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# Overview and outlook on the distribution market in China, which has entered a new growth stage

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# Consumer markets in china, which have maintained double-digit growth

Since the growth rate of GDP in China fell below 8% in 2012, it has flattened out at around 7%. The Chinese central government launched an economic development initiative called the "new normal" in 2014, to maintain the stable economic growth rate in the mid 6% to 7% range in the near future. At the same time, the policies push toward shifting the industrial structure by improving added value, transitioning to a higher emphasis on quality and efficiency, and shifting toward a consumption-based economic growth structure.

While the macro-economy is showing decelerated growth, the consumer market has maintained double-digit growth in recent years. The 10.7% growth rate of China's consumer market in 2015 indicates a tendency toward deceleration from the 12% rate in 2014. However, the consumer market had a higher rate of contribution to GDP, increasing from 48.2% in 2013 to 51.2% in 2014, and jumping to 66.4% in 2015. In the "new normal", the consumer market is expected to play a pivotal role in economic growth. Rather than the "three public expenditures" (which means public spending on travel abroad, entertaining, and the purchase and use of public vehicles), the increase in public goods among normal consumers has become the driving force behind the growth of the consumer market in 2015.

Yet another characteristic of recent years is that the growth rate of per-capita income, which was 8.2% in 2015, has outstripped the growth rate of GDP which was 6.9% during the same year. Incomes are expected to keep rising, as China's 13th five year plan calls for per-capita income in 2020 that is double what it was in 2010. Double-digit growth of the consumer market is also forecasted to continue in 2016, stimulated by developments such as the advancement of goods and services industries and the change in the government's old "one-child policy".

# The Physical Retail Distribution Industry Grapples for Innovation

As the economic structure changes, the distribution industry finds itself thrust into a period of transition. In 2015 the Chinese e-commerce market (EC market) leapt 43% from the previous year. The rate of electronization (the ratio of e-commerce to the total transactions in the consumer market) grew to 13.5%. Total transaction value for T-Mall, the largest company in the e-commerce business, exceeded those of major retailers who operate physical stores (offline retailers) and the company has risen to substantively become China's top-ranked distributor. Offline retailers which have driven the consumer and distribution markets in the past are feeling an unprecedented sense of urgency, and have embarked on structural reforms and competition out of fear for their own survival.

The first to be affected by the expanding e-commerce market were large retailers such as department stores, hypermarkets, and shopping centers. Aside from the rapid expansion of e-commerce, the central government's "austerity measures", skyrocketing labor and rent costs, and increased international shopping are causing the problem of declining profitability for large companies to become more evident. In this tough economic climate, offline retailers have embarked upon basically four types of management reforms.

## 1 Returning to the autonomous management model

For many years, retailers in China had been excessively dependent upon suppliers, entrusting them to handle everything from consumer analysis to product development and operations. As the business climate has changed, they have been attempting to return to the inherently appropriate model of "autonomous management" (not renting a sales floor, but selecting and stocking the products, and designing the sales floor from the standpoint of product planning), but it has not been an easy hurdle to clear. Wangfujing, one of China's well-established department stores, started putting efforts into developing its own autonomous brand in 2013, but for all intents and purposes the sales floor rental-focused "cooperative management" model still persists. Feeling a sense of impending crisis, in 2015 Wangfujing began earnest efforts to return to the autonomous management model by teaming up with major distributors Bailian Group, and trading firm Li & Fung to launch a joint venture that specializes in autonomous brand development.

## 2 Store facilities that offer experience and inventiveness

As a strategy to achieve differentiation from e-commerce companies, stores that deliver a physical experience that cannot be had online are now being introduced. Recent years have seen a succession of new indoor play facilities for children, and elaborate coffee shops, cafes, and art salons, mainly in shopping centers. For example, when massive retail complex Chaoyang Joy City in Beijing underwent renovation in 2015, it opened a new comprehensive leisure space called "Joy World" for patrons to enjoy their dates, browse through information, relax, and engage in social activities. With a theme of nature, 35% of the 10,000 m² area is covered with greenery, and laden with inventive store tenants such as music lounges, art salons, movie theaters and restaurants.

