The New Face of Distribution in China: A Dynamic Uncertain Future Facing Chinese Executives

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Abstract

The rapidly changing dynamics of China includes the emergence over the past decade of the well educated, high income consumer (creating demand for better services, more convenience, etc.), tougher competition across all sectors (exacerbated by WTO entry in 2002), and distribution becoming more complicated due to changing regulations, new entrants, and constantly shifting market opportunities. Each makes it challenging for suppliers and distributors to develop business plans/strategies that anticipate and take advantage of the vast opportunities available. The purposes of this manuscript are to provide insights as to the current status of distribution in China and to share some of the comments received from interviews with Chinese executives concerning difficulties they face in their efforts to create value through distribution.

Search Words: China; Distribution; Wholesalers; Retailers

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Wholesalers. In terms of wholesale and retail markets, dominating the traditional landscape have been Level 1 and Level 2 wholesalers. Wholesalers have been product-specific, registered in categories. For instance, according to Chinese government statistics, "Wet Market" registered wholesalers include Grains & Oil (n=29,000), Meat Poultry & Eggs (n=6,000), Fruit & Vegetables (n=4,700), and Seafood (n=2,800). Other categories include consumer products (Household Goods and Sundries; Tobacco; Confectioneries, beverages, packaged foods) and apparels (Textiles; Garments; Shoes and hats). Wholesalers represent the following forms and approach to market:

Level	Competitors	Roles
1	SOE	-City/provincial coverage -Serve large accounts directly -Sell to Level-2 wholesalers
1	Private city-level	
2	Sub-wholesalers	-Physical link between city and small retail communities -Serve nearby retail outlets

Until 1994, regulation severely protected wholesalers in China from domestic and foreign competition, giving wholesalers significant bargaining power over manufacturers and retailers. Pre-1994, little incentive existed for SOEs to modernize or close efficiency gaps. When deregulation occurred, low entry capital requirements brought many new domestic competitors into the industry. As an example, in Guangzhou the post-regulatory period saw an influx of wholesalers, raising the total from just over 4,000 in 1995, to 6,700 in 1996, and over 12,000 in 1999 (Guangzhou Statistical Yearbook). This increase had expected results, including intense interfirm fighting for market share and accompanying price competition, leading to gross margins collapsing to as little as 5% or less. Meanwhile, SOEs gained the ability to choose for themselves where to sell, at what prices, and through channels of choice (MacMurray and Woetzel 1994). Still, even with more liberal policies, SOEs and local firms continue to have considerable protection; foreign manufacturers (including JVs and imports) are not allowed to engage in wholesaling activities except for their own products[1].

Wholesalers account for over 85% of consumer product distribution. However, low profitability due to intense competition, high cost and resultant low margin suggests that there will be a vigorous shaking out period ahead. If China follows trends in other markets, this shaking out period will be turbulent but result in more efficient channels, with likely outcomes including (a) vertical integration by wholesalers, retailers and manufacturers, providing a means for better channel coordination; (b) wholesaling shifting from a regional to a multi-regional and eventually national level, with accompanying efficiencies due to scale and improved systems approaches; (c) less product specialization and more multi-category distribution; (d) higher quality of functions provided with more efficiency; (e) higher margins as concentration and efficiencies increase. These dynamics have been steadily at work since the early 1990's, with MNCs working to close efficiency gaps, carefully sidestepping government distribution networks and building their own (Shaw and Meier 1993).

Retail. Retail fragmentation in China continues to be a challenge for sales and distribution decisions. Estimates of the number of retail outlets in China (1999) were 9.2 million, while average sales per outlet were approximately US$22,000. At the same time, a number of modern retail formats are on rapid rise in China, with department stores (CAGR of 14% projected for the 1995 – 2005 period), supermarkets and discount stores (CAGR 21%) and convenience stores (CAGR 34%) experiencing much of this growth. Dramatic changes also affect such categories as pharmaceuticals where the past decade has evidenced the rise in pharmacy chain stores. Whereas hospitals traditionally were the outlet for most scripts, chains have become established sources. Over 600 independent pharmacies now compete in Shanghai and in Guangzhou, Caizhilin (90+ stores), Jian Ming (30+), Sui Liang (25+) and Bai Ai (5+) dominate this new sector.

With retail structures changing rapidly, so too is retail management. Faced with rapid changes (particularly the influx of western capital and management), pressures to improve sales service, shelf space allocations, and promotions has led many MNCs to invest heavily in training for their Chinese partners (China Hand 1997). As expected, fragmentation and rapid change makes it expensive and complex for suppliers as they develop and revise their go-to-market China strategies.

Coverage Strategy. A coverage strategy might include some combination of state-owned distributors (SOE's), collective wholesalers, private wholesalers, and self-distribution. The mix is shaped and constrained by availability, access to target markets, and the ability to push products in ways aligned with brand's position. Obviously, the ideal situation is one where channel members provide desired coverage, have good incentive to sell, and possess necessary skills. In this arena, factors such as history of success in related product lines, compatible product lines, and a cooperative attitude all assist in determining whether particular distributors/wholesalers are a possible match for supplier needs.

