

China's Department Stores Report 2015

March 2016



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Introduction

2015 was a particularly difficult year for China's department store sector as many operators struggled with lackluster sales and dropping profitability under the "new normal" of slower economic growth. China's GDP growth rate slowed to 6.9% in 2015, its lowest level in 25 years. This was due in part to the government's efforts to restructure and rebalance its economy. The plunging stock market also hurt business and consumer sentiment. Many department store operators' expansion plans have come to a halt, while trends of store closures remained widespread in both first-tier and lower-tier cities. On the one hand, new retail formats such as new forms of shopping malls, specialty stores and cross-border e-commerce have continued to emerge in the market and posed increasing threats to the department store sector. On the other hand, the rapidly changing consumer habits and behaviours have forced operators to adapt and change. An increasing number of department store operators have launched business transformation and corporate restructuring strategies to capture new opportunities. Some have stepped up efforts to enhance product and service offerings and enhance online-to-offline (O2O) integration with the hope to achieve a breakthrough with innovative business practices.

China's department store sector is leaping into a whole new scene with both challenges and opportunities lying ahead. In view of this, the Fung Business Intelligence Centre (FBIC) joins forces with China Commerce Association for General Merchandise (CCAGM) to produce the *China's Department Stores Report 2015*. The report analyses the macroeconomic data, collects financial reports from 80 domestic department store operators to gauge the sector's business performance in 2015, as well as conducts a survey with over 60 department store companies to explore their latest developments and strategies. The report then identifies key trends and major challenges faced by the sector, and suggests recommendations for the government as well as department store operators hoping to stay competitive and gain a foothold in the challenging market environment. Finally, the report addresses the future outlook of the department store sector under China's "new normal" and "Internet plus" era. We would like to express our heartfelt thanks to all department store operators, industry experts and practitioners who have supported us and participated in the preparation of this report.

Executive Summary

China's department store sector has been struggling with sluggish sales growth and decreasing profitability over recent years. According to the survey conducted by the China Commerce Association for General Merchandise among 80 key department store operators from November to December 2015, 46.28% of the sampled department stores suffered from underperforming sales with negative year-on-year sales growth in 2015. Operating environments remain challenging especially under the “new normal” economy of slower economic growth. Further, the trend of store closures has been intensified since 2015 on the back of unfavourable factors, both externally and internally –

External headwinds: slowdown in economic growth, rising competition from other retail segments such as shopping malls and specialty stores, mounting pressures from the booming e-commerce and changing needs of consumers, particularly the Chinese Millennials have all imposed pressures on department store operators;

Internal challenges: institutional limitation, specifically the concessionary business model adopted by department store players, lack of talents, coupled with obscured strategic directions to transform and upgrade the business have further put a strain on the sector.

Key trends and developments of the department store sector in China include:

- **Traditional department stores reinvent and upgrade.** An increasing number of department store operators in China have **diversified their business by engaging in multiple retail formats**, such as shopping malls, factory outlets and convenience stores so as to strengthen their core competencies, increase market share and expand revenue streams. Some have even **tapped into other business sectors** such as food & beverage, real estate and entertainment sectors. To cope with the increasingly sophisticated demands of consumers who focus more on shopping experience, many department store operators have converted their stores into lifestyle centers with more leisure and entertainment facilities such as cinema, restaurants and kids' play area.
- **Exploring new business models and practices.** To enhance the quality of products and services, as well as improve the competitiveness of stores, some players have adopted the self-operated model or buyer's model, resulting in a growing number **of buyer's shop and multi-label stores across the country**. Many department store operators have also placed greater emphasis **on increasing the proportion of merchandise direct sales and developing private labels**. At the same time, some have tried to build synergies with suppliers and brands by connecting and integrating with each other's ERP, inventory and POS systems.
- **Embracing “Internet plus” – from e-commerce to m-commerce to O2O.** Faced with losing customers to online retailers, an increasing number of department store players have stepped into the e-commerce space. Many have launched mobile apps which support mobile shopping in-store. They have also focused

more on integrating their online and offline (O2O) businesses, and **actively deploying O2O strategies** across all channels. A common means for department store operators to develop O2O strategies is to **collaborate with leading Internet giants** and leverage their capabilities in marketing, mobile payment, logistics and data analytics, as well as their large consumer base.

Eyeing the huge opportunities brought by cross-border e-commerce, many department store operators have been actively **tapping into cross-border e-commerce business** – either by establishing online cross-border shopping websites or by launching physical experiential stores which sell both duty-paid and bonded imported products.

- **Industry consolidation via mergers and acquisitions activities.** As a way out amid slowing growth, mergers and acquisitions (M&A) in the department store sector have been very active over recent years. Dalian Dashang Group is one of the most active players in recent M&A activities as it acquired two domestic department stores in 2015.
- **Revamping the organisational structure and management system.** In the “Internet plus” era, it is imperative for department store operators to **create a flexible and streamlined organisational structure** and to adapt to the rapidly changing market. Many forward-looking companies have started to transform their organisational structure from a vertical top-down structure to a horizontal and “borderless” structure. Besides, some department store operators have started to carry out in-depth adjustment of business strategies based on consumption characteristics of different regions.

China's department store sector is not expected to recover in the short term as we expect to see some downward corrections in the economy as well as the retail market in 2016. However, against the backdrop of increasing disposable income, rapid urbanisation and rising living standards, together with the government's continual supportive measures and positive policy stance towards the development of retail sector in the 13th Five-Year Plan (FYP), China's department store sector is expected to enjoy sustainable growth.

I. Market Overview

Against the backdrop of deteriorating market conditions and weak consumer sentiment in China, a number of major department store operators have witnessed a significant slowdown in sales over recent years. Fierce competition from other retail formats such as shopping malls and specialty stores as well as mounting pressures from e-commerce players were some major challenges facing department store operators. In addition, serious homogenisation, coupled with rising operational costs, further resulted in closure of outlets and poor sales performance in 2015. China's department store sector has entered into a critical period of tactic adjustment and business transformation.

1. Department store sales growth slackens off over 2015

(1) Sales performance of key department stores operators

The China Commerce Association for General Merchandise (CCAGM) conducted a survey with 80 key department store operators from November to December 2015 to understand their annual sales and financial performance in 2015. The survey gives a panoramic and representative view of the industry's performance as the majority of these department store operators are leading enterprises and typical operators within the department store sector.

In terms of scale of business, 92.50% of surveyed enterprises had annual sales of 100 million yuan or above; among them, 46.25% had annual sales over 1 billion yuan and 11.25% exceeding 10 billion yuan. Exhibit 1 shows the number of surveyed department store operators by annual sales in 2015.

Exhibit 1. Annual sales of 80 sampled department store operators, 2015

Annual sales in 2015 (million yuan)	Number of surveyed enterprises	Percentage of total sample	Cumulative percentage
>10,000	9	11.25%	11.25%
5,000-10,000	6	7.50%	18.75%
2,000-5,000	7	8.75%	27.50%
1,000-2,000	15	18.75%	46.25%
500-1,000	12	15.00%	61.25%
100-500	25	31.25%	92.50%
< 100	6	7.50%	100.00%
TOTAL	80	100.00%	-

Source: CCAGM

Total sales proceeds of the 80 sampled department store operators increased 9.30% year-on-year (yoy) to reach 439,764.1 million yuan in 2015 and core operating profits up 1.95% yoy to reach 18,200.8 million yuan. Total expenses and operating expenses soared 3.16% and 7.43% yoy to 20,579.4 million yuan and 9,762.7 million yuan respectively. Net profits dropped 12.05% yoy to 4,614.3 million yuan and ratio of sales down noticeably by 19.53% yoy. Year-end total assets of the sampled department store operators amounted to 118,666.5 million yuan, up 2.32% yoy. In terms of operating area, the 80 sampled department store operators registered a total operating area of 13,319,950.2 square metre (sqm) in 2015, an increase of 10.4% yoy. The average number of employees of the sampled department store operators dropped 1.11% yoy to 211,281 (Exhibit 2).

Exhibit 2. Operating results of 80 sampled department store operators, 2015

		2015	2014	Yoy changes
Total sales proceeds	(million yuan)	439,765.1	402,348.8	9.30%
Core operating profits	(million yuan)	18,200.8	17,852.9	1.95%
Total expenses	(million yuan)	20,579.4	19,949.7	3.16%
Operating expenses	(million yuan)	9,762.7	9,087.2	7.43%
Net profit	(million yuan)	4,614.3	5,246.5	-12.05%
Ratio of sales (ROS)	(%)	1.05%	1.30%	-19.53%
Year-end total assets	(million yuan)	118,666.5	115,978.4	2.32%
Year-end net asset value	(million yuan)	30,222.9	28,810.9	4.90%
Average number of employees		211,281	213,652	-1.11%
Operating area	(sqm)	13,319,950.2	12,063,278.7	10.42%

Source: CCAGM

As shown in Exhibit 3, the overall sales performance of the sampled department store witnessed a drastic drop in 2015. 53.80% of sampled department store enjoyed positive yoy sales growth in 2015 while 46.25% suffered from negative yoy sales growth. Among those who have registered positive sales growth, only 8.8% enjoyed exceptional sales growth of more than 20% yoy in 2015, the majority (53.8%) recorded a low single-digit yoy growth of less than 5% in 2015.

Sluggish sales growth, declining profits and rising operating costs are expected to continue into 2016 amid fierce competition from other retail formats and rising cost of operations.

