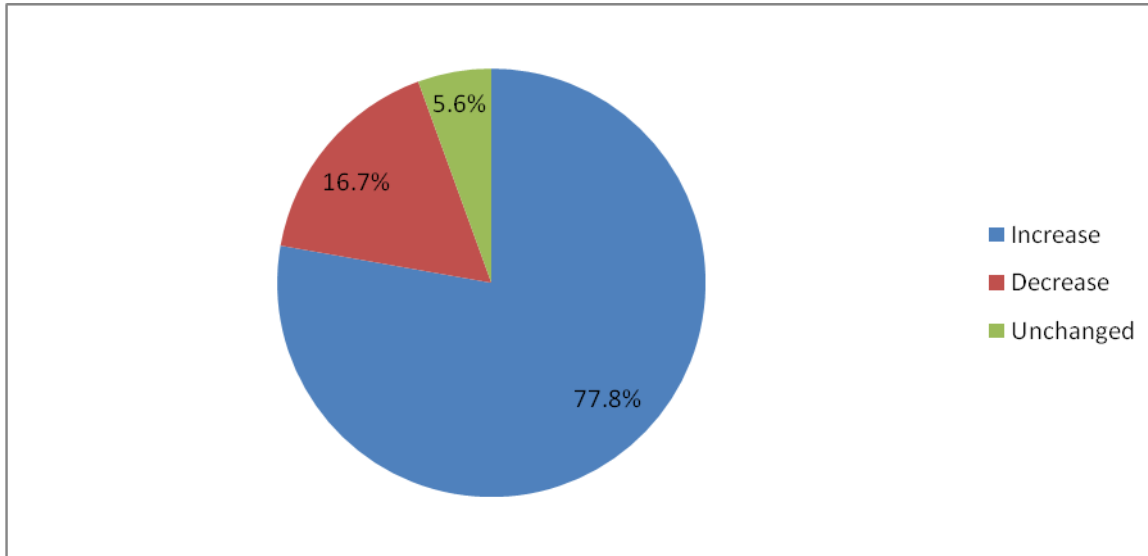
**III. Key findings**

**1. 78% of surveyed retailers increased the total number of suppliers in 2010**

As compared to 2009, approximately 78% of our surveyed retailers had increased the total number of suppliers in 2010 (see Exhibit 3). We believe expansion in total number of suppliers is probably driven by SKU proliferation and category expansion of retailers in China. On the other hand, the relatively small scale and narrow product lines of suppliers in China may also be a major reason behind.

<sup>4</sup> Stores of the retailers are located in more than one single province/city, but within a geographic region or two adjacent provinces/cities.

**Exhibit 3: Total number of suppliers, 2010 vs 2009**

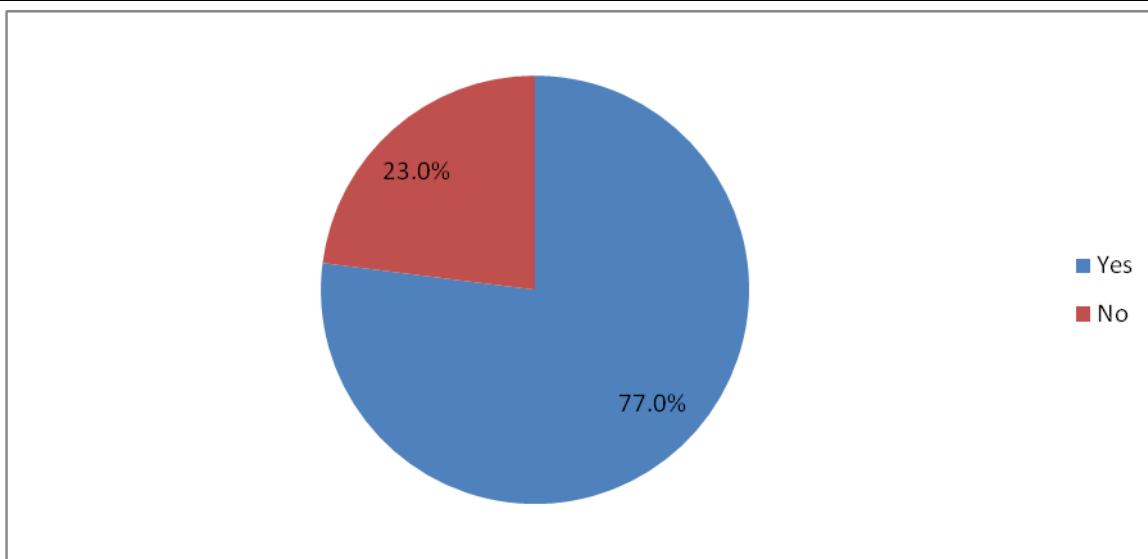


Source: the CCFA and Li & Fung Research Centre

**2. Majority of surveyed retailers (77%) plans to increase centralized purchasing in 2012**

Centralized purchasing refers to the situation in which purchasing activities are consolidated and carried out by central purchasing unit(s). 77% of our surveyed enterprises plan to increase centralized purchasing, either at regional or national level, in 2012 (see Exhibit 4).

