Distribution in China

I. Distribution Channels

The liberalization of China's distribution sector in the last years has opened a new vista of choices to foreign companies looking to move and sell their goods in the country. No longer are they required to use an uncoordinated network of domestic wholesalers, although some may choose to retain existing ties if these have worked well. Instead they may consider using one of a growing body of international and Hong Kong-based logistics businesses moving goods around and in and out of the country, or perhaps one of the many new domestic distributors which have emerged in recent years, or possibly decide to go it alone.

The last option can be expensive—and time will certainly be required to build up an extensive, reliable system—but gives better control over the distribution of goods. Obviously this is easier if a company's markets are restricted to a small number of locations, but companies which are big enough can go far beyond this over time.

Foreign-invested manufacturers are officially allowed to engage in distribution under guidelines issued by the Ministry of Commerce (MOFCOM) in April 2005, either on their own behalf or through a foreign-invested commercial enterprise set up to handle such tasks. Although the administrative process involved in redefining an existing business scope may take much longer than that required for establishing a stand-alone distribution company, both options have become easier since approval rights for FICEs were transferred to provincial authorities at the end of 2005.

Another reason for companies to rethink their distribution channels is the rate of change in the market itself. In the fast-moving consumer goods sector, the spread of hypermarkets and chain store operations throughout China offers foreign manufacturers and their agents new convenient distribution channels and test-marketing platforms for their goods (though simultaneously creating a new set of problems, particularly in the area of credit risk).

Under China's previous wholesale system of distribution, the supply network was controlled by city- and township-level commercial bureaus. The customer or retailer has little influence on the choice of goods and when and how these are distributed. As market reform deepens, wholesale and retail operators proliferate and compete for customer attention. The rise of supermarkets and hypermarkets with their high-volume ordering has forced radical changes on the old distribution system.

Foreign Agents and Distributors

Until the liberalization of the commercial sector in 2004, foreign distribution companies could not obtain national wholesale licenses. However, a few firms managed to get local licenses for a variety of services. These services ranged from the co-ordination of goods—which passed through Chinese foreign trade corporations (FTCs)—to distribution, whereby they took title to goods on behalf of a foreign company and sold them into China. This still works for companies without a manufacturing base on the mainland, as it enables them to turn their goods over to Hong Kong traders who will arrange for import, deal with myriad wholesalers in China, and handle all promotion and marketing. But this approach has two major problems. One is expense: foreign traders typically take a margin of 30-40%—cheap if the goal is to avoid headaches, but certainly not the lowest rate available. Some multinationals have concluded that they can do the job more cheaply themselves. The other is control: many manufacturers believe it is worth putting up with the hassles of distributing their own goods just to stay abreast of the market. Most manufacturers, however, still prefer to outsource their distribution needs.

Wholesale Markets

Wholesale markets mushroomed during the 1980s-90s, plugging a major gap in China's traditional distribution system. They can be found in or near every city (major cities, including Beijing, can boast more than ten wholesale markets), but they are often in out-of-the-way locations.

Managed by the appropriate local administration of industry and commerce, many are held outside. Goods from these markets can be found on store shelves in almost every city in the country. The markets provide a highly effective conduit for getting goods to rural towns and villages. Although the markets look disorganized, their turnover rates are believed to be impressive. With an estimated 70,000-90,000 specialized and wholesale markets in the country; trade volumes are estimated to be well over Rmb1 trillion. Most of these markets are small and localized: a report issued in early 2005 put the number with an annual turnover of more than Rmb100m (US$12.5m) at just 1,760.

Many of the larger markets are located in Shandong, Zhejiang, Jiangsu, Guangdong, Liaoning and Hebei provinces. Various plans have been announced to reform the markets and make them part of a more conventional wholesale structure.

Domestic Distributors

In the pre-economic reform era, Chinese distributors were typically state-owned and specialized in the products they carried. Rationed goods, such as grain, oil, sugar, cigarettes and liquor, were distributed through local monopolies. In many cases the distributors operated both wholesale and retail operations, taking goods from producers at their warehouses and then selling them to consumers at their own retail outlets.

