

China's Distribution Service Market Entering Phase of Full-Scale Opening

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Entering its third year as a member of the World Trade Organization (WTO), China's distribution service industry has embarked upon the most crucial stage of market opening. While timing and specific opening measures differ depending on individual business categories, markets in most business categories are scheduled to be opened on a phased basis three to five years after China joined the WTO. China's gigantic market is certain to begin opening mainly in the coastal areas, which have a population of nearly 500 million.

Ahead of other service industries, plans call for the removal of almost all regulations in the distribution industry by the end of 2004. Regulations concerning the deployment of chain franchise systems and commercial trade (exports and imports) as well as limitations on foreign capital investment, areas, and volume (number of companies and outlets) will be abolished, thereby establishing a fair and competitive environment.

Success in participating in the Chinese market requires a full understanding of specific situations, and thorough preparations must be made. In particular, it is vitally important to explicitly exhibit the "basic stance of contributing to the development of China's economy." Detailed participation strategies should also be developed and implemented with the greatest possible care. Issues such as "cooperating with the Central People's Government and local participating governments," "the format of participation and the selection of partners," and "understanding and following accepted commercial practices of individual business categories" are especially important.

I Current Status and Attractiveness of China's Distribution Service Market

On January 11 through 14, 2004, a general meeting of the National Retail Federation of the United States was held in New York. As many as four out of eight major themes concerned global retailing. While the distribution industry continued to be thought of as a domestic industry to date, this year's general meeting symbolically indicated that new trends had clearly begun.

A major trigger that has accelerated these trends is, as expected, China. At this year's general meeting of the National Retail Federation, top executives of the world's largest retail companies made comments one after the other that suggest substantially different approaches with respect to globalization from those in the past, especially in terms of their focus on China. In particular, the remarks of Lee Scott, Chairman of Wal-Mart Stores, the world's largest retail company, attracted a great deal of attention from participants. In a straightforward manner, he noted the aggressive deployment of stores for the growing market in China by discussing its competitive stance against France's Carrefour.

"The Chinese market is exciting. Not to speak of rapid market growth, they have the world's best understanding of the way Wal-Mart does business and are trying to incorporate the same method. Since most government regulations have been or are being eliminated, this year we plan to rapidly expand our operations." As these remarks came from Chairman Scott who usually takes a steady approach in doing almost anything, we can also assume that the company intends to engage in active operations.

This chapter discusses the current status and attractiveness of China's distribution service market, which

has just entered the core stage of opening, and on which the world's distribution service companies are setting their sights.


1 Market Opening Entering the Core Stage

More than two years have passed since China became a formal member of the World Trade Organization (WTO) in December 2001. This year marks the third year of the phased market opening in the distribution service field, which previously had an extremely closed environment. As this year also marks the target year of the government's public commitment, the opening of this huge market will become a reality in many parts of the distribution service industry.

According to the WTO Protocol on the Accession of the People's Republic of China, the targeted business categories extend to a variety of areas. These include distribution (wholesaling, retailing, franchising, commission agent services, etc.); trade; finance (banks, insurance, securities, etc.); telecommunications and information processing; businesses related to legal affairs, taxation, and accounting; businesses related to medical services, beauty, and education; and traveling, engineering, research, and consulting businesses. While specific measures and timing for opening differ depending on individual business categories, the schedule for opening has been prepared on a phased basis such as within three years and within five years. In the distribution industry, ahead of other service industries, almost all restrictions are scheduled for gradual elimination by the end of 2004.

Table 1 summarizes the important points of the WTO Protocol on the Accession of the People's Republic of China concerning operations involving distribution, wholesaling, and trade. With the exception of some regulations, plans call for the implementation of market opening in most fields of the distribution industry within three years after China's joining the WTO.

Table 1. Major Points of "Distribution," "Wholesale" and "Trade" Market Opening through Joining the WTO

		Retail Industry	Wholesale Industry
December 2001	Immediately after joining the WTO	• Enabling provision of related services such as follow-up service after sale	
	Within one year after joining the WTO		• Permitting joint venture firms meeting prescribed conditions to engage in wholesaling of imported and domestic products
December 2003	Within two years after joining the WTO	• Opening all provincial cities • Allowing majority investment by foreign-capital companies • Relaxing volume restrictions (number of companies and outlets)	• Allowing majority investment by foreign-capital companies • Relaxing volume restrictions
Present 	Within three years after joining the WTO	• Planning to abolish "volume restrictions," "regional restrictions (limiting or specifying sales areas)" and "investment restrictions (limiting the investment ratio of foreign capital)"	• Planning to abolish "volume restrictions," "regional restrictions (limiting or specifying sales areas)" and "investment restrictions (limiting the investment ratio of foreign capital)"
		• Planning to abolish all restrictions within three years concerning wholesale and retail businesses that are not related to franchises and outlets	
December 2004		• Planning to grant trading rights to companies meeting prescribed conditions	

Note: Compiled based on the WTO (World Trade Organization) Protocol on the Accession of the People's Republic of China.