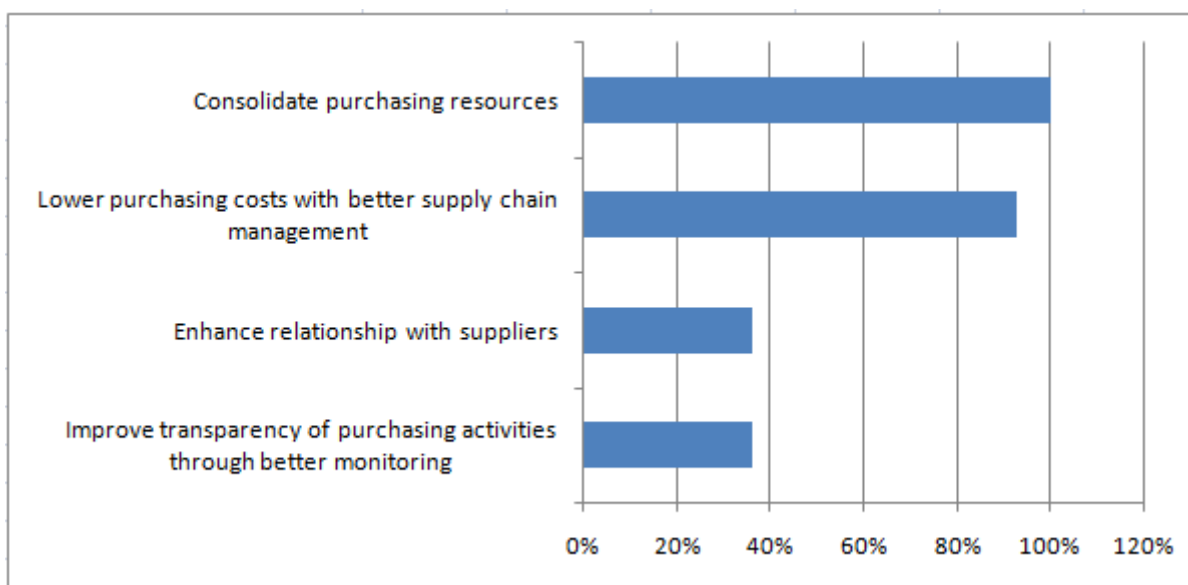
**Exhibit 4: Plan to increase centralized purchasing in 2012**



Source: the CCFA and Li & Fung Research Centre

As seen in Exhibit 5, among retailers planning to increase centralized purchasing, consolidating purchasing resources (100%) and lowering purchasing costs with better supply chain management (93%) were mostly cited as the drivers behind the plan to increase centralized purchasing. Other advantages of centralized purchasing mentioned by retailers include enhancing relationship with suppliers (36%) and improving transparency of purchasing activities (36%).

**Exhibit 5: Drivers behind the plan to increase centralized purchasing**



Source: the CCFA and Li & Fung Research Centre

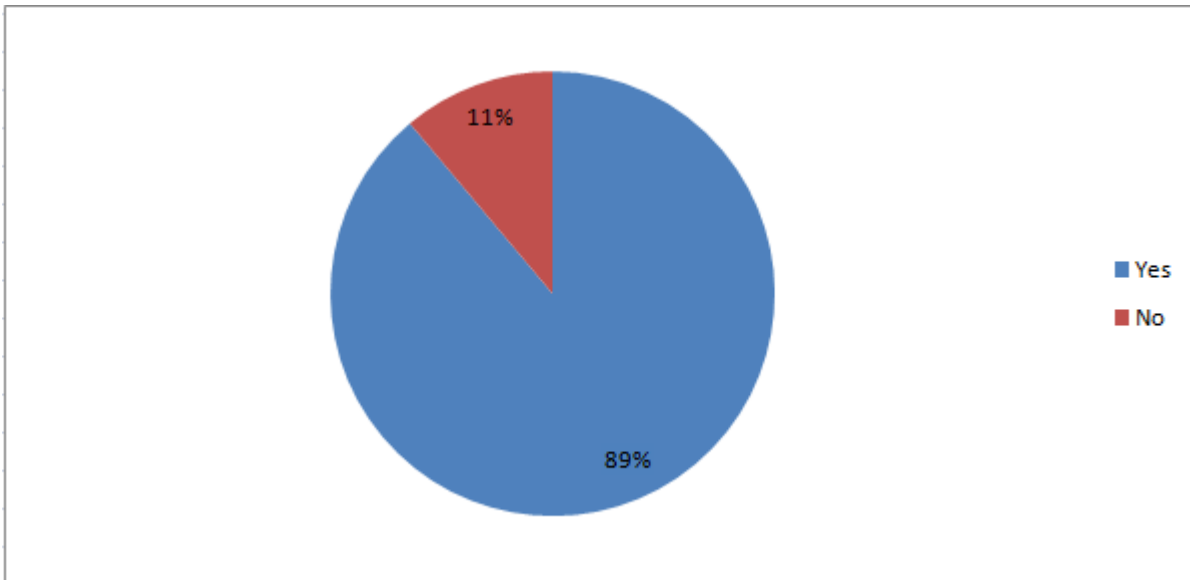
### 3. Most surveyed retailers plan to expand direct purchasing in 2012