In the mid-1990s these state monopolies began to spin off distribution subsidiaries. At the same time, private companies sprung up to handle business from the increasingly dynamic manufacturing sector. Today, local distributors consist of city-specific monopolies, state-owned autonomous companies spun off from state monopolies, and private companies.

A new breed of domestic distributors has emerged to cater specifically to the fast growing and demanding electronics components sector. More nimble than their traditional counterparts, these Chinese distributors are confronting foreign competitors head on and are not shy to copy the tools of their foreign rivals, such as acquiring franchised lines, design services and automated supply-chain management systems.

Domestic wholesalers are generally weak in the following areas:

- Finance
- Warehousing and transport
- Market widespread presence

Retail Distributors

China's total retail sales volume has grown rapidly over the last decade and a half—from around Rmb 940 billion (US$118 bn) in the early 1990s to Rmb 6.72 trillion (US$840bn) in 2005. In the wake of such dramatic growth, the retail environment was radically transformed—from state-owned stores and provision shops to hypermarkets and 24-hour convenience stores. The retail sector is still undergoing rapid change, with many chain stores expanding their presence more quickly than their revenue growth would appear to justify.

The emergence of chain stores and other modern retailers, however, has eased the task of coordinating distribution for manufacturers in certain fields, such as fast-moving consumer goods (FMCG). In China's leading cities, foreign store operators are becoming an increasingly important force, particularly for

FMCG sales. If we look at some of the (15) 1st and 2nd cities (Beijing, Shanghai, Guangzhou, Shenzhen, Chengdu, Dalian, Shenyang, Tianjian, Ji'nan, Qingdao, Nanjing, Hangzhou, Wuhan, Chongqing and Xi'an), we find that 11 retailers account for 24% of all FMCG sales. The top retail chain is Carrefour of France, with 5% of the sales.

Overall, however, the vast majority of retail outlets are still individually owned mom-and-pop shops or kiosks, a blessing and a curse for foreign investors who must use them to reach cities in China's vast interior. This is unlikely to change as unemployment prompts increasing numbers of urban dwellers to set up their own businesses.

Modern trade—particularly larger supermarkets and chain stores—is slowly forcing some smaller concerns to merge or go bust. The government, keen for a leaner and meaner retail industry, tacitly approves of this process of attrition—hoping for the emergence of a small group of truly national players with the potential to launch international operations. The government also approves of the rapid expansion of modern trade as an affordable means of extending modern retailing into the rural markets. In terms of both outlets and turnover, however, small stores still dominate China's retail landscape.

The most common retail structures are:

- **Mom and pop kiosks.** Small, individually owned stores are by far the most prevalent type of retail outlet in China. The National Bureau of Statistics recorded 39.2 million units (individual registrations) in 2004, of which 41% were engaged in retailing. Others were in construction, sanitation, restaurants, health care, medical and other professional services. These stores are typically small, with shop space of 10 sq metres or less. Most sell snacks, fruits and drinks and a smattering of personal care or household items, such as soap, shampoo and detergent. The outlets are difficult to reach uniformly given their sheer numbers.

  Manufacturers concentrating on the rural market generally supply village through the wholesale-market network; while urban ones can be reached not only through wholesale markets, but also through hypermarkets and traditional distributors.

  With these stores there are hardly any accounts receivables to manage. This because the owners pay for their goods in cash while foreign-invested convenience stores tend to buy on short-term credit—up to a month—while supermarkets and hypermarkets take longer to pay.

- **Supermarkets.** After increasing rapidly in number, from almost none at the start of the 1990s to more than 60,000, supermarkets are now a common feature of China's urban landscape. This ultra-fast growth, however, has created problems. Consolidation is the trend, with both domestic and foreign operators scaling back operations or completely withdrawing from the market. Domestic operators have begun to make their stores larger and expand their range of offerings, moving toward the standard brought in by foreign-invested chains in the mid-1990s. To help modernise their operations, local firms have also engaged in several co-operative deals with foreign companies.