A change of major significance is the elimination of regulations concerning franchise systems. In the past, the format of collecting royalties in an evolution of chains under a franchise system had strong connotations of a structure of exploitation under capitalism and was thought of in an extremely negative way in China under socialism. Accordingly, the implementation of franchise businesses by means of foreign capital was strictly restricted under the Law of Trial Operations for Foreign Investors to Invest in Commercial Enterprises (distributed on June 25, 1999), and stringent examinations were imposed at the time of granting approval.

However, with the enforcement of the Regulations on Administration of Technology Export & Import on January 1, 2002, the need for approval by the Central People's Government was nearly eliminated with respect to the establishment of royalty rates, etc. (Table 2). This move enabled freely setting licensing periods and the extent of confidentiality as agreed upon by both parties. Through this deregulation, regulations concern-

ing the evolution of franchise businesses are planned for repeal by the end of 2004. Accordingly, most of the environment for deploying chains under a franchise system will finally be established in China this year.

The granting of trading rights (export and import management rights) will also be an extremely significant step forward. Although trading rights were never granted to foreign-capital distribution companies (trading firms, wholesale and retail companies, etc.) that entered China in the past except for special cases, China's accession into the WTO opened a way to grant trading rights to foreign-capital distribution companies within three years. This is an epoch-making event for the Chinese government, which will markedly increase the possibilities and opportunities for business expansion by foreign-capital distribution companies.

However, one condition for acquiring these rights is to actually participate in the Chinese market and to conduct export and import transactions through a Chinese trading firm. Therefore, many European and US companies

Table 2. Changes in Regulations Concerning Licensing Contracts

	[Old] Regulations on Administration of Technology Introduction Contract	[New] Regulations on Administration of Technology Export & Import	
History	<ul style="list-style-type: none"> • May 24, 1985 • December 30, 1987 (detailed rules) • Abolished on January 1, 2002 	<ul style="list-style-type: none"> • Adopted by the State Council on October 31, 2001, in relation to participation in the WTO • Promulgated on December 10, 2001 • Effective January 1, 2002 	Amended
Approval	<ul style="list-style-type: none"> • Requires approval of the Central People's Government or its authorized organization • *Without approval, remittance to foreign countries is not possible 	<ul style="list-style-type: none"> • No approval required (Articles 8 and 10); however, registration is required (Regulations on Administration of Technology Export & Import Contract Registration, effective January 1, 2002) • *No approval is required for technologies other than those specified on the technology import restriction list. ^{Note} In principle, free technology imports were permitted (Articles 5 and 7) Note: Technologies related to Article 16 of the Foreign Trade Law of the People's Republic of China (technologies concerning national security as specified in Paragraph 1, Article 8, and technologies to protect specified industries) 	Amended
Maximum term of licensing contract	<ul style="list-style-type: none"> • Ten years 	<ul style="list-style-type: none"> • Based on agreement between the contracting parties (in principle, no restrictions) • *However, the provisions that limit the term of a licensing contract to ten years in the case of licensing from the joint-venture parties to a joint-venture firm remain in the Regulations on Implementation of the Chinese-Foreign Joint Venture Law. (As these provisions are based on the old regulations, revisions are planned according to the context of the new regulations. There is a problem in terms of consistency during a transitional period until revisions are made). 	Amended
Contract period for obligations of confidentiality	<ul style="list-style-type: none"> • No obligations of confidentiality are imposed on a licensee after the termination of a contract. A licensee can continue to use technology even after termination of the applicable contract. 	<ul style="list-style-type: none"> • Based on agreement between the contracting parties (in principle, no restrictions) • *Parties are required to keep secrets within the scope and period specified in a contract (Article 26) • *In actual terms, it is possible to prohibit continued use of a technology after the expiration of the applicable contract (Article 28). 	Amended
Countersuit obligations	<ul style="list-style-type: none"> • Countersuit obligations are imposed if a party is sued by a third party. 	<ul style="list-style-type: none"> • Only obligations of a licensor to cooperate with a licensee in resolving a problem are specified (Article 24). 	Amended
Warranties concerning technology contents	<ul style="list-style-type: none"> • In addition to two warranties, "warranty that the licensing party is a legitimate owner of the relevant technology" and "warranty that the licensing party has the right to license," "warranty of the achievement of the technological goals" is also included (old Article 6). 	<ul style="list-style-type: none"> • Same as at left (Article 25) • *Because whether technological goals can be achieved is largely affected by numerous environmental factors, it is difficult to guarantee the achievement of results. Accordingly, it is necessary to include provisions that certain conditions are necessary with respect to warranty provisions and achievement of goals. 	Continued
Damage compensation obligations	<ul style="list-style-type: none"> • A licensor shall assume responsibility for any infringement of any third party rights through the use of the relevant technology by a licensee. 	<ul style="list-style-type: none"> • Same as at left 	Continued

Source: Compiled based on the Regulations on Administration of Technology Introduction Contract and the Regulations on Administration of Technology Export & Import.

that advanced into the Chinese market recently or that are planning to enter the market this year consider the acquisition of trading rights to be a major goal.