Exhibit 3. Yoy changes in sales revenue of 80 sampled department store operators, 2015

Yoy changes in sales revenue	Accumulated number of department store operators	Cumulative percentage
(i) >0%	43	53.80%
>20%	7	8.80%
>10%	17	21.20%
>5%	27	33.80%
(ii) <0%	37	46.20%
<-10%	20	25.00%
>-10%	17	21.20%
TOTAL (i) + (ii)	80	100.00%

Source: CCAGM

(2) Trend of persistent store closures

Facing the tough retail environment, the sector has witnessed a trend of store closures for both local and foreign department stores over the past few years, with the situation further intensified in 2015. Some operators have suspended expansion plans and focused on revamping existing stores or closing unprofitable stores and withdrew from certain cities in order to stay competitive. According to Linkshop, a Chinese commercial information portal, there were 121 store closures involving major retail enterprises (including department stores and supermarkets) in 1H15, among which, 25 closures involved department stores. According to PEdaily¹, among all department store closures in 2015, foreign players represented 57.9% while domestic players represented 42.1%. Central Department Store, the largest department store player in Thailand, for instance, closed two stores in 2014 and its last store in China in August 2015 which signified its complete withdrawal from the China market. Examples of selected department store closures are shown in Exhibit 4.

The trend of store closures has carried into 2016. A recent example was the closure of Mo Mall in Chengdu in February 2016².

Exhibit 4. Selected department store closures in China, 2015-2016 (as of February 2016)

Department store	Country of origin	City	Opening year	Closing month
Rainbow Department Store	China	Huzhou	2010	Feb-2015
		Quanzhou	2010	May-2015
		Chengdu	2011	Jun-2015
Wanda Department Store	China	Ningbo	2012	Jan-2015
		Yixing	2012	Jan-2015
		Taicang	2013	Jan-2015
		Wuhu	2012	Jan-2015
		Jinjiang	2013	Jan-2015
		Wenzhou	2013	Feb-2015
		Dongguan	2013	Feb-2015
		Shenyang	2012	Mar-2015
		Shenyang	2012	Mar-2015
		Qingdao	2012	Jun-2015
Far East Department Store	China	Tianjin	2006	Mar-2015
Sunshine Department Store	China	Shenyang	2013	Mar-2015
Parkson Department Store	China	Tianjin	2004	Apr-2015
Golden Eagle Department Store	China	Hefei	2010	May-2015
		Hefei	2010	May-2015
La Vita Department Store	China	Tianjin	2001	May-2015
Central Department Store	Thailand	Chengdu	2012	Aug-2015
Ito Yokado Department Store	Japan	Beijing	2007	Apr-2015
Marks and Spencer	UK	Changzhou	2012	Mar-2015
		Changzhou	2012	Aug-2015
		Shanghai	2012	Aug-2015
		Wenzhou	2012	Aug-2015
		Wuxi	2012	Aug-2015
Mo Mall	China	Chengdu	2002	Feb-2016

Source: Linkshop.com.cn, PEdaily.cn; compiled by FBIC

2. Increasing competition from counterparts in other retail segments, particularly e-commerce

Department stores have been facing tough competition from retailers in other retail segments such as shopping malls, convenience stores, and specialty stores over the past years. The latest figures published by the National Bureau of Statistics of China (NBS)³ show that retail sales for department stores reached 380.6 billion yuan in 2014, up 2.8% yoy, the lowest growth among other major retail formats (Exhibit 5).

Exhibit 5. Retail sales growth for different retail formats, 2014

Retail format	Yoy growth
Factory Outlets Center	47.7%
Convenience stores	11.1%
Specialty stores	3.8%
Supermarkets	3.2%
Department stores	2.8%

Source: NBS; compiled by FBIC

Moreover, the rapid growth of e-commerce has posed an imminent threat to department store operators as department stores continue to lose market share to online sales channel over recent years. Online retailing offers customers the advantage of wider selections, competitive pricing, and easier comparison. According to the Ministry of Commerce (MOFCOM)⁴, in 2015, online retail sales of physical commodities increased by 31.6% yoy to 3.24 trillion yuan, accounting for 10.8% of the total retail sales of consumer goods.

3. Changing needs and preferences of consumers, particularly the Chinese Millennials

The emergence of a new generation of consumers – the “post-80s” and “post-90s”, or the Chinese Millennials, has become a new and important segment of customers for the retail sector. Millennials are characterised by being more demanding and having higher expectations than their previous generations. With easy access to information in the Internet era, the Millennials are comparatively more sophisticated and are constantly looking for novelty, quality products, and personalised shopping experiences. They are tech-savvy and also rely heavily on social media for updated information and exchange of ideas. In terms of shopping behavior, they are used to online shopping and have strong preferences towards seamless shopping experience and O2O formats. Some traditional department stores that are immutable and operate their business in a conventional way may fail to meet the needs of this new consumer group and run the risk of losing relevance.

II. New developments and key trends

1. Traditional department stores reinvent and upgrade

(1) Engaging in multiple retail formats and tapping other business sectors

Over recent years, numerous department store operators in China have diversified their retail business by engaging in multiple retail formats, such as shopping malls, factory outlets, supermarkets and convenience stores so as to strengthen their core competencies, increase market share and expand revenue streams. Exhibit 6 shows examples of department stores who have tapped into the shopping mall sector. Wangfujing Department Store has invested heavily in business transformation, particularly in developing shopping malls and factory outlets. By the end of 2016, the group will complete two mega-scale shopping centers with floor area over 200,000 sqm in Harbin and Sichuan respectively. Over the next five years, Wangfujing has committed to build 15 to 20 shopping centers with size no less than 100,000 sqm each. Further, the group has also laid long-term business strategies for factory outlet business. Two factory outlets will be opened in September and October 2016 in Xian and Yingchun respectively, and another large-scale factory outlet in Kunming will be opened in 2017.

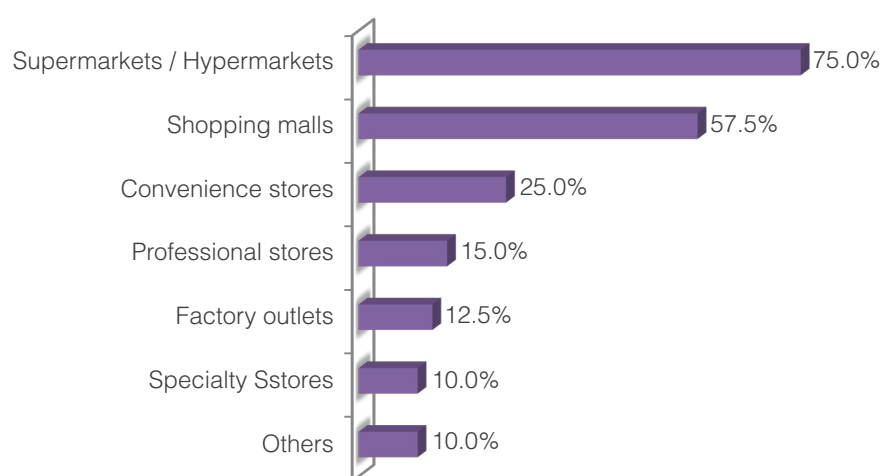
Exhibit 6. Selected department stores that have tapped into the shopping mall sector (as of February 2016)

Department store	Shopping mall project	Location
Intime Department Store	Intime City	Heilongjiang: Haerbin
		Hebei: Tangshan
		Shandong: Zibo
		Hubei: Wuhan
		Zhejiang: Hangzhou, Jinhua, cixi, Ningbo, Jiaxing, Taizhou
		Hunan: Hengyang
		Sizhuan: Neijiang, Panzhihua, Chengdu
		Shanxi: Xian
		Anhui: Hefei, Wuhu
Rainbow Department Store	Rainbow Shopping Centre	Guangdong: Shenzhen Jiangxi: Jian Zhejiang: Hangzhou
Grandbuy Department Store	Grandbuy Sunny Mall	Guangdong: Zuhai, Heyuan
Haiya Department Store	Haiya Mega Mall	Gugndong: Shenzhen
Better Life Department Store	BBG Plaza	Hunan: Changsha, Jishou, Xiangtan, Liuzhou
Xinhua Department Store	CC mall	Ningxia: Yinchuan
Parkson Retail Group	City Lifestyle Mall (a joint venture with Korean-based E-Land Group)	Shanghai (to be opened by the end of 2016)

Source: Company websites; compiled by FBIC

The CCAGM and the Fung Business Intelligence Centre (FBIC) conducted a survey among key department store operators in China^a to understand their latest developments and strategies in areas related to operation models, proportion of merchandise direct sales, e-commerce and O2O strategies. According to the survey, the majority of department store operators (70.0%) have been actively expanding their scope of business to other retail formats. Among which, 75.0% operate supermarkets or hypermarkets, 57.5% operate shopping malls and 25.0% operate convenience stores (Exhibit 7).

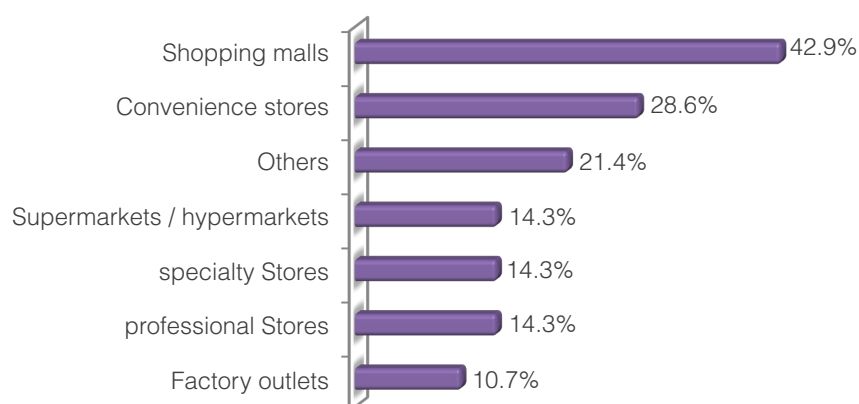
Exhibit 7. Sampled department store operators that have tapped into other retail formats



Source: The survey with 61 department store operators by CCAGM and FBIC; compiled by FBIC

Over half of the surveyed department stores operators (52.8%) reported that they plan to expand their current scope of business and engage in other retail formats. Of which, 42.9% of them plan to operate shopping malls; 28.6% plan to run convenience stores (Exhibit 8).