### 3 Developing multiple businesses

E-commerce has little impact on small-scale retailers such as convenience stores, whose number of stores grew 19.5% in 2013. At the same time, mass closures of large-scale businesses continued, with 35 store closures in 2013, 201 in 2014, and 121 in the first half of 2015. Major distribution groups that have focused on large-scale businesses are also anticipating the implementation of omni-channel strategies, and have announced that they will be building up the small-scale retail category. For example, major Chinese distribution groups based in various areas of the country such as BBK Electronics, Tianhong, and China Resources have announced "ten-thousand store plans" one after another in 2015, to beef up and expand the convenience store business category.

### 4 Enhanced Supply Chains

Reducing operational costs in the face of skyrocketing labor and rent expenses has become a pressing issue. However, this is done differently than it is in Japan. Rather than making steady improvements starting with operations, the focus is on lowering costs through bulk procurement. With the aim of higher efficiency and lower costs through shared supply chains, 22 companies including regional distribution groups such as BBK and Tianhong are collaborating to construct global procurement platforms. Yonghui Superstores, a major Chinese hypermarket chain, is investing in Shanghai vegetable groups.

## The rapidly changing and restructuring online market in China

Total transaction volume in China's e-commerce market reached 3.99 trillion yuan in 2015 (projected), while the e-commerce ratio has grown to 13.5% (projected). Competition is becoming even fiercer in China's online market, which continues expanding with a growth rate in excess of 40%.

This is characterized by instantaneous market growth, revamping of services, and markets that change structure in the blink of an eye. The concept of group purchasing was first introduced in China in 2010, and it only took two years for the number of companies that provide group purchasing sites to grow from a dozen or so to a peak of 5,000. However, a period of fierce competition ensued, and combined with the entry of massive Chinese internet companies Alibaba and Tencent, several companies were unable to get out from under their low revenue models. Complaints also poured in as rapid expansion caused service quality to erode, which led to a loss of trust from consumers. In 2012 many of these companies started falling by the wayside, the playing field shifted, and in 2014 the number of such sites had whittled down to 176, a mere thirtieth of that it was three years before. While the number of players nose-dived, the size of the market never stopped expanding. By 2014 it had grown to 500 billion yuan, a five-fold increase from what it was in 2011.

Another rapid transformation seen in China's e-commerce market is the shift of online shopping to mobile devices. In 2012 it was normal for online shopping to be done from a PC, but as smartphones proliferated, China's mobile internet market exploded. Access is easier from a mobile device than from a PC, and allows you to do your shopping anytime that you have a moment free, such as on the way to work, during break time, and before bed. 30% of internet shoppers had already made the jump to mobile devices in 2014, and in the first half of 2015 the total value of transactions executed through mobile devices had exceeded the total value done through PCs. Aware of this advantage, E-commerce companies enacted a variety of different campaigns to promote the move to mobile devices, such as mobile device-only coupons and limited time prices, as well as limited-time products. These served to accelerate the transition.

The rapid growth of the mobile internet market has also led to a swift proliferation of third-party mobile payment services. The Chinese version of Facebook "WeChat" incorporated a payment service for the first time in August 2013, and the electronic version of "Red Envelopes" (the Chinese equivalent of Japanese New Year's Gifts of money) was released on Chinese New Year in January of the following year. 40 million red envelopes were sent over the course of one week, bolstering the number of remittance services users all at once. Subsequent partnership with O2O (online to offline), a popular type of service in China, and advancements into offline resulted in WeChat Pay boosting its share of the mobile payments market from 10% in the third quarter of 2014 to 20.1% in the third quarter of 2015, with user numbers stretching to more than 400 million.

The growth of the internet market does not necessarily equate to smooth growth for online companies. Over the last several years, new services and business models have emerged, grown, fallen by the wayside, and reorganized. The competitive environment between online companies has intensified even further, and companies that do not seek innovation or transformation on their own will be weeded out. As a result of this, however, Chinese consumers can have confidence that the retail and services markets in the country will advance, catalyzing the consumer market even more.