Retailers in China are keen to increase direct purchasing. 89% of our surveyed retailers plan to increase direct purchasing in 2012 (see Exhibit 6). Among which, 40% of retailers plan to increase the share of direct purchasing by less than 10%; another 40% plans to increase the share by 10-20% (see Exhibit 7).

As shown in Exhibit 8, improving distribution efficiency (88%) as well as lowering costs (81%) are the key reasons for retailers to expand direct purchasing. 63% of surveyed retailers also believe direct purchasing can help them improve product safety.

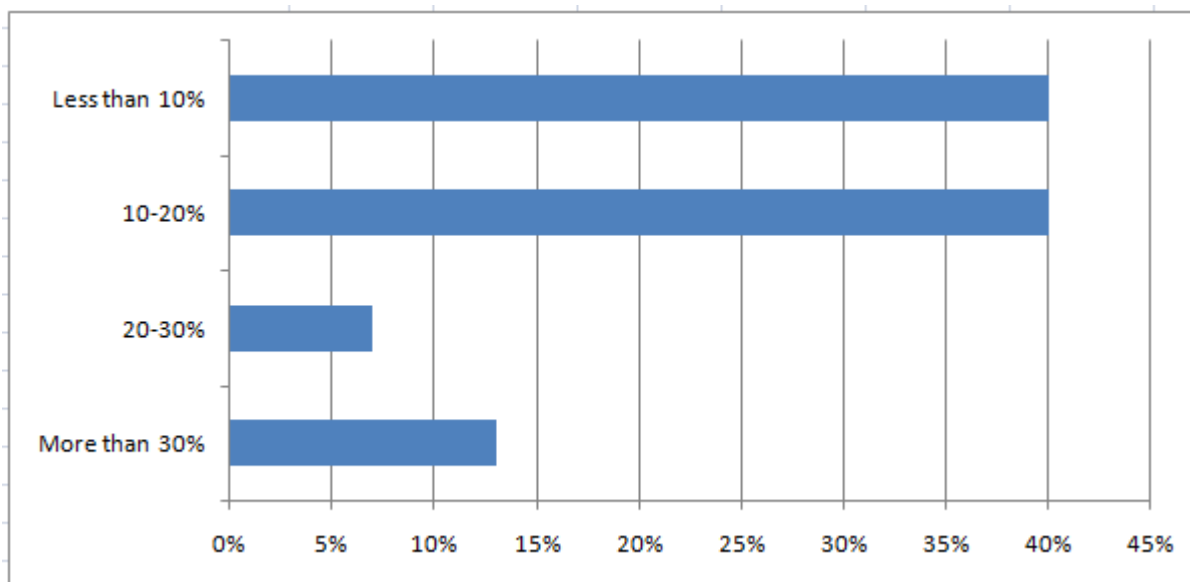
We believe the growing trend for retailers to make direct arrangement with principals will pose further pressure on wholesale distributors in China.