The opening of the distribution service industry through China's joining the WTO also has a major significance for the foreign-capital manufacturing industry. Although many manufacturing companies were quick to advance into China, considerable time was required for them to absorb the opinions of end-users in China and to reflect such opinions in their products because domestic sales channels were almost completely limited to domestic companies. Accordingly, although there were no problems in terms of product manufacturing under export specifications, there were many cases in which things did not go as well as anticipated with respect to the development of products targeted at China's domestic market.

From now on, however, it will become possible for a company to actually use its own sales channels for the domestic market, to engage in various types of distribution service businesses including follow-up services after sales, and to expand direct contact with customers. The number of business types that foreign-capital companies can directly operate will increase, ranging from trade and finance to marketing research, etc., which are supplementary businesses necessary for product sales. With respect to automobiles, machine tools, and various precision devices, it will become possible to quickly develop products suitable for China's market and to improve products according to the preferences of the Chinese people through an expansion of direct contact with customers.

2 Coastal Areas Where Conditions for the Development of Distribution Service Businesses Have Been Established

With respect to China's distribution service market, besides the progress made in opening its market through

joining the WTO, a factor that should not be overlooked is that many conditions for full-scale market development have begun to be established, primarily in the coastal areas that make up the forward-looking regions.

Manufacturers in Japan, Europe, and the United States have almost completed their advances into the coastal areas of China, and their ongoing activities are now increasingly targeted inland. In contrast, in the case of the distribution service businesses that cannot resort to exports, full-scale development can only become possible after a series of changes to the social infrastructure are developed, sufficient goods are provided, and the standard of living reaches the stage where sufficient disposable income is generated. Accordingly, the market environment to evolve large-scale businesses in China was not as fully available for the distribution industry as it was for the manufacturing industry. However, the establishment of the economic conditions for distribution service businesses to enter a full-scale development stage has finally begun in the coastal areas of China.

As shown in Table 3, the average per-capita gross domestic product (GDP) in the coastal areas is approximately \$1,700, which is slightly less than two times the national average. The figures for Shanghai and Beijing have already exceeded \$3,000, and a rapid growth at an annual rate of more than 10 percent is also evident in other coastal areas. In several years, areas in which the GDP will exceed \$2,000 and register close to \$3,000, which is said to be the threshold value for service industries to begin development in developing countries, will start to emerge one after another. Shanghai and Beijing are already at the same level as that of Japan during the middle to latter years of the 1970s.

In the coastal areas, steady progress is being made on the development of major social infrastructures such as expressways, trunk roads, railway networks, large-capacity high-speed communications networks,

Table 3. Major Indicators for Coastal Areas (as of 2001)

Area	Population at End of 2001 (Million persons)	Per-capita GDP (\$)	Tertiary Industry GDP (Billion yuan)
Nationwide	1,284.53	966 (8.0)	3,453.3 (34.1)
Coastal areas	482.31	1,701 (10.9)	2,777.3 (40.9)
Beijing	14.23	3,352 (10.2)	192.0 (61.3)
Tianjin	10.07	2,666 (12.5)	96.0 (47.5)
Hebei Province	67.35	1,093 (9.6)	209.3 (34.4)
Liaoning Province	42.03	1,571 (10.2)	225.8 (41.4)
Shanghai	16.25	4,908 (10.9)	275.6 (51.0)
Jiangsu Province	73.81	1,739 (11.6)	396.7 (37.3)
Zhenjiang Province	46.47	2,002 (12.3)	306.5 (40.0)
Fujian Province	34.66	1,632 (10.5)	185.9 (39.7)
Shandong Province	90.82	1,407 (11.6)	385.1 (36.5)
Guandong Province	78.59	1,801 (10.8)	479.4 (41.1)
Hainan Province	8.03	973 (9.2)	25.1 (41.6)

Note: The figures in parentheses for the per capita GDP (Gross Domestic Product) indicate the growth rate (%) over the previous year; the figures in parentheses for tertiary industry indicate the ratio (%) among the GDP of all industries.

Source: Compiled based on China Statistical Yearbook 2002.

etc. Under the 9th five-year plan of the Central People's Government, investment in the infrastructure mostly in the coastal areas was actively implemented.

In particular, the ratio of infrastructure investment in traffic/transportation and postal service/communications to the total basic construction investment increased from about 10 percent in 1990 to about 27 percent in 2000, and a total of 400 billion yuan (1 yuan = ¥13 – ¥14 or \$0.12) was invested. About 80 percent was spent in investments related to traffic and transportation, such as roads and railways, and about 20 percent was spent in investments in postal and communications services (China Statistical Yearbook 2001). While the total length of expressways in the United States, which has almost the same land area as that of China, is approximately 90,000 km, the length in China is currently about 20,000 km. However, progress in the development of the expressway networks offers year-by-year improvements in major coastal cities, and large-scale development projects similar to those in the United States are underway.