Exhibit 8. Sampled department store operators that have planned to tap other retail formats

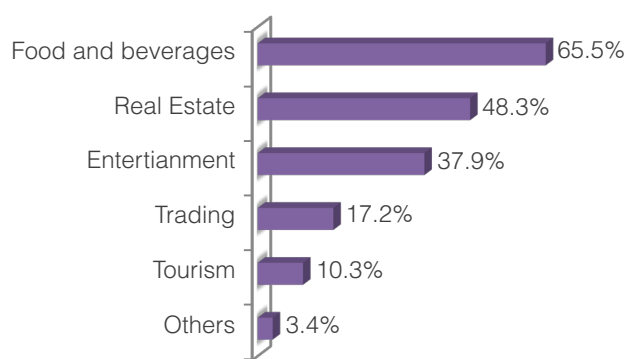


Source: The survey with 61 department store operators by CCAGM and FBIC; compiled by FBIC

^a A quantitative survey was conducted by the China Commerce Association for General Merchandise (CCAGM) and the Fung Business Intelligence Centre (FBIC) among 61 key department store operators in China during November to December, 2015.

Furthermore, in view of the dynamic market situation in China, tapping into other business sectors especially the food and beverages (F&B) sector has become a strategic move of many department store operators in recent years. For instance, in January 2015, Parkson Retail Group announced to venture into F&B business. The Group has entered into a joint venture (JV) agreement with AUM Hospitality Sdn. Bhd. to establish a JV company for the purposes of developing its F&B business in China⁵. According to our survey, 53.7% of the surveyed department store operators have plans to tap into other business sectors. 65.5% of them operate in the F&B sector, 48.3% enter the real estate sector, and 37.9% operate in the entertainment sector. (Exhibit 9)

Exhibit 9. Sampled department store operators that have planned to tap into other sectors



Source: The survey with 61 department store operators by CCAGM and FBIC; compiled by FBIC

(2) Adding lifestyle concepts and focus on shopping experience

An increasing number of department store operators in China have been undergoing business transformation – turning from traditional department stores into lifestyle-concept retail business and focusing more on selling a lifestyle rather than merely products, so as to attract consumers' attention and appeal to their increasingly sophisticated demands. Many have adopted a shopping mall-oriented approach to provide more leisure facilities, such as kids' play area, entertainment, F&B and cinemas to attract more foot traffics, encourage repeated patronage and enhance their customer experience (Exhibit 10).

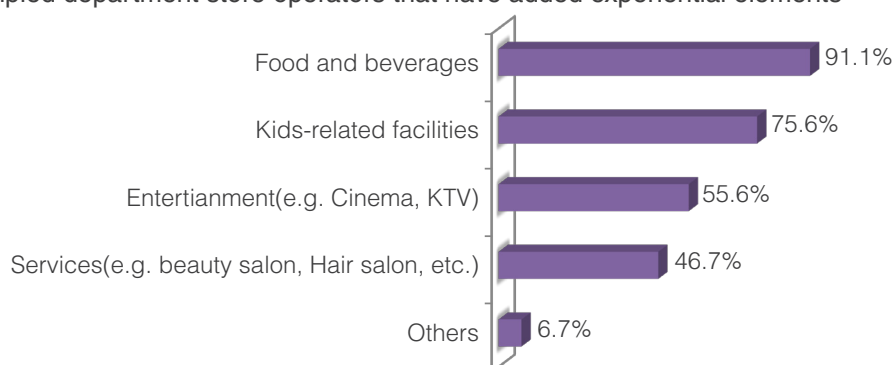
Exhibit 10: Selected examples of lifestyle and shopping experience enhancement by department store operators in 2015

Department Store	Lifestyle and shopping experience elements
Golden Eagle Retail Group ⁶	The group has accelerated its strategic transformation from a fashion-oriented department store to a “comprehensive lifestyle center” in recent years. Dining, entertainment, gourmet supermarket G-Mart, aquarium, beauty and personal care, hair styling, cinemas and preschool education facilities have been introduced in these lifestyle centers. As at 30 September 2015, the group operated nine comprehensive lifestyle centers with a total gross floor area of 936,569 sqm. The operating area of these comprehensive lifestyle centers accounted for 28.8% of the group's total operating area.
New World Department Store China Ltd. ⁷	New World Department Store launched “Living Gallery”, a one-stop department store, to cater the various needs of customers and give them a brand new shopping experience. 20-30% of retail spaces are allocated to lifestyle-related amenities, including dining, gym, beauty and kids playground. The group also launched “Fashion Gallery”, a themed department store with strong focus on trendy apparel and accessories.
Parkson Retail Group Ltd. ⁸	Parkson has been adding dining facilities to its physical stores. It has also signed exclusive franchise agreements with a number of F&B brands including American fast food Johnny Rockets, casual restaurant Franco, coffee shop The Coffee Library Bar, and sandwich shop Quiznos.
Maoye International Holdings Limited ⁹	The group has been adjusting the trade mix in its physical stores. It has allocated more than 20% of retail space to lifestyle amenities in its Zibo and Taiyuan branch.
JiuGuang Department Store (Suzhou) ¹⁰	The department store introduced the world renowned Fissler Academy in July 2015 which comprises a café and a cooking studio.

Source: Company websites; various Internet sources; compiled by FBIC

The keen intention of department store operators to increase lifestyle and experiential elements in their stores has fully manifested in our survey results. Over 85.5% of department store operators have increased “experiential elements” in their stores. Among them, 91.1% have added F&B elements, followed by kids-related facilities and shops (75.6%), entertainment (55.6%) and services such as beauty salon (46.70%) (Exhibit 11).

Exhibit 11. Sampled department store operators that have added experiential elements



Source: The survey with 61 department store operators by CCAGM and FBIC; compiled by FBIC

In terms of effectiveness in increasing foot traffics – 41.9% claimed to have obvious improvement, while 58.1% of the surveyed operators claimed to have slight improvement.

In terms of effectiveness in increasing sales – 22.5% of the surveyed operators have observed obvious improvement, while 67.5% claimed to have slight improvement.

2. Exploring new business models and practices

(1) Emergence of buyer's shops and multi-label stores

An evolving retail landscape and changing consumer needs have forced traditional retailers including department store operators to think of new ways to operate their businesses. Some players may adopt the self-operated model or buyer's model so as to enhance the quality of products and services, as well as improve the competitiveness of the stores.

Case study 1: Hi Department Store Hi百货 DEPARTMENT STORE

It is the first domestic upscale lifestyle department store to fully engage in direct merchandise sales and name itself as a “revolutionary department store”. Hi Department Store operates its business in the form of multi-label store, with its directly-sourced merchandises. Unlike other traditional department stores relying heavily on the concessionary model, all of Hi Department Store's merchandise is sourced exclusively by in-house buyers. Bypassing distributors and agents, Hi Department Store buyers source and select unique and creative merchandise, aiming for “world cultures” within their products. Currently, Hi Department Store has three stores in China which are located in Guangzhou, Shanghai and Beijing respectively. Each store has a bookstore “Hi Book”, a cafe “Hi Café”, and a DIY area called “Hi Class”, to provide social gathering places for consumers to enrich their shopping journeys. Not only does this new retail format bring an avant garde shopping experience to consumers, but also enhance the evolution of China's department store sector in terms of personalised procurement and sourcing.

Source: Company website, various Internet sources.



Hi Café



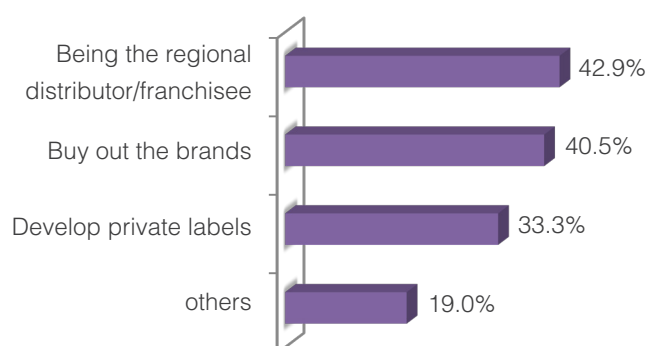
Hi Book

(2) Increasing the proportion of merchandise direct sales and developing private labels

Increasing the proportion of merchandise direct sales

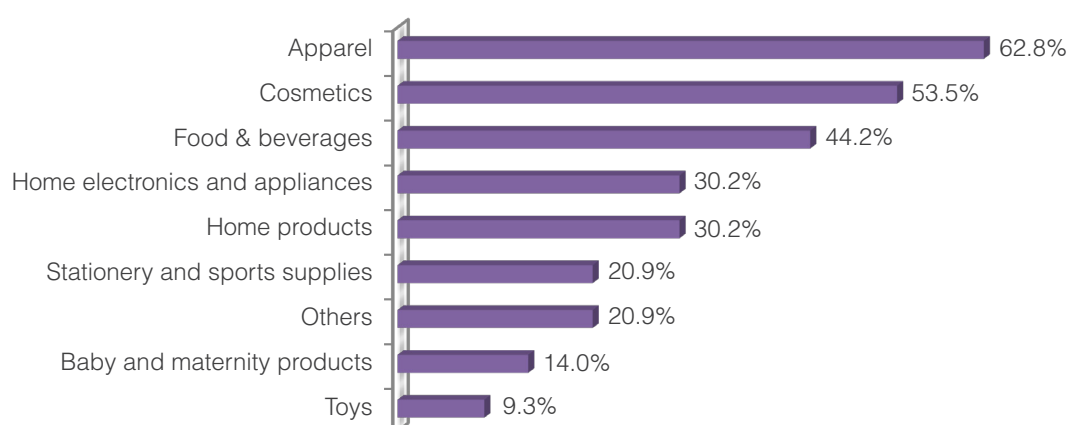
Having experienced the drawbacks of the concessionary model, many department store operators have placed greater emphasis on increasing the proportion of direct sales and developing private labels and treated this as a key theme of business transformation. They hope to increase product differentiation so as to stay unique in the market and strengthen their competitive edge. According to our survey, majority of the sampled department store operators (58.0%) designated less than 10% of products for merchandise direct sales. Among those operators who have started merchandise direct sales model, 42.9% became a regional distributor or franchisee, 40.5% directly own the brand, 33.3% develop private labels (Exhibit 12). Among the major categories sold in department stores, the proportion of merchandise direct sales are highest in apparel, cosmetics, F&B, and home electronics and appliances (Exhibit 13).