**Exhibit 6: Plan to expand direct purchasing in 2012**



Source: the CCFA and Li & Fung Research Centre

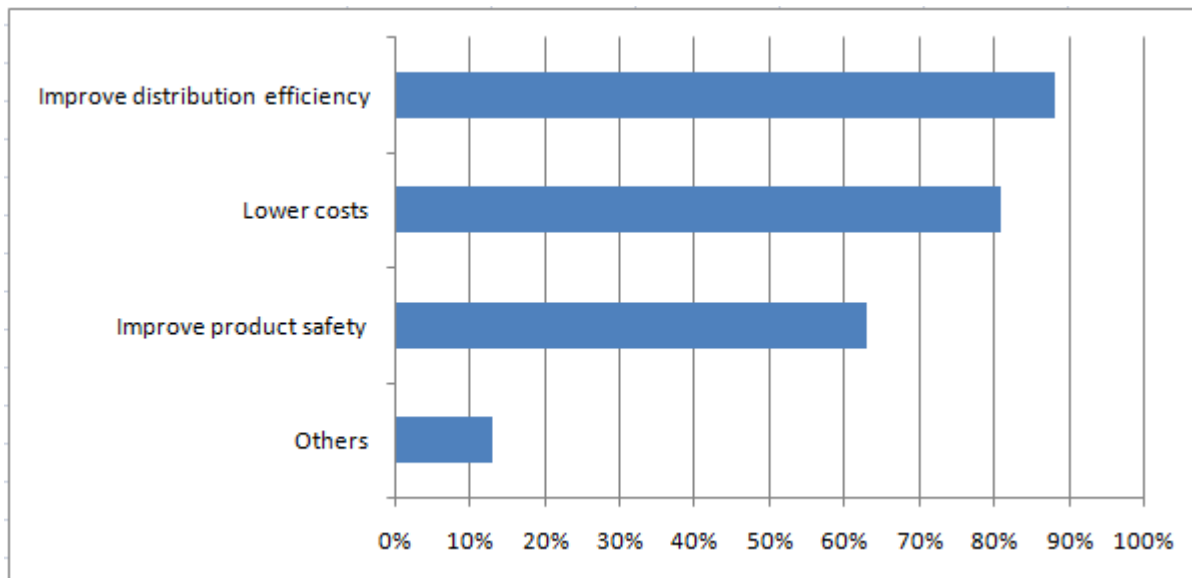
**Exhibit 7: Estimated increase in the share of direct purchasing in 2012**



Source: the CCFA and Li & Fung Research Centre



**Exhibit 8: Reasons to expand direct purchasing**



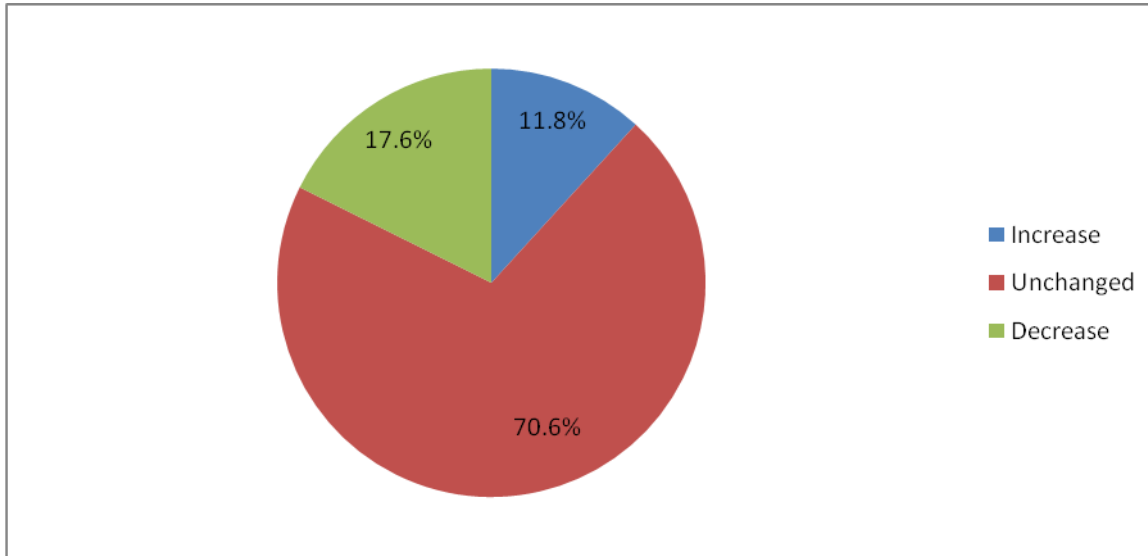
Source: the CCFA and Li & Fung Research Centre

**4. Slight improvements in retailers' payment period to suppliers in 2010**

There was slight improvement in retailers' payment period to suppliers in 2010. As compared to 2009, approximately 71% of surveyed retailers had the same payment period to suppliers in 2010; another 18% of surveyed retailers had shortened payment period to suppliers (see Exhibit 9).