At present, development activities are being expanded inland from the coastal areas under the 10th five-year plan, "Major Development Projects in Western Areas." Thus, the development of basic infrastructures for the distribution service industry is being implemented at a rapid pace. Six major regions in the coastal areas—the Yangtze (Changjian) River Delta, Beijing-Tanjin Corridor (Area), Zhujiang (Pearl River) Delta, Shandong Bandao (Peninsula), Minnan Delta, and Liaodong Bandao (Peninsula)—and their environs constitute a market of about 500 million people, which is close to half of China's total population. Markets are being expanded further inland (Figure 1).

3 Political Support and the Reorganization of Domestic Industries toward the Expansion of the Distribution Service Industry

With an eye on the great potential offered by the distribution service industry to provide employment, the

Figure 1. Overview of Participation by Foreign-Capital Companies



Source: Compiled based on various materials concerning China.

Chinese government started to emphasize the expansion and development of this industry from the standpoint of industrial policy. In studying China's distribution service market, this government focus cannot be overlooked.

While remarkable economic growth continues to occur in the coastal areas as the "world's factory," as explained previously, it is also true that China currently faces considerably serious issues related to the presence of a dual structure in exchange for rapid development, which include the expanding gaps in income between the advanced areas and the inland and agricultural regions, the worsened performance of state-owned companies, and the prevalence of bad loans.

In order to improve this situation, expectations for the development of the service industries, including distribution, which offer a high potential for employment, have been rapidly increasing within the Chinese government as well. In fact, a high-ranking official of the State Council noted, "of course, the development of the manufacturing industry is important, but the development of tertiary industries, especially the distribution service business, is the key to the rehabilitation of state-owned companies, and is a matter of great interest

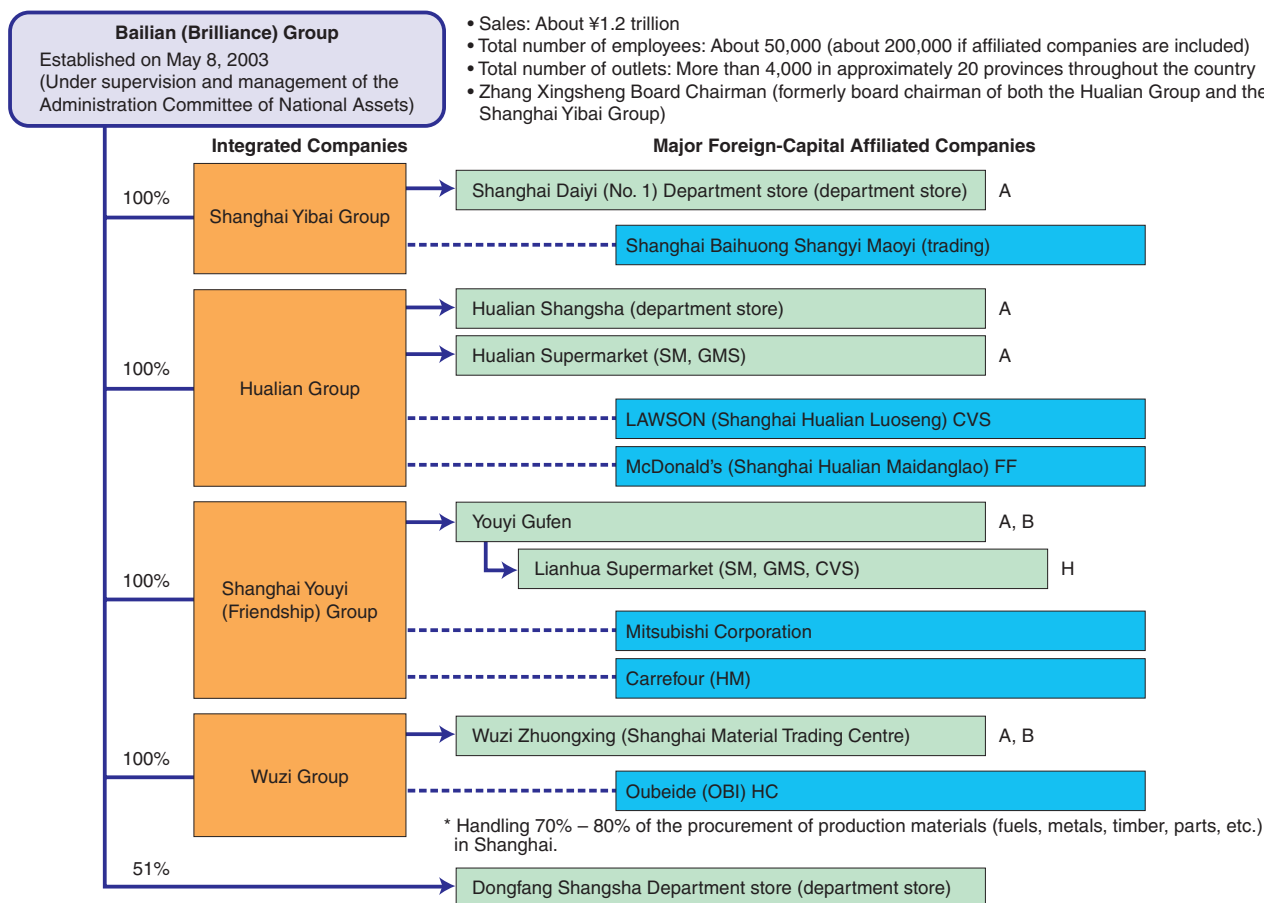
in determining new industrial policies aimed at the nation's development."