Exhibit 12. Forms of merchandise direct sales model of sampled department store operators



Source: The survey with 61 department store operators by CCAGM and FBIC; compiled by FBIC

Exhibit 13. Major product categories of merchandise direct sales of sampled department store operators



Source: The survey with 61 department store operators by CCAGM and FBIC; compiled by FBIC

Hebei-based regional department store operator Xinyulou Department Store is engaging entirely in merchandise direct sales. Leveraging its strong local networks and long-standing relationship with suppliers, Xinyulou purchases all of its products directly from suppliers. 98% of their merchandise is sourced by a team of in-house buyers. It is noteworthy that the group runs an “apprenticeship program” in nurturing its own buyers, in which junior buyers are apprenticed to and trained by experienced buyers.

A number of department stores have engaged in merchandise direct sales by obtaining the sole distribution rights in the local market. For example, Parkson department store has spent over 84 million yuan in signing the sole distribution rights of around 30 world-renowned brands in China since 2014. These brands are distributed exclusively in Parkson department stores and its online store, and are mostly from the U.K, France and Italy, covering apparel, footwear, gifts and accessories. Parkson even bought out several special brands originating from Malaysia, in order to introduce them to the domestic market. In the near future, Parkson will continue its strategy of strengthening and enriching its merchandise resources by adding more than 100 international brands to the group's product distribution lists¹¹.

Developing private labels

Apart from increasing the proportion of direct sales, some operators have sought to differentiate themselves by developing private labels, hoping to enjoy better profit margins and increase competitiveness (Exhibit 14). For example, Wangfujing Department Store launched its first private label “First Wert” in January 2015, which covers menswear and accessories. The reason for choosing menswear as its first private label category is that menswear usually involves relatively smaller changes in style and lower inventory risks. Dashang Group has set up a dedicated private label company to focus on research and development of private label lines, including packaged food, tissue and hygiene products, apparel, footwear and homecare products.

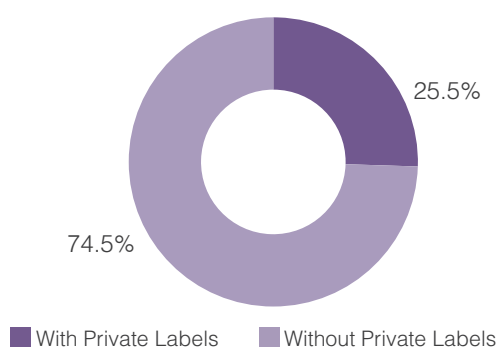
Exhibit 14: Private labels of selected department stores

Department Store	Private Label	Category
Intime Department Store ¹²	Just Intime	Womenswear
New World Department Store ¹³	LOL (Love Original Life)	Lifestyle
Ito Yokado ¹⁴	pbi	Apparel
	IY&Basic	Home textile
	Huatang	Paper cups, paper towels
Wangfujing Department Store ¹⁵	FIRST WERT	Menswear
Golden Eagle Department Store ¹⁶	Aquila D'oro	Menswear
	IVREA	Menswear
	LISALEN	Womenswear
	WONDERFUL LIFE	Home textile
	Antonghui	Childrenswear
Parkson Department Store ¹⁷	Zie Zac	Apparel
	Zie Zac Junior	Childrenswear
	Serena	Womenswear
	Style Unlimited	Womenswear
Xinyulou Department Store ¹⁸	Gengyun	Menswear
	Xinyulou Yichu	Womenswear
Tee Mall ¹⁹	TEEM QUALITY	Menswear, Childrenswear, Daily products, Food
New Hua Du Supercenter	CitiesVie	Apparel
	CitiesBlue	
Hefei Department Store Group	Yueran Huimei Wanxiu	Apparel
	Hejiafu	Home products
	Huajin	Cosmetics
Shangdong Weifang Commercial Group – Jia Le Jia Supermarket	Hongutn	Home products
	Jiajiayoufu	Home products
	Pinxian	Food
Mopark Department Store ²⁰	Mopark	Socks and accessories
Dashang Group ²¹	Newmart	Tissue and hygiene products, laundry care, slippers, underwear, socks
	Baidaiyi	
	Aomashi	
	Maizhesen	Tissue and hygiene products
	Arthur	Women's apparel and footwear
	Qiaohui	Men's apparel and footwear
		Men's shirts
		Dishwashing detergents

Source: Company websites; various Internet sources; compiled by FBIC

That said, development of private labels is still not prevalent in China. There are huge investments involved in developing private labels, as well as difficulties in competing with the established brands in the market. According to our survey, only 25.5% of the surveyed department store operators have their own private labels, and they accounted for less than 7% of their total revenue, much lower than retailers in developed markets where own-label products typically generate 10-30 % of sales (Exhibit 15).

Exhibit 15. Sampled department store operators that have their own private labels



Source: The survey with 61 department store operators by CCAGM and FBIC; compiled by FBIC

For operators who have more experience in operating the merchandise direct sales model and developing private labels, they have strategically widened the scope of direct sales business to cover broader aspects. For example, New World Department Store China launched a private label, LOL (Love • Original • Life) Concept Shop, in March 2013. The brand adopts a direct procurement model and sells skincare, electronics, artworks, furniture and other lifestyle products sourced from all over the world. Since 2015, the retailer has expanded LOL's product offerings to include books, coffee and derivatives from art exhibitions to attract more young customers. It has also announced a plan to build an European-style artisan bakery brand to bring healthy-eating ingredients and concepts to consumers in the near future²².

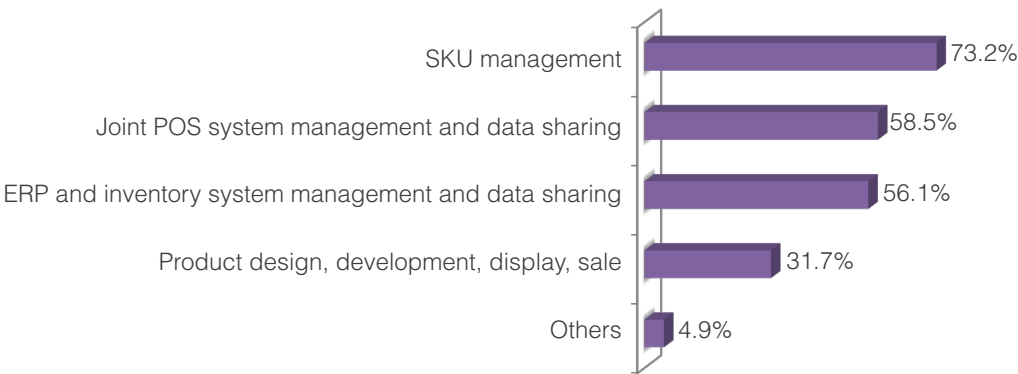
It is noteworthy that the gross margins generated from private labels are usually much higher than that from concessionary sales. According to financial reports of New World Department Store, its private label LOL has a gross margin of around 50%, which is higher than its traditional concessionary business. We believe that more department store operators will expand their private label business so as to differentiate themselves in the market.

(3) Building synergies with suppliers and brands; connecting and integrating with each other's ERP, inventory and POS systems

An increasing number of department store operators have formed strategic alliances with players along the supply chain in order to build synergies and outperform their competitors. In May 2015, Wangfujing Department Store and Bailian Group teamed up with Li & Fung Trading (China) Holdings Ltd. to form a JV aiming to transform China's retail industry through enhancing supply chain efficiency. The key business of the JV includes facilitating the development and management of private labels and licensed brands. The JV will develop one to three private labels and up to six licensed brands over the coming three years.

Meanwhile, some department store operators have tried to connect and integrate their Enterprise Resource Planning (ERP), inventory and point-of-sale (POS) systems with suppliers and brands. Based on our survey, 75.9% of the surveyed department store operators claimed to have stronger collaboration with suppliers and brands in recent years. Most of the collaborations are in the form of SKU management (73.2%), followed by joint POS system management and data sharing (58.5%), and ERP and inventory system management and data sharing (56.1%) (Exhibit 16).

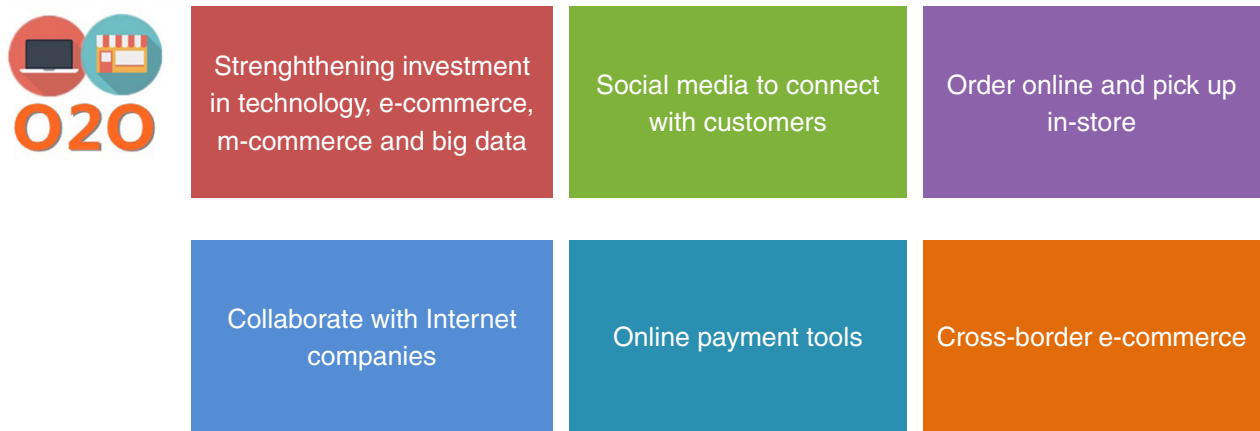
Exhibit 16. Forms of collaboration between sampled department store operators and upstream suppliers or brand owners



Source: The survey with 61 department store operators by CCAGM and FBIC; compiled by FBIC

3. Embracing “Internet plus” – from e-commerce to m-commerce to O2O

(1) Leveraging the rapid growth of e-commerce and m-commerce



Faced with losing customers to online retailers, an increasing number of department store players have stepped into the e-commerce space – either by launching their own standalone transactional website or opening online store on third-party platforms (Exhibit 17).