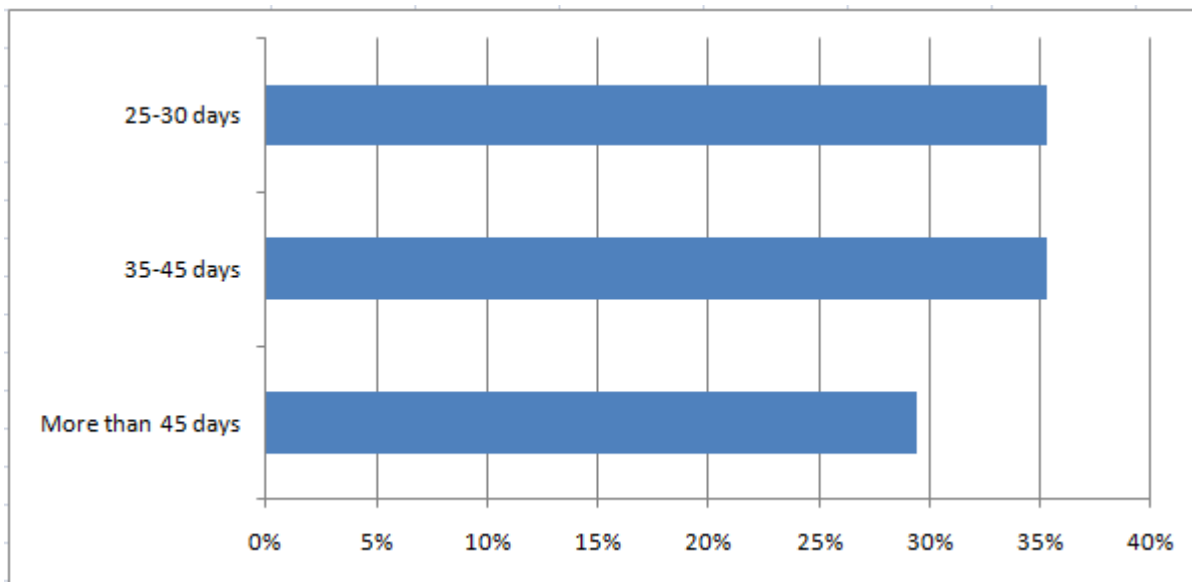
70% of our surveyed retailers settled payments with their suppliers within 45 days in 2010 (see Exhibit 10).

