

Advisory

Investing in the Retail Market with 1.3 Billion Consumers



1. China's Retail Market

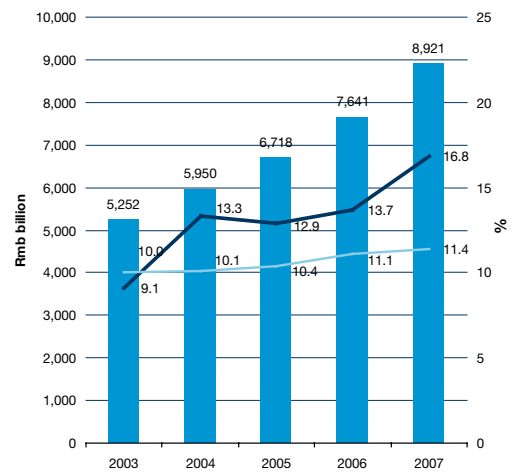


1.1 An Industry with a double-digit growth in the past 5 years

China's retail market enjoyed a steady growth with a CAGR of 14% from 2003 to 2007, growing at a faster rate than GDP. This was mainly driven by

- Continued Urbanisation
- Significant growth of disposable income, especially that of urban residents
- The growth of the young, economically active middle class - the proportion of people aged between 30 and 44 increased from 25.6% in 2000 to 26.9% in 2005

China total retail sales of consumer goods (2003-2007) and YOY growth between retail and GDP



*Note: Total retail sales include both wholesale and retail trade
Source: National Bureau of Statistics of China

1.2 Retail Formats in China

China has seen substantial growth across almost all retail formats – from malls and hypermarkets to gas station convenience.

Retail format in China

	Shopping malls	Hyper-markets	Super-markets	Convenience stores	Specialty stores	Department stores	Gas station	No Shop retail
Definition:	• Large area with different brand stores	• Stores with sales area >25k sq ft	• Stores with sales area of 4k-25k sq ft	• Small stores with extended opening hours	• Size of stores can range significantly	• Stores with sales area >25k sq ft, usually multi-floor	• Unique format specially for motor vehicles	• Retail through modern channels, e.g. TV, mail, website
Products:	• Cross-sectional products	• Mainly food & beverage • Typically >35% of space devoted to non-foods, e.g. textile, daily commodities, etc	• Typically >70% of space devoted to foods • Other products including daily commodities	• Limited product variety • Usually food, beverage and daily commodities	• Focus on selling one specific product line, e.g. electrical appliances, home & furniture	• Multi-product	• Products consist of different type of fuel	• Multi-products
Independent / individual:	• Not common	• Not common	• Some are individually owned and operated	• Not common	• Some stores are chains • Small-size stores are usually individual owned and operated	• The majority are independent, e.g. Shanghai No1 Dept Store	• Not common	• Many independent
Chain:	• Some are owned by the same property developer, e.g. Times Square	• The majority are chains, e.g. Carrefour, Wal-Mart, Lotus	• Many are chains, e.g. Hualian, Lianhua	• The majority are chains, e.g. Kedi, 7-11, FamilyMart	• Many are chains, e.g. Gome, B&Q	• Some are chains especially in major cities, e.g. Parkson, Pacific	• The majority are chains, e.g. Sinopec	• Some are chains

1.3 Characteristics of Different Retail Formats

However, the stage of development of the various formats is quite varied.