  In a positive development for manufacturers, China's supermarket chains are beginning to centralise their purchasing rather than leave it to individual stores. Most chains tend to deal with local distributors only, though they do buy from some of the larger JV manufacturers. Manufacturers or their distributors may still have to offer additional payment to ensure prominent display for their products. Accounts receivables can be a problem among domestic chains, which generally expect credit from distributors and wholesalers. Supermarkets usually make payment within 60-90 days, but have grown tardy in the past few years, largely due to greatly increased competition and the pressure this has had on margins.

- **Convenience stores.** Convenience-store (C-store) chains have had mixed success in China. Several locally owned C-stores dominate Shanghai, while one foreign operator controls Guangzhou and none have significant operations in Beijing. Leading players are looking to extend beyond their home cities and are likely to acquire weaker local operators.

Most urban dwellers in China still rely on small mom-and-pop stores for convenience staples, including cigarettes and beverages, but in the high-income cities—such as Shanghai and Guangzhou—chain stores offer an attractive option.

In Shanghai fast-expanding local and Japanese chains controlling the sector. However, in Guangzhou and Shenzhen, the sector is dominated by 7-Eleven, with its franchise managed by HongKong-based DairyFarm International, which is part of the Jardine Matheson Group. As of October 2006, Dairy Farm operates 270 7-Eleven stores in Guangdong.

Despite less than impressive results, international retailers are still enthusiastic about China's C-store market. Lawson Inc, Japan's second-largest convenience store operator, has increased its stores in Shanghai to a total of more than 280, while 7-Eleven Japan, an arm of Japanese retail giant Seven & I, has opened some 30 7-Eleven stores in Beijing since forming a joint venture with Beijing Shoulian Commercial Group and China National Sugar & Alcohol Group in 2004.

- **Hypermarkets.** Full-service hypermarkets—featuring a store size of 2,500 sq metres or above and carrying at least 5,000 stock-keeping units—are leading a revolution in China's retailing sector. Consumers are responding enthusiastically to the hypermarkets' wide range of products, clean and pleasant shopping environment, and affordable prices. In a single trip, consumers can purchase clothing, electronics, kitchenware, as well as a wide range of fresh and packaged foodstuffs.

The hypermarket sector is dominated by foreign players. However, domestic companies in Guangzhou have produced a response to this model: warehouse stores. The stores copy some of the simpler hypermarket features—large inventory and low prices—while boasting larger floor plans and Spartan decor that allow them to cut prices even further. They offer more items and more convenient locations than the hypermarkets.

While the warehouse sector is largely the domain of domestic operators, foreign-invested chains are breaking in. Carrefour, which entered China in 1995, is the largest foreign retailer in China, with retail sales totaling some US$2.2 billion in 2005. In July 2004, Carrefour announced plans to open 650 stores in China, including 50 Champion outlets in the next three years and 600 hard-discount stores by the end of 2006. While it looks unlikely to reach this target, it still had more than 80 hypermarkets plus nearly250 discount stores opened as of October 2006. Wal-Mart's sales revenues in 2005 were about half Carrefour's. As of October 2006, it operated 66 stores in 34 Chinese cities, employing about 36,000 people, but was reported to be planning to buy the Sino-Taiwanese Trust-Mart chain, comprising around 100 stores in 20 cities, for US$1bn.

In varying degrees, hypermarkets in China are trying to act both as bulk retailers serving individual consumers and as cash-and-carry wholesalers serving the kiosk and mom-and-pop-store market. Hypermarkets depend on highly sophisticated inventory-management techniques to facilitate marketing. Some, such as Makro, Haoyouduo and Wal-Mart's "Sam's Club", use a membership-card system to create massive customer databases which track individual purchase patterns used for highly targeted direct-mail promotions. However, these stores have failed to gain traction in a market where consumers appear unwilling to pay for membership.

- **Department stores.** In China a department store can mean a store of any size that sells general non-food merchandise. Many self-styled department stores are simply one-storey, storefront operations with a few hundred square metres of floor space. Most cities, however, have several multi-storey department stores selling a full range of goods. Large cities, such as Beijing, Shanghai or Nanjing—and many medium-sized ones—have far more large department stores than their market can support, thanks to over-expansion in recent years.