Exhibit 17: Online stores of selected department stores in China (as of February 2016)

Enterprise	Standalone transactional website	Store on third-party online platform
Shanghai Friendship Group Incorporated Company	http://www.blzoom.com/	Nil
Dalian Dashang Group Co., Ltd.	http://www.51tiangou.com/	https://tiangou.world.tmall.com
Chongqing Department Store Co., Ltd.	http://www.cbmall.cn/	Nil
Changchun Eurasia Group Co., Ltd.	http://www.oysd.cn/	Nil
Beijing Wangfujing Department Store (Group) Co., Ltd.	http://www.wangfujing.com/	http://wangfujing.tmall.com/
Liqun Group Co., Ltd.	http://www.liqunshop.com/	Nil
Rainbow Department Store Co., Ltd.	http://www.tianhong.cn/	https://tianhong.world.tmall.com/
Zhenghua Department Store Development Co., Ltd.	http://eshop.zhenshang.com/	Nil
Parkson Retail Group Ltd.	http://www.parkson.com.cn/	Nil
Intime Department Store (Group) Co., Ltd.	http://www.yintai.com/	http://yintaibaihuo.tmall.com/ http://yintai.jd.com/ http://shop.yhd.com/m-149881.html
Wei Bai Group	http://www.zbasw.com/	Nil
New World Department Store China Ltd.	http://buy.xinbaigo.com/	https://loveoriginallife.world.tmall.com
Beijing Caishikou Department Store Co., Ltd.	Nil	http://caibai.tmall.com/ http://caibai.jd.com/ http://shop.yhd.com/m-135839.html?tc=3.0.5.39196814.10&tp=51.%E8%8F%9C%E7%99%BE.124.0.15.KdCn20N
Guangzhou Grandbuy Co., Ltd.	http://www.gbhui.com/	https://grandbuy.world.tmall.com
Shijiazhuang Beiguo Group (Department Store section)	http://www.ruyigou.cn/	Nil
Nanjing Central Emporium Group Stocks Co., Ltd.	http://www.600280.com/	https://njzysc.world.tmall.com
Hunan Friendship and Apollo Co., Ltd.	http://www.tepin.com/	Nil
Jinan Hualian Commercial Group	http://www.hlyigou.com/	Nil
Handan Sunshine Department Store (Group) Co., Ltd.	http://www.ygttg.com/	Nil
Guangzhou Friendship Group Co., Ltd.	http://mall.cgzfs.com/	Nil
Xiongfeng Group Co., Ltd.	Nil	http://hopeful.tmall.com/
Nanning Department Store Co., Ltd.	http://www.mmgo.cn/	Nil
Shanghai Xujiashui Commercial Co., Ltd.	http://www.xjh.com/	Nil
Wuhan Zhongbai Group Co., Ltd.	http://www.zon100.com/	https://zhongbai.world.tmall.com
Jiahua Stores Holdings Ltd.	http://go.szbjh.com/	Nil

Source: Company websites; various Internet sources; compiled by FBIC

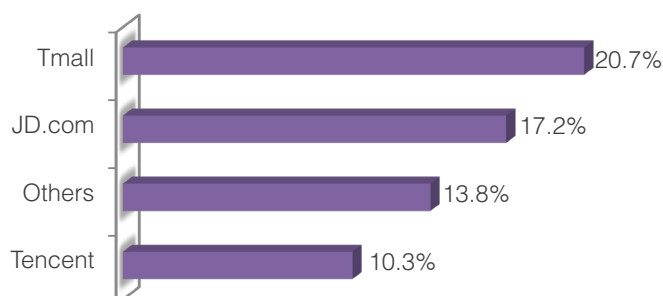
According to our survey, over half of the surveyed department store operators (55.2%) have already started their e-commerce business – among them, 69.0% have established wholly-owned transactional website and 55.2% have opened stores on third-party e-commerce platform such as Tmall (20.7%), JD.com (17.2%), WeChat (10.3%) (Exhibit 18 and 19).

Exhibit 18. Forms of e-commerce business of sampled department store operators



Source: The survey with 61 department store operators by CCAGM and FBIC; compiled by FBIC

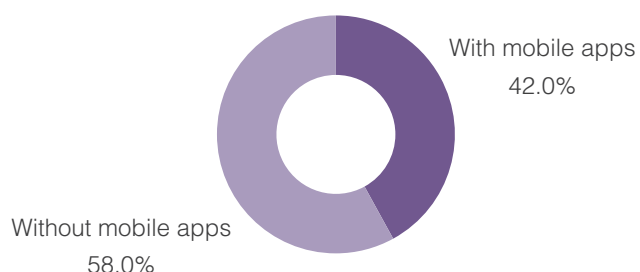
Exhibit 19. Existing third-party e-commerce platforms used by sampled department store operators



Source: The survey with 61 department store operators by CCAGM and FBIC; compiled by FBIC

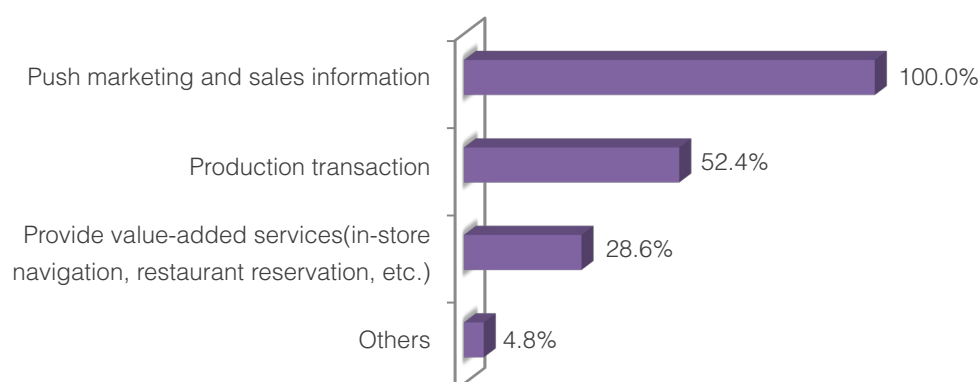
Meanwhile, mobile shopping has been the major driving force behind the growth of e-commerce. According to the China Internet Network Information Center (CNNIC), as of December 2015, there were 340 million of mobile shoppers in China, an increase of 43.9% yoy. The proportion of mobile shopping to e-commerce expenditure increased from 42.4% in 2014 to 54.8% in 2015²³. In view of this, an increasing number of department store players have launched mobile apps that support mobile shopping. According to our survey, 42.0% of the surveyed department store operators have already rolled out their mobile apps; they used the apps mainly for pushing marketing and sales information to customers, carrying out transaction, and providing value-added services such as restaurant reservation, in-store navigation to customers (Exhibit 20 and 21).

Exhibit 20. Proportion of sampled department store operators with and without mobile apps



Source: The survey with 61 department store operators by CCAGM and FBIC; compiled by FBIC

Exhibit 21. Major functions of mobile apps of sampled department store operators

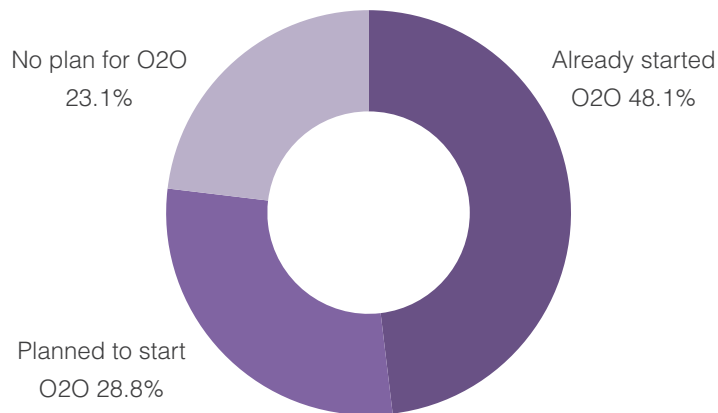


Source: The survey with 61 department store operators by CCAGM and FBIC; compiled by FBIC

(2) O2O strategies become an industry consensus

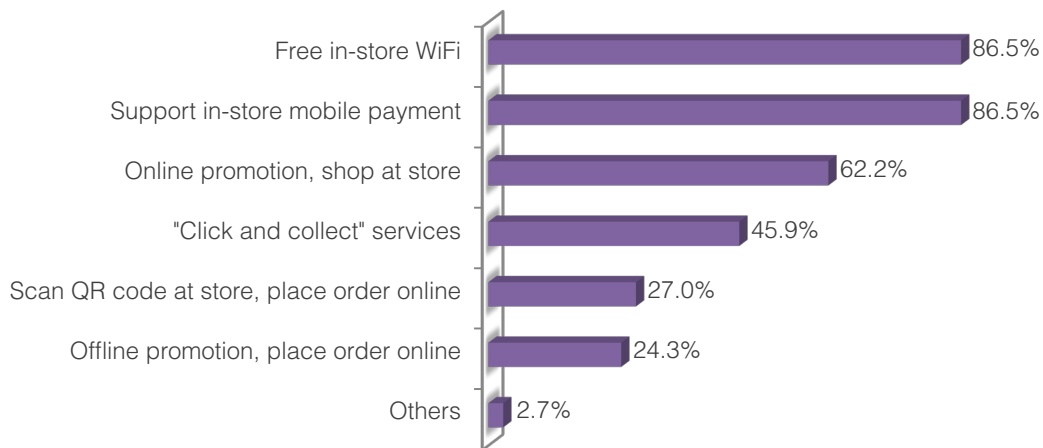
To adapt to the digital era, department store operators have to focus more on integrating their online and offline business, facilitating shopping convenience, and better serving customers' needs. Indeed, over the past year, many department stores in China have demonstrated growing sophistication with regard to O2O adoptions. It has become a mainstream for operators to actively deploy O2O strategies across all channels – brick-and-mortar, online and mobile. In our survey, 48.1% of the department store operators have already deployed O2O strategies in their business – mostly in the form of setting up free in-store WiFi, supporting mobile payment, providing “click and collect” services, etc. 28.8% of the department store operators have yet to start deploying O2O strategies but are planning to do so (Exhibit 22 and 23).