Retail Formats	Key Characteristics
Department Stores	<p>Evolving to stay competitive</p> <ul style="list-style-type: none"> Once a popular retail format in China, department stores are being marginalised by many other modern retail formats To survive and stay competitive, many established department stores in major cities such as Beijing and Shanghai have to reinvent themselves in various ways, such as focusing on mid and high-end customers or incorporating different kinds of retail formats like supermarket and specialty counters in the store
Hypermarkets	<p>Development led by international retailers</p> <ul style="list-style-type: none"> With market saturation in first-tier cities, hypermarket operators are looking for expansion in lower-tier cities and the inland regions With the removal of restriction on ownership, coupled with their localisation strategies, some foreign retailers are buying out their Chinese joint venture partners On the other hand, to remain competitive, innovation in product and service offerings is vital to attract consumers
Supermarkets	<p>Dominated by domestic players / highly fragmented</p> <ul style="list-style-type: none"> With the proliferation of supermarkets of all sizes and descriptions, intense competition is driving inefficient operators out of the market Larger players are also try to forge strategic cooperation via alliances
Convenience Stores	<p>Still in development stage</p> <ul style="list-style-type: none"> Development of the format is most dynamic in Shanghai and Guangdong, but otherwise sporadic across China The sector comprises mainly domestic chains, such as Quick of Lianhua and Alldays and Kedi of Nong Gong Shang. Foreign players including 7-Eleven, Lawson, FamilyMart and Circle K are also developing quickly Because of the proliferation of convenience stores, competition is getting intense and net margins are squeezed
Specialty Stores – Electronics & Appliances	<p>In demand from middle-class consumers</p> <ul style="list-style-type: none"> The top retailers in the sector are domestic players and foreign investment in this domestically dominated sector is very low Gome and Suning are the market leaders
Specialty Stores – Home & Furniture	<p>Home ownership has increased market</p> <ul style="list-style-type: none"> Even though the sector is still fragmented and is made up of independent stores each offering particular products such as kitchen fixtures and baths, a number of foreign and domestic home goods retailers have opened stores to target the middle class and educated professionals B&Q and IKEA are the leading international players with different operation models The major domestic players in this sector, e.g. Redstar, Yuexing etc. are more like commercial property operators rather than retailers
Discount Stores	<p>Still in development stage</p> <ul style="list-style-type: none"> The discount store first appeared in China in 2003, as introduced by Carrefour under its fascia, DIA Goods sold through these discount stores are mostly private label merchandise and are priced more competitively than in hypermarkets This format is still in the development stage in China and is confined to Tier I cities

1.3 Characteristics of Different Retail Formats (cont'd)


Franchising	<p>A means for regional penetration</p> <ul style="list-style-type: none"> China has 1,900 franchise systems, with 822,000 outlets and is growing at 40% annually Franchise brands number about 2000, covering a diversity of products and services At present, franchising business accounts for only 3% of China's total retail sales and has huge potential for further growth Key players include KFC, Mc Donald's, 7-Eleven, Pizza Hut, Haagen-Dazs, etc
Direct Selling	<p>Potential for further growth</p> <ul style="list-style-type: none"> Despite the fact that significant questions remain, the introduction of the direct selling rules in 2005 has provided the legal framework for direct selling operators to tap into China's retail market The potential of direct selling is believed to be bright Key players include Amway (personal care), Mary Kay (cosmetics), Avon (cosmetics), etc.
Online Shopping	<p>A new route to consumers</p> <ul style="list-style-type: none"> It is reported that there are more than 20 million online shoppers in the country, among whom more than half use online payment With the maturing payment and credit system and the rising computer-savvy young population, online retailing presents a viable alternative route to reach China's consumers Key players include Taobao, Alibaba, eBay, etc.

2. Typical China Retail Issues – 8 Major Risk Areas


While the retail market is growing fast, potential entrants and or acquirers should proceed with caution as many of the fundamental aspects of retail best practice have yet to develop. Our experience indicates that there are several key risk areas that need to be managed or addressed in order to drive enhanced investment value:


Areas	Description
<p>Growth driver</p> <p>1</p>	<ul style="list-style-type: none"> On average, China retailers are outpacing the growth of their counterparts in the mature US and European markets However, a significant portion of the growth is mainly from new stores (expansion into 2nd tier and 3rd tier cities where customer flow and consumer power is less strong) and performance of new stores is generally deteriorating. Same store (like-for-like) growth is often limited Geographical difference and local protection make nationalisation of regional/local brands/players very difficult The quick expansion is often not sustainable, especially on the individual retailer basis. The individual ability to handle additional scale, both commercially and operationally, is another matter altogether

Areas	Description
<p>Location / lease arrangements</p> <p>2</p>	<ul style="list-style-type: none"> While property developments are not in short supply, there is tremendous competition for good retail sites. Large sites attract several local and MNC hypermarkets and electronics players. Small footprint retail space remains fragmented and unstructured Rents in key markets are unrealistically high given the amount of new space under development Rental increased significantly in the past several years, rental for renewal or new stores often affect the performances Land/property ownership and arrangements with landlords are often complicated (multi-tier subleasing is not uncommon). Some arrangements may be legally ambiguous