The 10th five-year plan projects an increase in the tertiary industry portion of the GDP from 33.2 percent in 2000 to 36 percent in 2005. Considering that the rate for Japan is now about 65 percent and that for the United States is about 75 percent, there is no doubt that this figure will continue to increase at a considerably high pace in keeping with the rapid pace of the development of the Chinese economy overall.

With the initiatives taken by the Chinese government for the promotion of distribution service businesses as a background factor, major reorganization of the domestic distribution industry is actively taking place throughout China before the market is fully opened to foreign capital. The structure of mergers and acquisitions planned among major domestic distribution companies has become clear. These moves are aimed at establishing a firm foundation of distribution service companies within China by the end of 2004 in order to compete with foreign-capital companies.

In Shanghai, the Bailian (Brilliance) Group was established in May 2003 (Figure 2). Steady progress also continues in Beijing in organizing huge state-operated

Figure 2. Formation of China's Largest Distribution Group, "Bailian (Brilliance) Group" (Management Integration of Four Leading Distribution Groups in Shanghai and Major Affiliated Companies)



Notes: (1) CVS = convenience store, FF = fast food, GMS = general supermarket, HC = home center, HM = hypermarket, SM = supermarket; (2) "A" and "B" indicate companies listed on the Shanghai market, and "H" indicates companies listed on the Hong Kong market.
 Source: Compiled based on the 9th China Retail Conference, Shanghai, 2003 and corporate data for Bailian (Brilliance) Group.

distribution groups similar to the Shoulian Group. In Shanghai, the so-called “city that never sleeps,” the rapid growth of convenience stores such as Lianhua Convenience (QUIK), Haode Convenience (Alldays), Kedi Convenience (KEDI), and Liangyou Jinban Convenience is simply amazing; similar growth is observed in Beijing as well. The establishment of drug-stores with nationwide coverage is also moving forward. Examples are Tongrentang Drugstores, Shanghai Fosun High-Tech Group, and Sanjiu (999) Enterprise Group.

At the 9th China Retail Conference, Shanghai held in November 2003, Zhang Xingsheng Board Chairman of the Bailian (Brilliance) Group noted, “in preparation for the full opening scheduled for the end of 2004, state-owned companies will be firmly united in promoting modernization and deploying outlets by fully utilizing China’s unique features.” This will include “a shift to a chain management format through the introduction of state-of-the-art management techniques.”

II Important Points regarding Participation in China’s Distribution Service Market

With major changes taking place in the regulatory environment, market environment, and political environment, as mentioned in the previous chapter, there is no doubt that entry into China’s distribution service market by large European, American, and Japanese companies will accelerate in the future. However, because there are a number of conditions unique to China, any attempts at market entry without fully understanding the situation will incur a large risk of failure. This chapter uses the distribution industry as the target industry in briefly summarizing the critical points that Japanese companies must attend to in attempting to enter China’s distribution service market.

1 Basic Stance of Contributing to the Development of the Chinese Economy

China currently follows the policies of a socialist market economy. While China introduced the concept of a market economy by joining the WTO, the country still pursues socialism as an ideal, and no change has been made in its ideology. Nothing has changed with respect to the fact that the Central People’s Government and the Communist Party ultimately have centralized authority and a great deal of power.

Even if various regulations are removed through China’s participation in the WTO, it is not realistic to believe that foreign-capital companies will have free rein in the Chinese market. The intentions of the local government in the area where participation is planned

and those of the Central People’s Government must be confirmed each time before any move is attempted. In each case, it will be easier to understand the situation if it is considered from the perspective that China is now seriously dealing with its national development through the combined efforts of the government and the people under the concept of “China Inc.,” which is similar to the situation in which Europe and the United States criticized Japan as “Japan Inc.”

Accordingly, the purpose of the participation of foreign-capital companies in the Chinese market is extremely important. Participation solely for pursuing profits will hardly be accepted by local governments and the Central People’s Government. A major goal of “contributing to China’s development” is required.

A company that is planning to participate in the Chinese market should further polish its participation objectives, and must separately and clearly state its strategies and scenario on how it will contribute to China’s development. In the case of the service industry, objectives that can resolve issues China is currently facing and/or supplement any portions that are lacking, such as improving the employment environment, creating employment opportunities, and/or providing a more convenient and affluent life, should be fully spelled out. It is also desirable to establish a scenario in which intended contributions are specifically expressed in terms of numerical data.