They generally track variable costs, but not fixed costs or the cost of inventory. Overstaffing is rife. Cashier counters are separate from merchandise counters, requiring the purchaser to make a round-trip to pay for and then collect merchandise. Space is often rented out to producers in "sell-through" arrangements, giving many stores a bazaar-like atmosphere, with representatives of different manufacturers competing for shoppers' attention.

Many traditional department stores are losing out to modern trade methods. While Chinese department stores can match large foreign retail businesses in decoration, structure and shopping environment, they lack good management methods and new ideas. While the department stores are able to hold on to their high-end customers looking to buy luxury products in a comfortable shopping environment, they are rapidly losing the bulk of their clientele—younger middle-income consumers—to the more fashionably stocked and better organized foreign-managed shopping malls and luxury stores.

II. Distribution and Agency Contracts

Key PRC laws applicable to distribution and agency contracts:

- Contract Law of the People's Republic of China, effective as of 1st October 1999
- General Principles of the Civil Law of the People's Republic of China, effective as of 1st January, 1987.

It is important to appreciate the legal and practical differences between distribution arrangements and agency arrangements. As in most other countries, distribution involves the sale of goods by the foreign company to the local PRC entity which will then resell such goods on its own account, not as agent for the foreign company, to PRC consumers directly or indirectly via retailers or other middlemen. The local PRC entity sells the goods at a higher price than that which it pays to the foreign company and thus generates gross profit. By contrast, agency involves the appointment by the foreign company of the local PRC entity as its agent to sell the goods, not on its own account, but as agent for and on behalf of its principal, the foreign company. Any contract of sale to a PRC consumer, retailer or other middleman thus binds the foreign company directly. The local PRC entity earns commissions from the foreign company instead of generating gross profit on re-sales.

Distribution contracts are probably more common than agency contracts and are certainly more appropriate when a foreign company does not wish to establish an agency relationship with a local PRC entity, i.e. give such entity express authority to enter into contracts on its behalf. Such agency relationships often require detailed and specific instructions from principal to agent. If such instructions need to be modified, PRC law provides that the agent must first obtain the principal's consent, except in the case of an emergency when it is difficult to establish contact with the principal. A foreign company unwilling to entrust this level of responsibility to a local PRC agent may instead prefer to appoint the local PRC entity as its distributor.

Unlike a supplier-distributor relationship, an agency agreement governed by PRC law creates a specific relationship between principal and agent. Such relationship is governed by Chapter 21 of the Contract Law of the People's Republic of China, adopted on 15th March 1999.

As is the case with distribution contracts, the purpose of appointing a local PRC entity as agent is to enable a foreign company to promote and distribute its products in China. An agency arrangement may be appropriate where the foreign company and the local PRC entity already have a close working relationship and both parties are satisfied with their level of communication. For example, under an agency contract, the principal may give the agent certain instructions. It is important that such instructions are stated in the clearest possible way and that there is no doubt regarding the scope of the agent's authority and responsibilities.

Chapter 21 of the Contract Law requires that the principal gives its consent before the agent delegates or entrusts any of its functions to any third party. This emphasizes the close nature of the relationship between the principal and agent under PRC law.

Key Provisions of the Distribution Contract

Set out below is an examination of some of the key issues to be considered by both parties when negotiating the terms of a distribution agreement.

(a) Governing Law

Although a distribution contract will allow and require a local PRC entity to promote and distribute the foreign company's products to PRC consumers, the contract need not be governed by PRC law and the parties are free, in the course of their negotiations, to agree on foreign law to govern the contract. A foreign company not having any other connection with the PRC may naturally prefer that the law of its home jurisdiction be the governing law of the contract. By contrast, if the foreign company has a PRC subsidiary serving as manufacturer and supplier of the products, it is highly likely that PRC law will govern the contract.

(b) Regulatory Approvals

Regardless of the governing law, the foreign company may need to secure certain approvals from the relevant PRC authorities before its products can be legally advertised or distributed in the PRC. Exactly which approvals are necessary depends on the products involved. Such issues should be addressed in the distribution contract and appropriate legal advice may be required. As an example, a foreign company exporting pharmaceuticals to the PRC would be affected by the newly enacted Drugs Administration Law. The foreign company would need to obtain an Imported Drug Registration Certificate issued by the State Drug Supervision and Administration Bureau in the PRC. The foreign company would also need to secure certain advertising approvals and the local PRC entity should be prepared to provide all necessary assistance for such purpose.