**Exhibit 9: Payment period to suppliers, 2010 vs 2009**



Source: the CCFA and Li & Fung Research Centre

**Exhibit 10: Payment period to suppliers, 2010**

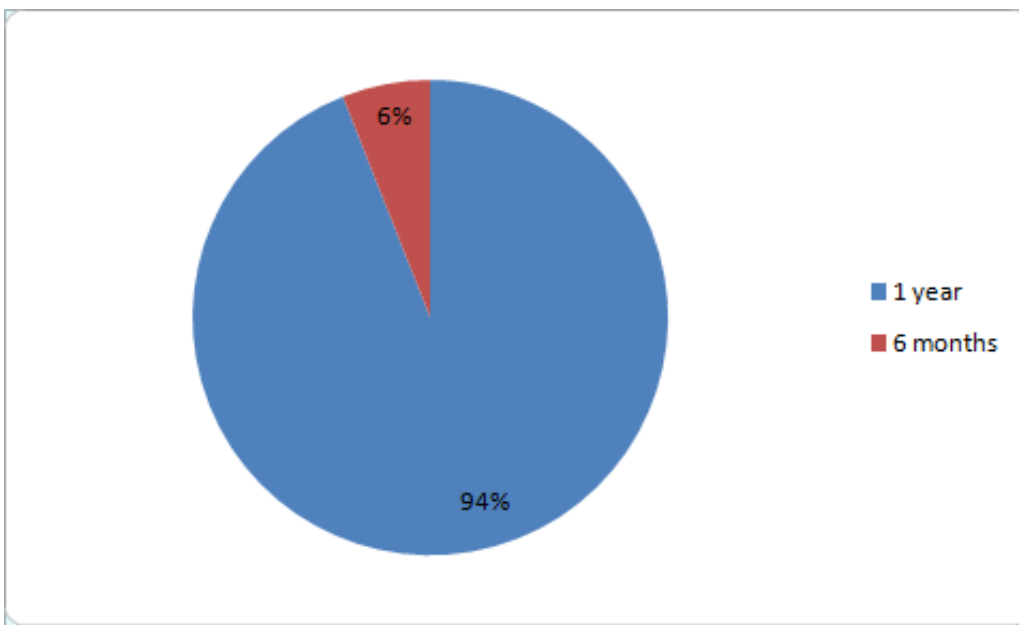


Source: the CCFA and Li & Fung Research Centre

**5. Retailers review purchasing contracts with suppliers more frequently for new or lesser-known brands**

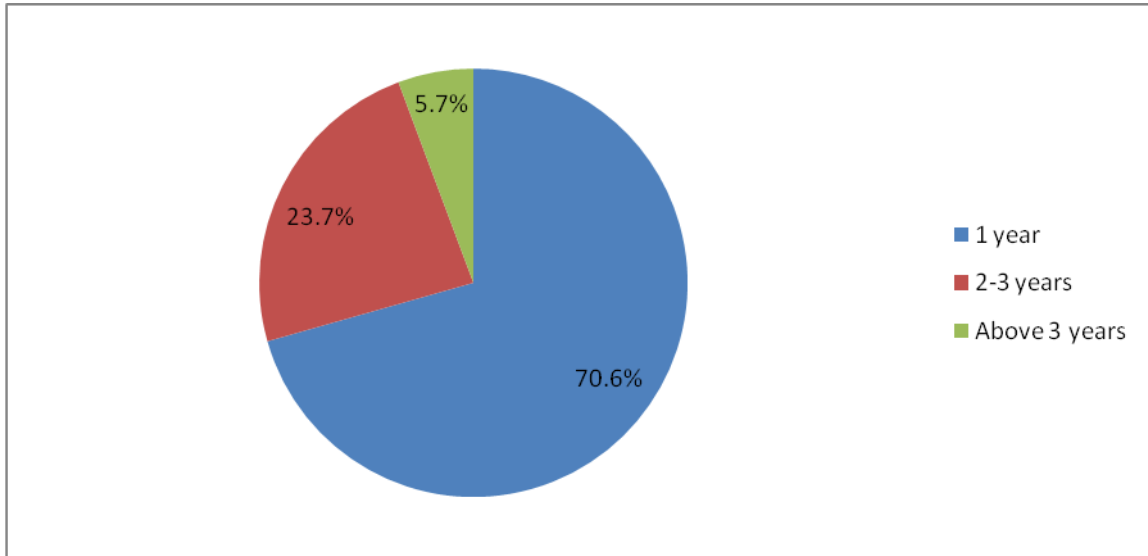
As expected, retailers review purchasing contracts more frequently with suppliers for new or lesser-known brands. 94% of our surveyed retailers reviewed the purchasing contracts with suppliers for new or lesser-known brands every year, and 71% of the retailers reviewed the contracts with suppliers for mature brands every year (see Exhibits 11 and 12).

**Exhibit 11: Contract period with suppliers for new or lesser-known brands, 2010**



Source: the CCFA and Li & Fung Research Centre

**Exhibit 12: Contract period with suppliers for mature brands, 2010**

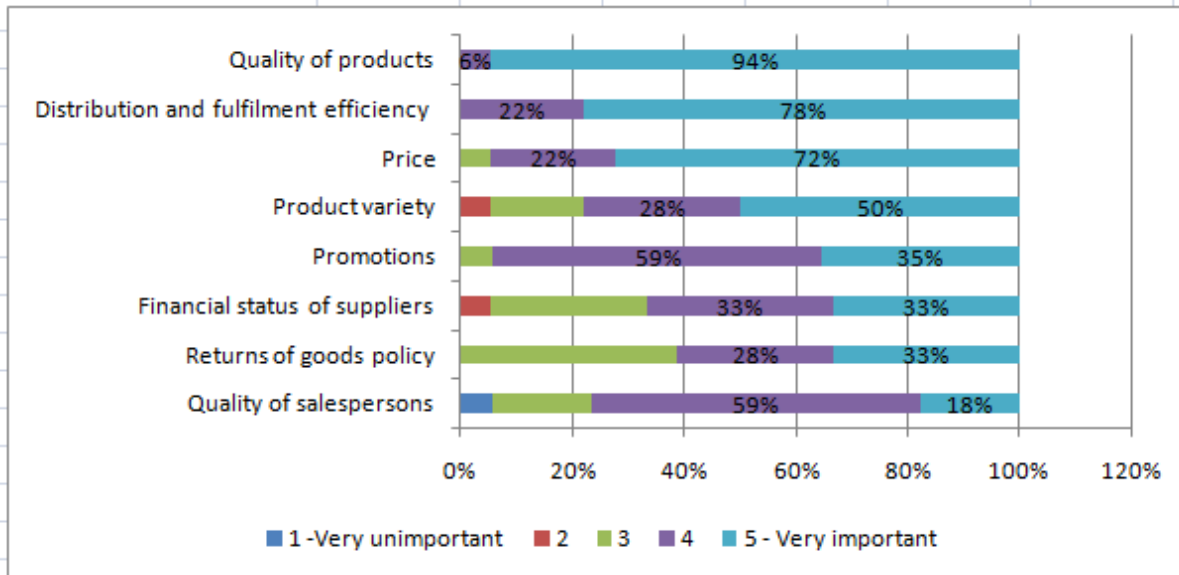


*Source: the CCFA and Li & Fung Research Centre*

**6. Quality of products, and distribution and fulfillment efficiency are the most important to retailers in supplier selection**

In our survey, we asked retailers to rate the relative importance of various supplier selection criteria. Among all, retailers see quality of products (94%), distribution and fulfillment efficiency (78%) and price (72%) as the most important factors in supplier selection (see Exhibit 13).

**Exhibit 13: Importance of various supplier selection criteria, 2010**



Source: the CCFA and Li & Fung Research Centre

#### IV. Latest developments

##### 1. Emerging trend of direct and centralized purchasing is observed; yet, wholesaling still plays an important role

Retail chain operators in China striving to shorten and streamline the retail supply chains, through the increase in direct purchasing as well as centralized purchasing, is a trend that is here to stay. These may threaten the survival of distributors, especially those traditional players serving solely as a middleman between manufacturers and retailers without much value-added services.