With respect to firmly establishing a basic stance of contributing to China’s development, the participating formats adopted by Volkswagen in Germany in the automotive field, Motorola in the United States in the mobile communications field, and Kodak in the United States in the photographic field can serve as benchmarks for distribution service businesses. Ahead of Japanese companies and despite being foreign-capital companies, they promoted joint business operations with Chinese companies in pursuit of China’s development as if they were Chinese companies. These efforts have led to success.

Volkswagen China still accounts for nearly 45 percent of China’s domestic market share of automobiles. The company was quick to enter the market in the format of a joint venture under the protective policy for the automobile industry, and was ranked first as the most admirable foreign-capital company in China (Chinese version of Fortune magazine). As though a Chinese company, Volkswagen China has now reached the stage of being able to exert control over participation by other foreign-capital automobile manufacturers.

Motorola has become the largest foreign-capital investment company in China with a domestic market share of about 30 percent. Similar to Volkswagen China, the company won the competition for participation with Japanese company groups, and was ranked second as the most admirable foreign-capital company in China (Fortune, *op. cit.*). Kodak purchased three state-owned

companies that showed worsened performance at \$1.2 billion, and contributed to the development of domestic industries and the creation of employment opportunities. Kodak is the only foreign-capital company for which local production was approved because of these contributions. It now has some 50 percent of the domestic market share.

In all of these cases, the major problems encountered by the Central People's Government and local governments were cooperatively resolved each time by jointly pursuing China's development. In return for such contributions, these companies continue to receive warm support.

2 Discrepancies in Views between the Central People's Government and Local Governments

While China has a land area equivalent to that of the United States, its population far exceeds that of the United States. It is said that China's population is composed of more than 50 races who speak more than 200 languages. Because of such diversity, discrepancies in views frequently occur between local governments and the Central People's Government.

A case in which such discrepancies led to a major dispute is the issue of the investment ratio concerning the deployment of Carrefour outlets. Distribution retail companies are not allowed to use only their own funds (100% foreign capital investment) in setting up outlets. Initially, however, Carrefour was in a rush to set up its outlets in each area and used only its own funds to establish many outlets simply on the basis of agreements with local governments such as the Shanghai government. Because of this action, the Central People's Government imposed a one-year freeze on setting up new outlets in 2001. The issue was eventually resolved by having Chinese companies acquire 35-percent shares in each local area in compliance with regulations of the Central People's Government. Nevertheless, there is no question that this occurrence was the impetus for a major review of Carrefour's China strategies, and delayed the evolution of further business operations.

In contrast, Wal-Mart is somewhat of an honor student as far as the Central People's Government is concerned. Wal-Mart appears to be in no hurry to set up its outlets and is making steady progress by resolutely observing the objectives of the Central People's Government. Accordingly, while Carrefour is now far ahead, Wal-Mart will also be quick to set up future outlets in new areas, inevitably leading to heated competition. Apart from which companies will meet with future success, quickly recognizing discrepancies in the views of local governments and the Central People's Government and properly responding to such differences will become increasingly important.

3 Format of Participation and Partner Selection

A possible company format that can be used by foreign companies to enter China's distribution service market involves either a joint venture (with a Chinese company) or a company established by its own funds (100% investment by a foreign company).

However, the Law of Trial Operations for Foreign Investors to Invest in Commercial Enterprises still applies because China is in the middle of its third year as a member of the WTO. Accordingly, the minimum investment of 35 percent from the Chinese side is still required in order to carry out sales activities based on the deployment of outlets. The format of a company using its own funds cannot yet be adopted.

Carrefour and Wal-Mart have each established total management headquarters in the format of commercial company management consulting firms, in Shanghai and Shenzhen, respectively. The purpose is to provide centralized management for sales outlets established through joint ventures in each of China's regions. In the case of Carrefour, its registered management scope includes commercial company management (selection of products and suppliers, methods of market penetration and financial management consulting), investment, trade, scientific technology, industrial technology, and real estate consulting. Also included is the development and training of in-group managerial personnel and the management of the company's own physical distribution operations.

In order for foreign-capital companies to evolve chain-based business operations within China, it is desirable that they adopt a format combining a management headquarters established by using the company's own funds and outlets in each area by joint ventures.

If a joint venture format is adopted, the next issue is how to select Chinese partners. To jointly conduct business with partners in China, in addition to considering companies in the Chinese mainland, it is also worth studying the possibilities of establishing joint ventures with companies in Hong Kong (companies in Hong Kong are now treated as foreign-capital companies), Taiwan, and Singapore, which use the Chinese standard language (Putonghua) and are well versed in the market economy. In fact, there are many successful cases involving such a format.

For Hong Kong companies, the number of cases in which investment exceeding 65 percent is allowed as special cases is increasing even though they are treated as foreign-capital companies. Various types of favorable treatment are often provided on the basis of the relationship between Hong Kong and China. As expected, careful responses are required with respect to joint ventures with Taiwanese companies because of the political elements involved. Nevertheless, such consideration

deserves full study for purely foreign-capital companies, including Japanese companies.