(c) Exclusivity

The issue of exclusivity should also be considered. Local PRC entities will wish to be appointed as sole and exclusive distributors to prevent competition. The foreign company should consider this issue very carefully – it may be extremely reluctant to grant exclusivity to a local PRC entity which is relatively unknown to it or does not have a convincing track record. One possible solution is to make exclusivity conditional on the local PRC entity consistently meeting or exceeding agreed sales targets; this would be preferable to reliance on a general obligation to use best endeavours to promote and distribute the products. If the distributor fails to meet such targets, it may continue to be a distributor, but on a non-exclusive basis, thus leaving the foreign company free to appoint other distributors on a non-exclusive basis. Alternatively, failure to meet the agreed target could constitute grounds for termination of the agreement in its entirety.

(d) Distributor's Obligations

It is standard practice to include the obligations assumed by the distributor in terms of market development, advertising and promotion and other matters. These sections address such issues, but are by no means exhaustive – in particular cases, further provisions may need to be added. A particular concern for foreign companies is to ensure that no competing products are marketed by their PRC distributors. Foreign companies invariably exercise complete control over the advertising and promotional materials used by local PRC entities to ensure consistency with the foreign company's standards.

(e) Proprietary Rights

Almost every distribution arrangement will involve products embodying intellectual property rights of one kind or another and promotion under particular brand names.
The difficulties encountered by some foreign companies in protecting their proprietary rights in the PRC are well known. However, it is essential that any distribution agreement address this subject.

(f) Term, Duration and Termination

The parties must decide whether or not the local PRC entity's appointment as distributor will be for a fixed term or open-ended (subject to termination by an agreed minimum period of notice). Where the distributor is granted exclusivity, it may not be in the best interests of the foreign company to make the appointment for a fixed term, unless it has the power to bring the agreement to an end before expiry of the fixed term due to a breach on the part of the distributor.

The circumstances in which either party will have the right to terminate the distribution agreement prior to the expiry of the fixed term should be clearly stated and the consequences of termination stated. Typical provisions include the parties' right to settle accounts, the foreign company's option to cancel shipments of products and distributor's obligation return or destroy all advertising and promotional materials while ceasing to represent itself as a distributor of the foreign company's products. It is also common for the distributor to be permitted to sell any remaining stocks of products, unless the foreign company agrees to repurchase the same.

Key Provisions of the Agency Contract

Set out below is an examination of some of the key issues to be considered by both parties when negotiating the terms of an agency agreement.

(a) Exclusivity

As in the case of distribution agreements, the question of sole and exclusive agency rights must be considered. The contract sample included at the end of this chapter assumes that the local PRC entity will enjoy exclusivity in a particular geographical area. The greater the precision with which an area can be defined or described the greater the likelihood of avoiding disputes at a later date. Sometimes a map will be appended to a distribution or agency agreement where the written description lacks precision. As is the case with distribution agreements, exclusive agency rights could be linked to achieving or exceeding agreed sales targets in a given period of time. It may be agreed that the local PRC entity will have exclusive rights in Shanghai only for instance and non-exclusive rights in the remainder of the PRC.

(b) Duties of Principal

Typically, the foreign party agrees to certain obligations such as providing written and other information to enable the local PRC entity to promote and sell the products, performing contracts with third parties entered into by its local PRC agent and dealing with enquiries relating to the products.

(c) Intellectual Property

As with distribution arrangements, the foreign company may wish to include provisions designed to protect its intellectual property rights relating to the products in question. In this agreement, the local PRC entity acknowledges that it will have no proprietary rights in respect of any intellectual property.

(d) Commission

Unlike a distribution arrangement in which the local PRC entity makes a profit on the resale of the relevant products, the PRC entity, as an agent, will be entitled to receive commissions from the foreign company depending on actual sales of products to third parties for and on behalf of the foreign company. These sections describe the mechanism to be followed in making such payments. Detailed percentages or fixed amounts can be set out in a separate schedule. A local PRC entity might also propose an entitlement to interest in the event of any delay in the payment of commissions.