Exhibit 22. Deployment of O2O strategies of sampled department store operators



Source: The survey with 61 department store operators by CCAGM and FBIC; compiled by FBIC

Exhibit 23. Major forms of O2O strategies of sampled department store operators



Source: The survey with 61 department store operators by CCAGM and FBIC; compiled by FBIC

Case study: Rainbow Department Store

Rainbow Department Store is one of the earliest department store operators to roll out an O2O business model. According to Rainbow Department Store, by 1H15, its mobile apps had more than 3 million registered users in total, and its e-commerce business witnessed a drastic growth of 66% yoy in total sales²⁴. Its omni-channel retail platform comprises of:

1. Physical stores

- “Department Store + Shopping mall + Convenience Store (Weiwo)” model

2. Online store

- “Tianhong.cn”: an official website that provides one-stop online shopping on large varieties of products including apparel, cosmetics, baby and maternity products, home products, electronics, F&B, imported goods, etc.

3. Mobile apps

- “Red Scarf” (Honglingjin): a platform that provides daily services for local customers. Customers can place order via the app whenever there is a Rainbow Department Store within a radius of 1.5 km of the customer's location.
- “Rainbow Home Delivery”: a platform that provides express delivery service for supermarket products offered by Rainbow Department Stores. Customers can order products on the app and received the goods within 2 hours.
- Weipin: a mobile-based e-commerce platform where any individual can become a Weipin store owner.
- WeChat: launched in September 2013, its WeChat public account supports mobile payment.

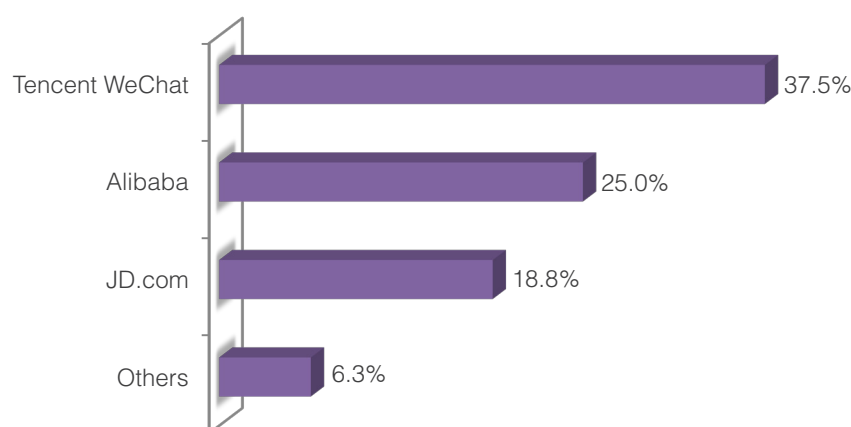


Source: Company website, various Internet sources

(3) Collaborating with Internet giants to develop O2O strategies

A common means for department store operators to develop their O2O strategies is to form strategic partnerships with leading Internet companies to expand their offline business to online and leverage their capabilities in marketing, mobile payment, logistics and data analytics, as well as their gigantic consumer base. According to our survey, 48.1% of the companies have formed partnerships with Internet companies – among them, 37.5% have partnered with Tencent, 25.0% with Alibaba, 18.8% with JD.com (Exhibit 24).

Exhibit 24. Partnerships with Internet companies to deploy O2O strategies



Source: The survey with 61 department store operators by CCAGM and FBIC; compiled by FBIC

There were large numbers of strategic collaborations and partnerships between department store operators and Internet players in 2015. For instance, Intime Retail Group announced to strengthen the partnership^b with Alibaba Group in December 2015 for omni-channel commodity integration. Under the new partnership, Intime would support the distribution of Alibaba's online products in Intime's stores; meanwhile, Alibaba would accelerate the online sales of Intime's products. Furthermore, in January 2016, Intime Retail Group formed a partnership with Alibaba's Tmall Supermarket. To foster a seamless shopping experience for customers, Intime would issue a new single-purpose stored-value card which can be used offline in dozens of Intime's retail stores and also online on Tmall Supermarket.²⁵

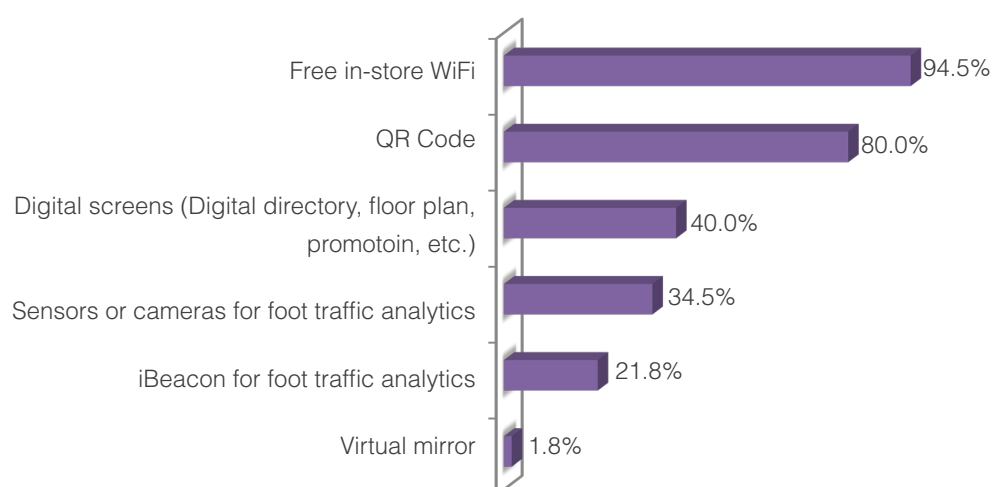
(4) Strengthening investment in technology, m-commerce and big data

In China, increasing numbers of department store operators are adopting innovative technologies to better engage with their customers and enhance customer experience. Many are launching shopping apps equipped with beacons technology to create personalised, unique in-store experience for customers. Some mobile apps provide an extra channel for department store operators to offer value-added services for customers, such as digital membership cards, store navigation, instant customer service and online pre-ordering. According to our survey, 94.5% of the surveyed department store operators have set up free

^bThe first partnership between Intime and Alibaba Group was established in March 2014.

WiFi storewide, 80.0% have set up QR code system, 40.0% have launched in-store digital directory and 34.5% have used foot traffic analytics (Exhibit 25). Alibaba's Miao Street is a well-illustrated example of how new technology can leverage a mobile app to integrate physical stores, products and customers, and to enhance customer's shopping experience (please refer to the case study of Miao Street App).

Exhibit 25. Adoption of technology in physical stores of sampled department store operators



Source: The survey with 61 department store operators by CCAGM and FBIC; compiled by FBIC

Case study: Alibaba's Miao Street App



Miao Street is a one-stop shopping and location-based mobile app developed by Alibaba with the aim of enhancing customers' shopping experience in brick-and-mortar stores. Its customer service-oriented features include free WiFi, indoor navigation, finding of car parking space, restaurant reservation and purchase of movie tickets, etc. Miao Street allows stores to send personalised messages to shoppers based on their location or demographics. When customers arrive at the store, the app can also send store coupons to customers and direct them to facilities such as ATM, restroom or escalator.

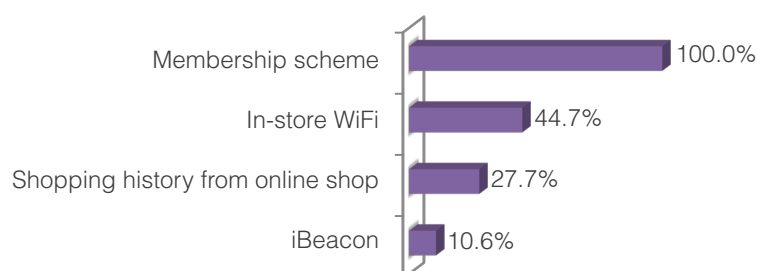
By the end of 2015, Miao Street has been expanded to more than 10 cities in China including Beijing, Shanghai, Shenzhen, Nanjing, Wuhan, Hangzhou, Ningbo, etc. Over 60 department store operators such as Intime Retail Group, Beijing Capital Retailing Group, Incity Mall, Wuhan Zhongbai Group support Miao Street in their stores.

Recently, Miao Street app has launched Miao Miao, an instant-messaging tool for brick-and-mortar stores to enhance their in-store e-commerce operations. Store managers and salespersons can post information of product discounts and promotional activities through Miao Miao. Customers can view such information and communicate with the store managers through Miao Miao.

Source: Various Internet sources

At the same time, department store operators are using mobile apps to collect customer information and carry out data analytics. 88.0% of our surveyed department store operators have collected customer data for big data analytics – means of collecting customer data and information include: Membership scheme (100.0%), in-store WiFi (44.7%), shopping history from online shop (27.7%) and iBeacons (10.6%) (Exhibit 26).

Exhibit 26. Means of collecting customer data and information by sampled department store operators



Source: The survey with 61 department store operators by CCAGM and FBIC; compiled by FBIC

Rainbow Department Store and Chang Chun Eurasia Department Store's enthusiasm in utilising big data in improving business operations make good reference for the whole sector. Rainbow Department Store has partnered with Baidu to establish a big data research center and carry out omni-channel retailing.