Having said that, we believe the demise of wholesale distributors in China is off the mark – firstly, despite rapid growth of chain operation in the past decade, China’s retail market is still highly fragmented with the Top 100 retailers achieving just 11 % of the market share in 2010, according to the China Chain Store and Franchise Association. Second, the vast geographical span of China offers a lot of development room for distributors, especially in some inner regions and the rural hinterland; many companies simply do not have the resources in developing own distribution channels in these regions. Besides, as brands rush to sell in China like bees to honey, many do not have the know-how in marketing and distribution and still need a distribution partner. Indeed, China is both a fast-growth and high-risk market. As brand principals seek to manage their fixed costs,

there is still huge room for wholesale players to grow.

However, it is true to say that the traditional middlemen's "buy and sell" model is under a great deal of pressure as market competition intensifies. To survive in the market, wholesale players must constantly reinvent themselves. Today, a lot of wholesale players are becoming more sophisticated. Some players have expanded their business offerings to include value-added customer services such as market analysis, inventory management and goods tracking.

Information technology applications are becoming much more widely used as well. The advancement of information and communication technologies has enabled more efficient flow of goods and services. For example, modern tracking technology has facilitated suppliers to track their goods and sales with greater accuracy. Platforms such as electronic data interchange also help enhance inventory management and improve supply chain visibility. Besides, with increasing Internet penetration and better online security, online wholesaling is increasingly popular. Some wholesale markets in China have sought to develop their own e-commerce websites or partner with e-commerce platforms such as Alibaba(阿里巴巴), Global Sources(環球資源), HC360(慧聰網), Made-in-China.com(中國製造網) and Global Market.com(環球市場) to increase their access to the market.

## **2. Cost of doing business in wholesale industry increases rapidly, adding heavy burden to wholesale players**

In our face-to-face interviews with some of the largest wholesale distributors in China, some of them expressed that they are facing challenges on various fronts. Chief among which is climbing costs. Wholesale distribution sector in China is labor-intensive; labor cost in the country is climbing very fast, especially in big cities such as Beijing and Shanghai. Some wholesale distributors said that high logistics costs in China, particularly transportation and warehousing costs, are also severely impacting their businesses. Nowadays, over 70% of the world's toll roads are in China<sup>5</sup>; toll fees are also very high in the country. To reduce heavy toll charges, overloaded trucks are a common sight in China.

Furthermore, government's initiative to alleviate traffic congestion also poses another challenge for

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<sup>5</sup> It is reported that there are approximately 140,000 kilometers of toll roads in the world; of which, 100,000 kilometers are located in China.

wholesale players. For instance, the Beijing government has imposed restrictions on car use; car owners in Beijing are prohibited from driving on roads on specific days each week depending on the last digit of the number plates. This may lead to underutilization of trucks for distribution companies and create inefficiencies.

### **3. Wholesalers and distributors with strong local networks are able to assist foreign brand companies and processing trade factories tap the domestic market**

With its strong economic fundamentals, China is an emerging consumer market with huge growth potentials; it is the top market for many foreign brands. Many foreign companies which are used to manufacturing and sourcing their products from China are planning to enter the Chinese market due to slow economic recovery in the United States and Europe. Given the vast geographical span and huge regional differences, building distribution channels in China is a complicated task. Wholesalers and distributors which have strong local networks and knowledge can help foreign brands reduce their time and costs to expand in China, particularly in lower-tier cities. For many branded products, penetration rates in China remain far lower than the international average. We believe foreign retailers will continue to place more resources on cultivating the underexplored regions which may offer ample business opportunities for wholesale distributors.

On the other hand, many export-oriented enterprises which have not actively explored the domestic market in the past now employ a twin-pronged strategy, by engaging in both domestic and foreign trade sectors. However, selling in China is no easy task; many export-oriented enterprises face a number of challenges such as high distribution costs, lack of price competitiveness, complicated tax system and existence of various forms of tax and administration fees as they sell in the domestic market. Indeed, for many export-oriented enterprises, the cost of selling in China is much higher than selling abroad.

Wholesalers and distributors with better capital strength and local distribution networks can help traditional processing trade enterprises expand domestic sales. They can serve as a matchmaker between manufacturers and retailers and provide services ranging from logistics, consultancy to capital financing, which will help reduce transaction cost of manufacturers.