In selecting a partner company in China, it is, of course, important to measure the personal potential of the management executives. The next essential task is to fully examine the direction of developing a current and potential joint venture business with a candidate partner. Since such a candidate also desires a joint venture because it lacks brand and know-how resources, a decisive factor will depend on whether both parties can combine and target their efforts in the same direction of development after jointly determining what that direction is.

At the same time, it is also important to understand the attitude of a candidate partner toward Japanese companies. There are almost no cases in which a joint venture could be established through the unilateral selection of a partner by a Japanese company. The management executives of the state-owned companies being considered by Japanese companies generally have a stronger sense of caution towards Japanese companies than they do to companies in the United States and Europe. In many cases, comparisons with US and European companies are made during negotiations for a joint venture. While no change can be made with respect to historical background, continued perseverance is required to provide explanations after accurately understanding the advantages and disadvantages in forming a partnership with US, European, and Japanese companies.

There are a large number of companies in the distribution service industry in the Chinese mainland that want to learn from Japanese companies the “mechanism and know-how used in Japan in providing carefully considered and attentive products and services” that are not available in the United States and Europe. The image that they have with respect to Japanese companies is sometimes intertwined with the high quality of Japanese products including electronics equipment and automobiles. Accordingly, this advantage of “attentive service” can be an effective selling point for Japanese companies.

4 Profit Structure Particular to the Chinese Distribution Industry: Low Gross Profit Ratio and Jin chang fei (Participation Fees)

In China’s distribution industry, a unique commercial practice of “Jin chang fei (participation fees)” exists. If this practice is openly rejected, business transactions in China become impossible in actual terms.

Account titles for these “participation fees” differ somewhat depending on the type of business. In broad terms, “participation fees” fall under the following eight account titles for transactions among manufacturers, vendors, and wholesale and retail companies in Shanghai and Beijing.

- (1) New account opening expense

- (2) New product account opening expense
- (3) Sales promotional expenses (display site usage expense or space expense, direct mail expense, warehouse usage expense, etc.)
- (4) Advertising expenses (inside- and outside-outlet advertisement posting expense, leaflet posting expense, etc.)
- (5) Various rebates (similar to those used in Japan in accordance with sales volume, etc., compensation, disposal expense, etc.)
- (6) New store opening celebratory gift money
- (7) Support money for specific campaigns, seasonal expense, etc.
- (8) Electronic transaction system usage expense, telephone charges, electric power charges, etc.

To avoid any misunderstanding, it should be clarified that not all participation fees under such complicated and diversified account titles existed in the past. It will be easier to understand if it is pointed out that today’s commercial practice of participation fees, which many people say is complicated and totally incomprehensible, has emerged at an accelerated pace within the past ten years.

In the past, China had a commercial practice of basic rebates that were used as sales promotional expenses and remuneration contingent on sales figures as determined in advance. Moreover, because all companies were state-owned, there was no structure in which profits were generated at each distribution stage (wholesale, retail, etc.) as intermediate margin on each distribution channel. It is therefore true that the ratio of gross profit was quite low.

The following three elements are involved as background factors behind the development of complicated and diversified participation fees.

The first element concerns the extensive requests for rebates from retail companies as a means of making both ends meet. At the beginning of the 1990s, retailers were placed in an environment of extremely severe price competition through the rapid introduction of a market economy. For example, in looking at the current situation of supermarkets in Shanghai, a surprisingly large number depends on participation fees to barely keep in the black. It is said that nearly two-thirds of all companies are actually operating in the red.

The second element relates to the participation of major foreign-capital companies such as Carrefour, which began full-scale participation in the middle of the 1990s. These companies prompted a shift toward having manufacturers, vendors, and wholesalers bear expenses to compensate for low gross profits in China’s market.

The third element involves China’s climate of traditionally valuing individual personal relationships more than the interests of one’s company. The trend of paying various rebates has been expanded as a sense of saving face for the person in charge.

While the background factors behind the rapid dissemination of the commercial practice of participation fees can be summarized into these three elements, the single underlying factor is the low gross profit ratio of the Chinese distribution industry. According to interview surveys, the average ratio of gross profit to net sales in the retail industry is 12 percent – 16 percent in Shanghai and 11 percent – 16 percent in Beijing, as indicated in Table 4. In comparison to the average ratio of gross profit to net sales in the retail industries in Europe, the United States, and Japan, the ratio in China is lower by 5 to 10 percentage points.

Because of this low gross profit ratio, many foreign-capital companies that entered the Chinese mainland from the beginning of the 1990s were distressed over the issue of improving profitability immediately after beginning their participation. There were also many cases in which they quickly encountered financial difficulties. In addition to European, US, and Japanese companies, many Hong Kong companies were also compelled to withdraw from the market by facing the stern reality of such low profit ratios from the mid-1990s to around 2000. It is still true that one of the major issues facing foreign-capital distribution companies entering the Chinese mainland is improving the gross profit ratio.