Areas	Description
 Sourcing / supplier arrangements	<ul style="list-style-type: none"> Sourcing channel/structure and supplier arrangements varies significantly among different retail formats. While direct purchases from manufacturers are increasing, wholesale or multi-layer sourcing is not uncommon in certain sectors Consignment sales can be seen in many retail formats Payments terms to suppliers are often extended. It is one of the major sources of funding for working capital and has become a major concern for government agencies Charges such as entrance fees, promotion and marketing charges are one of the major sources of profits and these are not controlled and can be a major driver of fraudulent activity Rebate/commission arrangements are often complicated and are another major source of profits and can also drive fraudulent activity

Areas	Description
 Liquidity	<ul style="list-style-type: none"> Chains are expanding aggressively. New store development (which requires decoration, equipment and rental deposits etc.) has been a major driver of the cash crunch faced by most domestic retailers Close of unsuccessful stores often results in the write-off of decoration costs Low stock turns and high-obsolescence are prevalent throughout many segments

Areas	Description
 Taxation	<ul style="list-style-type: none"> Similar to other privately-owned businesses in China and probably more so due to the large number of cash transactions, privately-owned retailers often adopt very aggressive approaches to evade taxes (VAT, business tax, corporate and individual income tax) Careful consideration needs to be given to the deal structure to protect acquirers from possible tax exposure. In addition, cost structures may differ significantly with full compliance with tax rules and regulations Stores are often required to file and pay taxes at local authority level. Non-compliance with local tax rules and filing requirements are common as are transfer pricing issues

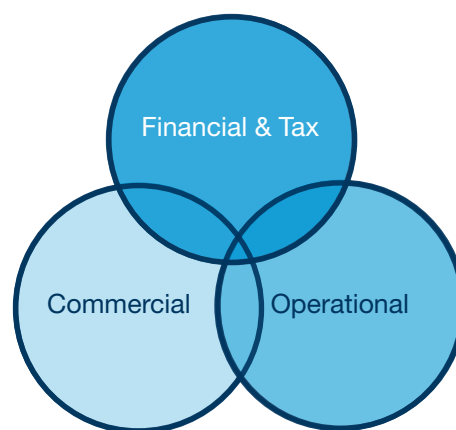
Areas	Description
 Performance measurement	<ul style="list-style-type: none"> Local retailers have little expertise in best practice retailing. <ul style="list-style-type: none"> Assortment planning and category management are almost non-existent Promotions are weakly managed without any means to measure impact or success Retailers have little knowledge about which products are contributing to the business or who their customers really are – let alone which are the most profitable Large department stores and electronics specialty stores leverage concessions to the extent that they have little control or interest in the store range, trading revenue/sq foot or environment

Areas	Description
 Distribution and logistics	<ul style="list-style-type: none"> While China's emerging retail logistics is more efficient than that in many other developing countries, it remains a challenge to cover the 9.6-million-square-kilometer market Distribution between and within the large cities has improved significantly. However, a large percentage of products is still delivered directly to the stores. This may create difficulties in managing store logistics. Stores are small and store design has historically not considered logistics in a significant way. Distribution to second and third-tier cities remains inefficient and unpredictable The insufficient supply chain and retail logistics constrain the emergence of national players in China. This also increases the working capital requirements disproportionately to cover high variability

Areas	Description
 Reporting, control and cash management system	<ul style="list-style-type: none"> China local retailers generally lack sophisticated retail merchandise and financial reporting systems that are able to generate reliable and quality management reports. Financial information is limited and almost irrelevant to investment evaluation Not surprisingly, the internal control function of many retailers is also weak evidenced by the high inventory loss volume The credit card system in China is not yet developed and hence retail involves a tremendous number of cash transactions. POS system and some internal control procedures are widely adopted by many retailers, however the effectiveness needs to be assessed