### **4. Government pays great efforts to improve distribution environment in China**

Recognizing the importance of distribution sector in boosting domestic consumption, the

government launched a series of measures to foster the developments of the sector in the past few years. For instance, to improve rural retail infrastructure and facilitate rural distribution, the *Rural Retailing Network Project*<sup>6</sup> (萬村千鄉工程) and the *Agricultural Produce Wholesale Market and Distribution Company Development Project*<sup>7</sup> (雙百市場工程) were launched by the Ministry of Commerce (MOFCOM) respectively in 2005 and 2006. In December 2008, the MOFCOM and the Ministry of Agriculture jointly issued the *Pilot Scheme Notice of Promoting Closer Cooperation Between Farmers and Supermarkets*<sup>8</sup> 《關於開展農超對接試點工作的通知》, hoping to flatten the agricultural produce supply chains. To promote healthy and sustainable developments of the distribution sector, the *Management Rules on Fair Transaction between Retailers and Suppliers*<sup>9</sup> 《零售商供應商公平交易管理辦法》 was launched in 2006.

In August 2011, the State Council issued the *Opinions of the General Office of the State Council on the Policies and Measures for Promoting the Sound Development of the Logistics Industry* 《國務院辦公廳關於促進物流業健康發展政策措施的意見》 (the *Opinions*). The *Opinions* aim at promoting healthy and sustainable development of the logistics industry; one of the major objectives of the *Opinions* is to review the policy of toll road system in China, including the number of toll roads as well as the mechanism of toll collection.

It is expected that China's distribution environment will be greatly enhanced in coming years. As stipulated in the 12<sup>th</sup> Five-year Plan, China will continue to strengthen the distribution sector and boost consumption by implementing some long-term measures. Moreover, the MOFCOM is going to unveil China's first national plan on domestic trade - the *Development Plan for Domestic Trade (2011-2015)* 《國內貿易發展規劃 (2011—2015年)》 (the *Plan*) - by early 2012. The *Plan* will outline the policy framework and path for domestic trade for 2011-2015; it is widely believed it will put huge

<sup>6</sup> Preferential treatment and financial and operational support are offered to retail enterprises to encourage them to conduct chain operation in the rural market.

<sup>7</sup> The *Project* aims to facilitate the distribution of agricultural produce to markets through restructuring large-scale modern agricultural produce wholesale markets as well as nurturing large-scale agricultural produce distribution enterprises.

<sup>8</sup> The scheme aims to promote closer cooperation between farmers and supermarkets in China so as to enhance agricultural produce supply chain efficiencies. Key initiatives include promoting direct sourcing from farmers, increasing fresh food sales in supermarkets, promoting cold chain logistics and developing private labels for agricultural produce.

<sup>9</sup> Under the management rules, retailers could not charge suppliers additional fees unless agreed by the parties in concern and specified in the contracts. Moreover, retailers should also pay for all ordered items, even if they are not sold; and the payment must be made no later than 60 days upon receipt of goods. There are other provisions to protect retailers' interests as well; for instance, suppliers are prohibited from practicing tie-in selling.



emphasis on the development of wholesale distribution sector including nurturing large-scale, sophisticated national distributors. The *Plan* will better the market environment and help foster a more orderly business environment.

## **V. Conclusion**

China's distribution landscape has witnessed significant changes over the past few decades. Gone are the days when wholesale distributors could earn big money easily by serving as middlemen between manufacturers and retailers. Wholesale distributors today must offer more added values in order to succeed.

Despite the fact that there is huge room for development for wholesale distribution in China, as the country moves towards a more consumption-led economy, we should expect consumers and retailers to continue to have stronger power in the retail supply chains. Wholesale distributors in China have to constantly reinvent themselves to stay in the game.

## **About the Organizations**

### **The China Chain Store & Franchise Association**

中國連鎖經營協會

Founded in 1997, the China Chain Store & Franchise Association (CCFA) is an official representative of the retailing and franchise industry in China. Currently, there are 900 enterprise members with 180,000 outlets, including domestic & overseas retailers, franchisers, suppliers, and relevant organizations. The total sales of China's "Top 100 retail chain operators", which are part of the members of the CCFA, exceeded RMB 1.66 trillion in 2010, with more than 150,211 stores in total.

CCFA participates in policymaking and coordination, safeguards the interests of industry and members, provides a series of professional trainings and industry information and data for its members and establishes platforms for exchange and cooperation.

### **Li & Fung Group**

利豐集團

The Li & Fung Group is a Hong Kong-based multinational company with three distinct core businesses: export sourcing, distribution and logistics, and retailing. Founded in Guangzhou in 1906, the Li & Fung Group achieved an annual turnover of around US\$18.5 billion in 2010. Today, the Li & Fung Group operates in some 40 countries and regions and employs over 37,000 people worldwide. One of its core competencies is "Supply Chain Management" (SCM).

### **Li & Fung Research Centre**

利豐研究中心

Li & Fung Research Centre is the research institute of the Li & Fung Group. It serves as a knowledge bank on China's economy, industries, logistics and distribution sector, with its research scope covering the whole spectrum of the entire supply chain, from ideas, production, distribution, retailing to consumers. It also offers research analyses and consulting services to colleagues and clients to assist them in their day-to-day decision-making.

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