From this perspective, it becomes evident that the commercial practice of participation fees has a very significant meaning in evolving a distribution service business in China. According to interview surveys with personnel in charge of accounting and accounting firms in China and based on the analyses of financial statements that were available, actual participation fees are estimated to be 6 percent – 10 percent (ratio to sales) in Shanghai, and 2 percent – 4 percent in Beijing. Accordingly, the real gross profit that includes this participation fee will become 18 percent – 26 percent in Shanghai and 14 percent – 20 percent in Beijing. These figures are close to the gross profit ratios that are gen-

erally applied in the retail industries in Europe, the United States, and Japan, and will be satisfactory.

Since the latter half of 2002, the Shanghai Municipal People's Government and the Central People's Government issued opinions (official notices) several times concerning the ambiguous issue of large participation fees, and started to call for taking more prudent approaches in collecting excessive participation fees.

At present, however, a joint notice (Opinions Concerning the Collection of Supermarket Expenses, issued on December 5, 2002) of the Shanghai Commercial Committee, the Shanghai Chain Store Association, and the Shanghai Administrative Bureau for Industry and Commerce indicates their position that "these commercial practices (including the collection of participation fees) essentially constitute economic activities, and we do not have rights to interfere with these activities. It is desirable to pursue the direction of eliminating ambiguity for the purpose of strengthening contract management." The Ministry of Commerce (MOC) also noted that, "the collection of participation fees should not be prohibited under the statutory provisions." In sum, the basic stance of the government is that it is not necessary to exercise control over payments that are made as fair and just compensation in accordance with a contract.

Companies planning to enter the Chinese market in the future should fully understand these commercial practices unique to China and changes in government policies related to such practices. On the basis of such understandings, it is desirable to formulate strategies concerning how to establish a company's own profit structure in China. China, a relatively new member of the WTO, is now at a transitional period. In addition, it is not a realistic solution to eliminate all sorts of participation fees, even though it might be ideal. Nevertheless, there is no doubt that the general trend in the future would be toward eliminating the exchanges

Table 4. Relationship between Ratio of Participation Fees to Sales and Actual Gross Profit Ratio

<Average Gross Profit Ratio and Average Participation Fees of Major Retail Businesses in Shanghai>			
	Average Gross Profit Ratio	Average Participation Fees	Actual Gross Profit Ratio
Supermarket	14	6 – 10	20 – 24
General supermarket	12	6 – 10	18 – 22
Convenience store	16	6 – 10	22 – 26

(Unit: %)

<Average Gross Profit Ratio and Average Participation Fees of Major Retail Businesses in Beijing>			
	Average Gross Profit Ratio	Average Participation Fees	Actual Gross Profit Ratio
Supermarket	11	2 – 4	14 – 17
General supermarket	— ^{Note}	—	—
Convenience store	16 (Maximum)	2 – 4	18 – 20

(Unit: %)

Note: Now in the midst of establishing a general supermarket category.

Source: Compiled based on interview surveys with distribution companies, accounting firms and consulting firms in Shanghai and Beijing.

of expenses and money that are incurred separately and are not included in a contract.

In consideration of these circumstances, it is important to focus on gradually negotiating the incorporation of participation fees in the cost of purchase as a uniform expense from the beginning of an agreement, eliminating the exchange of money that is not included in a contract, and firmly establishing a contract that provides for incentives in accordance with mutual sales efforts. This contract should be modified as necessary and in such a way as suitable for the current situation. In addition, mechanisms should be established in which a company's headquarters can accurately understand the situation of participation fees at each individual outlet. On the basis of these mechanisms, company administration should continually show its management direction, and should strictly stipulate the range of the discretion of each outlet and of individual personnel as well as that of company headquarters.

As China enters its third year of phased market opening after officially joining the WTO, this year will most assuredly see a full-scale market opening in its distribution service industry. In the coastal areas, a foundation for substantial distribution service industry growth has been made available in terms of both income and infrastructure. The Central People's Government is placing great expectations on the development of the distribution service industry, which offers a high potential for providing employment opportunities.

Because China's distribution service market still contains unlimited possibilities, it is very attractive for foreign-capital companies that have sufficient management capabilities and funds. To succeed in market participation, however, specific circumstances should be fully understood. These include not only the details of the WTO agreement concerning applicable business

categories, but also such specifics as the laws, regulatory status and direction, and taxation that are applicable to individual categories, preferential systems applied in each area, market trends, and participation formats. After fully understanding these details, it is necessary to carefully work out preparations aimed at acquiring permission or approval.

What is especially important among these preparations is to match a company's management and business strategies with the policies and concepts of each applicable government. It is also important to formulate a winner group strategy involving a partner company and create a development scenario for the future. It is vital to continue to contribute to the development of China through the building of a good, long-term relationship with the government by using a personal network established with government officials in a positive and genuine sense.

In addition, the distribution service industry inevitably includes commercial practices specific to an applicable business category. It is therefore important to fully understand the background and origin of such practices, and deal with such practices in a straightforward manner after accurately identifying what is actually occurring.

Note: Translation of some legal and organizational names is based on the corresponding meanings of the Chinese terms. In addition, phonetic spellings are used for the English versions of some Chinese company names.

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