Another example is Chang Chun Eurasia Department Store. The operator has used big data analytics on its SKU management for products sold at its supermarket. The operator has identified the most popular items based on the data collected and launched its e-commerce website with the top 100 most popular products so as to enhance sales.

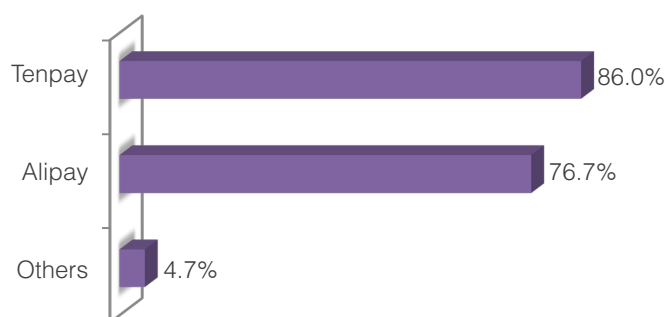
(5) Strongly leveraging social media to connect with customers

Over recent years, department store operators have put tremendous emphasis on social media marketing. Influential and popular social media platforms such as Weibo and WeChat are some of the key channels department store operators use to connect with customers, and to perform targeted marketing. For example, Beijing-based Yangsha Youyi Shopping City (Yangsha) has adopted a comprehensive social media strategy by leveraging Weibo, WeChat, Weidian (microshops platform) and Miao Street to carry out interactive marketing activities. These social media platforms serve different purposes. Weibo offers a channel for Yangsha to post information of marketing events, sales activities, hot topics, etc.; Wechat focuses on pushing marketing and sales information among WeChat's Moment or "circle of friends"; Miao Street app directly pushes notifications to customers; while Weidian supplements the other channels and strengthens the marketing impact by blasting product discounts information to shoppers.

(6) Enhancing convenience in shopping via online payment tools such as Alipay and Tenpay

Nowadays in China, mobile online payment has been increasingly popular. Along with growing varieties of payment platforms at different retail channels and formats, mobile online payment, to some extent, has replaced physical wallet to become the most common payment option. According to the CNNIC²⁶, as of December 2015, the number of mobile online payment users in China reached 358 million, with an annual growth rate of 64.5%, and the utilisation ratio of mobile online payment increased from 39.0% in 2014 to 57.7% in 2015. With the prevailing trend of mobile online payment, many department stores have already supported mobile payment tools in their physical stores. Based on our survey, 79.6% of the surveyed department store operators have introduced online payment tools at physical stores, among them, 86.0% accept Tenpay and 76.7% accept Alipay (Exhibit 27).

Exhibit 27. Existing mobile payment tools of sampled department store operators



Source: The survey with 61 department store operators by CCAGM and FBIC; compiled by FBIC

(7) Cross-border e-commerce becomes a new business opportunity for traditional department store operators

China's cross-border e-commerce development has captured considerable attention globally. Many foreign brands and retailers are selling their products via cross-border e-commerce platforms. At the same time, cross-border e-commerce is increasingly becoming a popular way for retailers to transform their business. An increasing number of department store operators which have suffered from slowing sales growth over recent years are actively tapping into cross-border e-commerce business.

Currently, most department store operators run the cross-border e-commerce business via two channels: either by establishing online cross-border shopping websites or by launching physical experiential stores which sell both duty-paid and bonded imported products. Duty-paid goods are goods imported to China under general trade procedures with value-added tax, consumption tax and import duties being paid. Customers can buy duty paid goods directly from the experiential stores and take them back home right away. Bonded imported goods, on the other hand, are goods that stocked in bonded warehouses in Free Trade Zones. The experiential stores display samples or photos of the imported products on shelves or walls, and customers can take the product card (usually with assigned barcode number) to the cashier to settle payment or they can scan the QR code to access the respective online platforms of the experiential stores to place order.

Guangzhou-based Mopark Department Store is one of the pioneers in launching cross-border e-commerce business of the department store sector. In April 2015, it opened a cross-border e-commerce experiential store in Guangzhou which mainly sells baby products, healthcare products, cosmetics and skincare products and personal care goods. In October 2015, the store was expanded from 400 sqm to 800 sqm, with SKU increased from 1,000 to 1,600. Since then, Mopark Department Store further added five more experiential stores in different branches. Exhibit 28 lists examples of selected department stores that have started cross-border e-commerce business.

Exhibit 28. Selected department stores that have started cross-border e-commerce business

Department Store	Started since	Location of the first cross-border e-commerce experiential store	Website
Mopark Department Store ²⁷	Apr-2015	Guangzhou	http://www.imopark.com
Better-Life Commercial Chain Share Co. ²⁸	Apr-2015	Hunan	http://www.yunhou.com/
Grandbuy Department Store ²⁹	May-2015	Guangzhou	http://www.gbhui.com
Intime Department Store ³⁰	Jun-2015	Hangzhou	https://westchoice.tmall.hk
Rainbow Department Store ³¹	Jul-2015	Shenzhen	http://www.tianhong.cn/ht/ht.html
Hunan Friendship and Apollo	Jul-2015	Hunan	http://www.tepin.hk/
Yihua Holdings Ltd. ³²	Aug-2015	Zhongshan	http://www.yihua888.com/
JiaHua Stores Holdings Ltd. ³³	Sep-2015	Shenzhen	http://go.szbjh.com/
Dalian Dashang Group Co. Ltd ³⁴	Sep-2015	Dalian	http://www.51tiangou.com/

Source: Various Internet sources, compiled by FBIC

4. Industry consolidation via merger and acquisitions activities

As a way out amid slowing growth, mergers and acquisitions (M&A) in the department store sector have been very active in recent years. A significant purchasing deal that shows the sector's eagerness to "go global" was Nanjing Xinjiekou Department Store's acquisition of British department store chain House of Fraser in 2014. Nanjing Xinjiekou is a subsidiary of San Power Group. In April 2014, Nanjing Xinjiekou bought an 89% stake in Highland Group Holdings Ltd., the owner of House of Fraser. The deal is expected to enhance Nanjing Xinjiekou's competencies as it can leverage on House of Fraser's operational model. The deal also enables Nanjing Xinjiekou to own and operate House of Fraser's unique brands in China³⁵. Exhibit 29 shows major M&A deals in China's department store sector from 2014 to 2015.

Exhibit 29. Major M&A deals in China's department store sector, 2014- 2015

Date	Bidder company	Target more in centre		
		Company Name	Sector	Origin
Apr-2014	Nanjing Xinjiekou Department Store	House of Fraser	Department Store	UK
May-2014	Better-Life Commercial Chain Share Co.	Nancheng Department Store	Department Store, supermarket, consumer electronics	China
Aug-2014	Beijing Cuiwei Tower Co., Ltd.	Beijing Modern Plaza; Beijing Ganjiakou Plaza	Department Store	China
Oct-2014	SanPower Group	Lashou.com	Group-buying website	China
Jan-2015	SanPower Group	Meici.com	Online shop	China
Aug-2015	SanPower Group	Brookstone	Online shop	USA
Oct-2015	Dalian Dashang Group	Xinjiang Youhao Group	Department Store	China
Nov-2015	Dalian Dashang Group	Shandong Weihai General Merchandise Mall Group Co., Ltd.	Department Store	China

Source: Various Internet sources, compiled by FBIC

5. Revamping the organisational structure and management system

(1) Optimising organisational management structure

In the “Internet plus” era, it is imperative for department store operators to create a flexible, streamlined organisational structure, and establish a reasonable and effective decision-making mechanism in order to adapt to the rapidly changing market. Like many other domestic department stores, Rainbow Department Store had adopted a vertical organisational structure in the past. It has now transformed into a flat-structured corporation by splitting the organisation into several smaller business units. As such, the retailer has adopted a “borderless” and horizontal management structure and has successfully reduced institutional barriers. It has also advocated the use of mobile devices as major means of internal communication to increase efficiency. Wangfujing Department Store is another case in point. In order to get rid of the bureaucratic inefficiencies, the company has introduced the partnership business structure and allowed top management to hold shares of the company.

(2) Segmenting and regionalising operations

In order to alleviate the impact of shrinking consumption on business performance, some department store operators have started to carry out in-depth adjustment of business strategies based on consumption characteristics of different business districts and regions. Wangfujing Department Store, for instance, has implemented a “one shop, one policy” initiative across its branches throughout the country, so as to make sure that needs that are unique to the particular region or area are met. The company has delegated a director who have full autonomy to make business decisions for each store in accordance to the characteristics and consumption habits as well as competitive landscape in that particular business district.

III. Major problems and challenges, and recommendations

1. Problems and challenges

(1) Strategic directions to transform and upgrade are obscured

Despite heavy investments and efforts being made in the transformation and upgrade of business operations over recent years, not many department store operators have obtained satisfactory results thus far. For some department store operators, their understanding of O2O strategies, upgrade of retail formats and enrichment of customer experience are biased and incomplete. Some have put overwhelming emphasis on hardware upgrade, but have neglected the needs to enhance software and merchandise mix simultaneously. As a result, only store facilities are improved but the stores still failed to increase sales.

Moreover, in terms of implementation of O2O strategies, many department store operators have still been lingering on the conceptual level. Their ability to achieve a full integration of O2O channels, to practically meet the needs of consumers on O2O platforms, and to utilise the big data in understanding customers' shopping preferences remain weak and unsustainable. Some department store operators also face a number of other challenges including financial constraints, lack of online operating experience and limited logistics support.

(2) Institutional limitations

The institutional nature of China's department store sector could be a drawback in today's fast-changing retail market. The department store sector in China is dominated by state-owned enterprises. Among the 72 publicly-listed retail enterprises, 38 are state-owned enterprises, accounting for 53% of the total. These state-owned enterprises usually respond and react slowly to the changes in the market.