# Outlook for the distribution market in China – Forming the Chinese *Omnichannel Economies* that transcend retail industry

As the Chinese distribution industry undergoes a major period of transition, offline retailers as well as online players--from major e-commerce companies to newly-established internet-based companies--continue to innovate, searching for new growth areas. Working to build an omnichannel economy that transcends retail, China's three largest internet companies in terms of financial resources, Baidu, Alibaba, and Tencent (referred to as BAT) have grown beyond their existing businesses and into offline retail and O2O platforms, as well as the services industry.

Here we will take an example from how the Alibaba Group has invested. Up until 2009, the company's investments involved acquiring around two to three small-scale e-commerce companies and search engines each year. Starting in 2010 the company turned its attention to distribution and IT services companies to improve e-commerce supply chains, targeting around 7 to 10 companies each year for investment. To improve upon its weakness in the area of mobile internet, it also funneled investments into services such as O2O, which facilitate social media for smartphones and run applications for taxi dispatch.

It was in 2013 that they expanded their target areas and scope for investment all at once. They invested in 26 companies in total that year, from O2O services to the field of health and medical care, media, and offline retail.

In doing so, the Alibaba Group has reached out beyond the limits of online retail, and into the services industry, as well as media, and offline retail. Looking at the investment pattern of the group, you can see that they are building an Alibaba ecosystem centered on e-commerce by first establishing a base of network technologies and distribution, then incorporating big data and highly customer-attractive services such as social media, O2O services, and net-based finance.

The other two BAT companies show similar tendencies. Tencent has invested in B2C e-commerce giant JD.com, and O2O food and beverage delivery agent service Ele.me. In offline retail it has invested in major hypermarket chain Yonghui Superstores (the direct investor in Yonghui Superstores is JD.com) which is expanding throughout all regions of China. With BAT at the forefront, this is how companies are forming encirclements (=economies) to facilitate omnichannel strategies that integrate online with offline.

The possibility of decline in the e-commerce market is the reason that major internet companies in China are hurriedly building omnichannel economies. While China's e-commerce market has been growing by more than 40% through the year 2015, there are doubts as to how long this thriving pace can be maintained. First off, there is a limitation to how large the assortment of products (number of SKUs) within China can become. Since Chinese manufacturers had been dependent on exports for a long time, they were lagging behind on analysis and product development for consumers within the country. Seeking profit margins, they were targeting the upper class with sales of quality products, without paying heed to the rise of the middle class. They also incurred problems with quality, received large volumes of complaints, and fostered distrust in consumers. The buying spree of products from countries such as Japan can be considered an example of consumers turning their eyes to overseas markets because of their distrust for what was being sold within China.

There have also been ominous signs coming from the "Double 11" (on November 11th) shopping campaign held by T-Mall and Taobao. While sales on the day of the event have continued to double each year, from 3.36 billion yuan in 2011 to 91.2 billion yuan in 2015, there has inversely been a decline in sales over the New Year's holiday period. Since "Double 11" is for selling low-priced products, lots of customers make impulse purchases, and this has resulted in a high rate of product returns. Some stores are said to have return rates of over 30%.

To expand their businesses, large-scale Chinese e-commerce companies are pursuing synergy effects from omnichannel economies by making advancements into the services industry and offline retail while also confronting challenges in the e-commerce market. Having become an advanced internet country without any maturity in its physical store businesses, China has developed a peculiar environment for its distribution market. Omnichannel economies that transcend retail industry are forming, with financial resource-rich BAT at the forefront. Japanese companies find themselves in an environment in which they are not likely to grow if they cannot coexist with these economies.

On the other hand, products and services from Japanese companies are still highly regarded in China. The buying spree phenomenon can be seen as a classic example of this. In this new environment, Japanese companies cannot plot their survival in China based on the idea that "Japan can carry over its advancements into China." One path to survival may be to benchmark new business models conceived within China that can appeal to these economies by "utilizing the strengths of each particular Japanese company."

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