3. How we can help?

3.1 Tailor-made proprietary retail diligence method to address the multidimensional issues of retailers in China



Questions to be addressed	Our services/approaches
Does the control and reporting system function? Is the reported information reliable?	<ul style="list-style-type: none"> • Operations, Controls and Reporting System Assessment • Cash Management and Controls Assessment • Quality Reporting and Controls Assessment
Are the reported sales genuine?	<ul style="list-style-type: none"> • Sales Analysis and Verification - Proprietary methodology to assess the quality of reported sales by cross-checking financial information with operation records, market intelligence and on-site observation
What has driven historical sales growth?	<ul style="list-style-type: none"> • Store Movement Analysis - store opening and closing, sales of new stores vs. old stores • Multidimensional Sales Metrics Analysis – e.g. store sales by region, location, age of store, sqm, no. of transactions, product category and etc. • Same Store (like-for-like) Analysis
What were the key drivers for gross margin changes?	<ul style="list-style-type: none"> • Product and Category Profitability Analysis • Supplier Agreements and Sourcing Analysis - supplier profile and key commercial arrangements with suppliers, including rebate, commission, entrance fees and etc. • Supply Value Chain Analysis - from buy-in to sell out
How did rental and decoration costs impact the results?	<ul style="list-style-type: none"> • Rental and Property Contract Review - Understanding of arrangements with landlords (e.g. period, rental escalating clauses, other commitments) • Property Accounting Review and Impact Analysis - Assessment of whether appropriate accounting treatments have been adopted for rental (i.e. straight-line method) and decoration (capitalisation and amortisation) • Rental and Property Development Review and Benchmarking - Analysis of rental and decoration by store (per sqm, past increase on renewals and etc.)
What were the other major operating costs and how did they impact profitability?	<ul style="list-style-type: none"> • Labor and Operational Cost Review and Benchmarking - employee profile, costs and efficiency (employee density and sales per capita, salary and social benefits) • Repair and Maintenance Cost Review and Benchmarking • Overhead Cost Benchmarking and Activity Based Costing - central costs (central functions, marketing, advertising and promotion, logistics and etc.)
How has the capex and working capital been funded?	<ul style="list-style-type: none"> • Capex Efficiency Review - historical capex (opening and decoration costs by store, by sqm, average period of refurbishments and etc.) and source of funding (including finance costs) • Working Capital Review and Benchmarking - major working capital items (debtors, inventory, and creditors) and trends (turnover days, reliance on supplier financing and etc.)
Are the operations/processes efficient?	<ul style="list-style-type: none"> • Process Analysis and Operational Benchmarking - Retail Operations, Supply Chain, Merchandising and Finance • Operational Due Diligence

Is the business plan /projection achievable?	<ul style="list-style-type: none"> • Business Modelling and Forecast Decomposition - analysis of the major growth drivers of the projection (sales, gross margin, rental, decoration and other operating costs, capex and working capital); comparison with historical trends • Market and Commercial Due Diligence - including analysis of the competitive landscape and potential threat from major rivals; understanding awareness and acceptance of retail brand and understand the buying behaviour and preference of retail customers; interviews with tenants and suppliers; analysis of value proposition of the retailer and key factors of sustainable growth • Organisational/operational Capability Assessment
Are the business and major revenue streams safe and under control?	<ul style="list-style-type: none"> • Business Risk and Controls Review • Operational Due Diligence • Forensic Transaction Analysis and Review

3.2 Continuous support to maximise the deal value

Taking Controls

- Develop and implement finance policies and control frameworks, factoring in all relevant business, regulatory, governance and internal control requirements
- Standardise, simplify and enhance back-office processes to adopt global standards of the buyer
- Use effective project management to realise and measure targeted synergies and other performance improvements
- Review progress regularly to ensure the deal is meeting its objectives

Optimisation

- Identify key success factors to maintain market share and capture new opportunities
- Build financial models to better manage the working capitals
- Improve supply chain performance by focusing on an organisation's distribution and fulfilment strategy, processes, and technologies, and providing measurable cost reductions and customer service improvements
- Assess system capabilities, identify gaps, and recommend alternatives for system enhancement
- Design and implement a tax strategy that fits clients' overall business plan, improves cash flow and ensures they gain tax efficient growth





Key Contacts

PwC Advisory has assisted dozens of investors in connection with their investments in retail businesses in China over the past 10 years. We are happy to discuss with you and support you in your deals.

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