(3) Talent gap and shortages restrict business transformation

Lack of experienced in-house buyers has long been an issue faced by China's department store operators, which has made their strategies to enlarge the proportion of private labels and direct sales merchandise hard to realise. A typical example is the apparel merchandise sector where experience buyers not only need to have an in-depth knowledge of fabrics and upcoming fashion trends but also need good negotiation skills to deal with brand owners and distributors. Usually it takes at least three years to nurture a junior buyer and around eight years to train a merchandise manager. Besides, the lack of talents who are experienced and knowledgeable in cross-retail formats operations and with expertise in O2O integration has hindered the progress of transformation. Meanwhile, department stores are also facing the pressure of losing senior management personnel and the high turnover rate of frontline sales staff.

(4) External challenges

Nowadays in China, consumers become more conservative in their spending, and increasingly look for value for money due to the economic uncertainty. The overwhelmingly popular fast fashion brands

such as Zara, Uniqlo and Muji have gained enormous success in the domestic retail market with strong development momentum. They have very mature supply chains and react extremely fast to the market and trends. Compared to them, department stores are still in the early stages of exploration. For department store operators, the journey to develop and grow the merchandise direct sales model and private labels business are not easy.

2. Recommendations

(1) Government's efforts

The retail industry is currently in a critical period of reinvention and transformation. The government can help to stimulate the process and encourage the upgrade of enterprises in the following aspects:

- **Streamline regulatory procedures** – streamline procedures and regulations in store openings and projects expansion; lower the threshold for licensing of new operation and marketing activities; improve processing efficiency for license approval, eliminate unreasonable regulations, and provide a more favorable business environment for the department store sector;
- **Fiscal and policy support** – consider rolling out policies to ease the tax burden of department store operators, and to consolidate resources to develop public digital infrastructure so as to encourage full O2O integration of enterprises;
- **Create a fair business environment** – ensure both physical entities and online operations are governed by unified policies and regulations; give out tax refund or subsidies to department store operators who have developed e-commerce businesses.

(2) Department Store operator's efforts

Department store operators should lay out overarching goals and review their business direction, explore new business and investment opportunities, strengthen and consolidate their merchandise and brand portfolio, take immediate actions against underperforming or loss-making stores and exercise stringent cost control. In short, they should:

- **Improve service standard** – department store operators should enhance their services by adding more humanised and personalised services such as private shopping guide service, product customisation, product storage and delivery service, etc. to entice repeated visits and increase customers' loyalty.
- **Speed up institutional innovation** – State-owned retail enterprises should boldly introduce market-oriented institutional mechanisms; introduce strategic investors and mixed ownership and other means to optimise management efficiency.
- **Carry out segmentation strategies to cater different groups of customers** – to differentiate themselves from the highly homogenous market, department store operators should carefully determine their target customer groups; segmentise their business and market position, and define relevant business strategies to different segments of customer groups.

IV. Outlook

China's department store sector is not expected to recover in the short term as we expect to see some downward corrections in the economy as well as the retail market in 2016. However, against the backdrop of increasing disposable incomes, rapid urbanisation and rising living standards, together with the government's continual supportive measures and positive policy stance towards the development of retail sector in the 13th Five-Year Plan (FYP), China's department store sector is set to enjoy sustainable growth in the longer term.

1. Retail environment

(1) 13th FYP will bring positive effects to domestic consumer market

The National People's Congress endorsed China's 13th Five-Year-Plan (FYP) for 2016-2020 in March 2016. A lot of important policy instruments to boost domestic consumption are mentioned in the 13th FYP. The plan put forward that by 2020, per capita income of both urban and rural residents will be doubled that of 2010. The rapid growth of disposable income will boost consumption demand and encourage consumer spending.

Another highlight of the 13th FYP is the liberalisation of the "two-child policy", which put the decades-long "one-child policy" to an end and allow two children for per couple. An increase in the number of children could have a positive impact on the consumption of products and services catering towards child rearing. The two-child policy will also lead to more spending on the second child, and thus contribute to economic growth.

Furthermore, the 13th FYP reiterates to lift more than 70 million rural residents out of poverty by 2020. By then, the consumption power of these populations would be tremendous. Meanwhile, the reform of the household registration ('hukou') system is another major focus. China currently has 280 million migrant workers from the rural areas. If they can obtain an urban 'hukou' and enjoy all urban basic public services, their spending power will increase significantly.

(2) New millennials will be the driver of consumption growth

At the same time, the millennials will become the main driver of consumption growth, as they have huge consumption intention with their wealth accumulated and inherited from their previous generations. With this massive and powerful consumer group, the Chinese consumer market will enjoy 14.9 trillion yuan incremental growth, which would be about 1.3 times larger than that of the current consumer market size of Germany or the U.K., according to a study by Boston Consulting Group and AliResearch Institute³⁶.

(3) Physical stores cannot be replaced by online retailers

In view of the persistent trend of retail store closures and the continual erosion of market share by e-commerce players, there has been widespread concern about the demise of brick-and-mortar stores. In reality, physical stores are far from vanishing, and there are some solid reasons –

First, for most consumers, visiting physical stores is essential during their shopping journey. Not only can they touch and feel the product but they can also enjoy customer service and multisensory experience which entice them to visit the stores again. A study by PricewaterhouseCoopers found that 86% of consumers would go to the store to see the products even though they may not necessarily make a purchase³⁷.

Second, despite the strong growth of e-commerce, many experts believe that online sales will not exceed 50% of total retail sales. The growth online retail sales has shown signs of slowing down. According to the NBS, total online retail sales in 2015 reached 3,877.3 billion yuan, an increase of 33.3% over the previous year; online retail transaction volume in 2015 was equivalent to 12.9% of total retail sales. iResearch predicts that by 2018, the proportion of total online retail transactions will account for 20% of total retail sales. Physical retailing will still dominate the retail industry.

Third, the competitive edge of e-commerce, namely low price, robust merchandise mix and fast delivery, can only be manifested in top-tier cities. For lower-tier cities, due to the complex topography and huge logistics and distribution costs, the advantages of physical retailers are more pronounced.

2. Development trends of department store sector

(1) Back to basics of retail: pursuit of the right merchandise mix and high quality customer service

The essence of retailing is all about providing desirable goods and service mix to a specific target market. To succeed in today's highly competitive marketplace, department store operators need to adhere to the principle of "putting the customer first" and take into account consumers' rapidly evolving shopping preferences. The right proportion of catering, shopping and entertainment facilities, as well as superior customer service to attract consumers and encourage repeat visits are important elements for success.

(2) Adoption of hybrid concessionary and merchandise direct sales models

At present, many Chinese department store operators are actively exploring merchandise direct sales and collaboration opportunities with upstream suppliers; however, lack of talent, financial pressure and other external challenges remain some major concerns for operators to carry out the transformation. Thus, most department store operators would likely adopt a hybrid model of concessionary and merchandise direct sales. This hybrid model will continue to become mainstream in the department store sector.

(3) Embracing the Internet; capturing the big data; creating an intelligent business

E-commerce, mobile Internet, and O2O are imposing ever more profound impacts on consumers and retailers. To respond effectively to today's new business dynamics, department store operators should embrace new technologies. For instance, the appropriate use of big data allows operators to spot trends and better adapt to consumers' changing needs and preferences. The key is to have in place an advanced information technology system that can access and share customer information across all channels. The department store sector should move along the track of agile and intelligent business operations with digital innovation to provide consumers with more diversified shopping options.

(4) Engaging in multi-format operation to achieve operation synergies

As consumers nowadays are becoming more discerning and looking for better shopping experience, department store operators which still operate in a traditional and single format manner will fail to meet their needs. On the contrary, department store operators which diversify their retail business by operating multiple formats have a higher chance to succeed.

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About the Organizations

CHINA COMMERCE ASSOCIATION FOR GENERAL MERCHANDISE

Founded in January 1990, China Commerce Association for General Merchandise (CCAGM) is a non-profit social organisation endorsed by the Ministry of Civil Affairs, under the guidance of the Stated-owned Supervision Administration Commission and the Ministry of Commerce. The CCAGM has nearly 800 members, encompassing large-and medium-sized domestic department stores, enterprises engaging in retail, wholesale, and manufacture of daily industrial products, and enterprises which provide related services to the department store industry. Its members come from 31 provinces, autonomous regions and municipalities in the country, covering all forms of ownerships. The CCAGM has 60 corporate members, including City Department Store Industry Association, Trade Association and Trans-regional Department Store Company Union Organisation, linking more than 15,000 indirect members.

After 20 years of growth and development, the CCAGM has completed the transformation of its work model from one that was influenced by the planned economy to one influenced by socialist marketing economy. In 2009, the CCAGM was appraised as a 4A social organisation by the Ministry of Civil Affairs.

THE FUNG GROUP

The Fung Group is a privately held multinational group of companies headquartered in Hong Kong whose core businesses are trading, logistics, distribution and retailing. The Fung Group employs over 46,800 people across 40 economies worldwide, generating total revenue of more than US\$24.65 billion as of December 2014. Fung Holdings (1937) Limited, a privately held business entity headquartered in Hong Kong, is the major shareholder of the Fung group of companies.

FUNG BUSINESS INTELLIGENCE CENTRE

The Fung Business Intelligence Centre (FBIC) collects and analyses market data on sourcing, supply chains, distribution and retail. It also provides thought leadership on technology and other key issues shaping their future.

Headquartered in Hong Kong, FBIC leverages unique relationships and information networks to track and report on trends and developments in China and other Asian countries. In addition, its New York-based Global Retail & Technology research team follows broader retail and technology trends, specialising in how they intersect and building collaborative knowledge communities around the revolution occurring worldwide at the retail interface.

Since its establishment in 2000, the FBIC (formerly known as the Li & Fung Research Centre) has served as the knowledge bank and think tank for the Fung Group. Through regular research reports and other publications, it makes its market data, impartial analysis and expertise available to businesses, scholars and governments around the world. It also provides advice and consultancy services to colleagues and business partners of the Fung Group on issues related to doing business in China, ranging from market entry and company structure to tax, licensing and other regulatory matters.