At present, even the biggest of wholesalers (Level 1's) have only provincial level coverage, with most having coverage models at city, district, or community levels. Current coverage models can be seen by an illustrative example:

> P&G currently works with over 300 Level 1 wholesalers providing city level functions of selling and order taking, physical distribution and credit taking. These wholesalers, in turn, sell directly to large grocery stores and small supermarkets, while using a network of over 1,000 Level 2 wholesalers to handle small grocery and kiosk locales (in addition, P&G works with large supermarket chains and hypermarkets through own logistics).

Major Trends and Implications. Major trends affecting the present and future of distribution in China include

–China's accession to the WTO in 2002
–The continued modernization and consolidation of wholesale and retail
–Consolidation and forward integration by manufacturers

The WTO has received considerable press the past several years. As Zunwalt (2002) attests, WTO entry formally positions China as a "fully vested player in the global economy…with tremendous benefits (including) expanding trade, further economic reform, attracting even higher levels of foreign investment, and fostering the rule of law." In particular, trade liberalization provisions include:

–The right to import from and export to customers directly within 3 years
–The right to engage in distribution of all products within 3 years (with exceptions) and
–Requirements that SOE's purchases are based solely on commercial reasons, among others.

Admittance into the WTO should result in fewer barriers to emergent distribution forms along with increasing competition for historically protected sectors. In anticipation, traditional players have been scrambling to protect markets that have, until now, been their exclusive domain and to accelerate learning. In many instances, residual protection continues to provide a buffer. Meanwhile, acceptance of the need to change and to promote new ways of doing business has become a mantra of business leaders across China. This is revealed by the rapid growth of executive training and executive MBA programs and increased use of outside consultancies (e.g., McKinsey, etc.) for determining strategic direction and go-to-market strategies.

What opportunities are suggested by the rapid rate of change? First, it is evident that domestic competitors must expect a tough future, one that requires them to rapidly change or fall behind. This realization is not new (steps to help SOEs take a more strategic approach to doing business has been ‘in the works’ for over a decade (c.f. MacMurray and Woetzel 1994) but the pressures are heightened due to WTO commitments. Second, FMCG’s will surely strive to develop selective distribution with only the most savvy and future oriented distribution partners. Since this sector represents substantial growth opportunity, an adapt or ‘go extinct’ mindset is required of all players. Third, management (especially western-based JV partners) must realize they are working with more intelligent, better managed distribution partners than their early experiences in China probably reflected. The rapidly changing face of the Chinese executive, with many now receiving western style MBA education augmented by world class executive education (e.g., top rated Pudong-based CEIBS has extensive executive training programmes) is constantly raising the bar in China[2].

Next, I discuss how Chinese executives feel about the challenges they face in this exciting yet uncertain distribution landscape. In sharing the thoughts of executives, a “personal face” can be put to the dynamics suggested above.

The Data and Insights

In each of the past five years numerous trips to China have been spent learning about the sales and distribution practices of Chinese domestic (including SOE’s) and joint venture firms. During each trip, in-depth discussions with Chinese executives have been held. These discussions, conducted in Mandarin then translated by language experts in China, consistently included three distribution questions: What are the greatest difficulties that you face with your distribution and wholesaler channels? What do you find most effective/ineffective about your distribution network? How do you motivate your distribution partners to focus on your products & services? These interviews now comprise a data set of over 100 executives; space permitting, typical types of comments follow, along with commentary.

Perhaps reflecting traditionally protected markets, suppliers repeatedly relate that distribution partners do not well-develop a strategic intent nor view relationships with a long time horizon. As result, there are frustrations in terms of gaining agreement with distribution in terms of market development, assuming roles/functions to assure greater market penetration, etc. While not unique to China, an emphasis on immediate profits, ideally received with as little work as possible, often results in frustrated suppliers:

There are too many layers, too little vision, too many special relationships and an excessive focus on the short-term. At this time, loyalty is impossible for us to gain. Sales Manager

Distributors do not want to fully understand the technical advantages of our products. They are more concerned with us bringing them business – they regard it as our problem to educate end users. General Manager

Distributors are not willing to assume any risks. Some demand funds to participate in promotions while others accept product only on consignment. Commercial Officer

They are ineffective due to their lack of professionalism and qualifications... salespeople lack knowledge and they do not invest in training…they have poor market information. General Manager

A concern voiced numerous times by suppliers (especially JVs) has to do with account receivables. As one Market Development Manager put it, “payment collecting is a difficulty because of triangular debt.” When asked to explain this term, he indicated that payment is a function of three firms, the supplier, distributor, and final customer. While distributors may acknowledge contractual agreements (e.g., 2/10 net 30), in reality many treat this as a “nice to have” part of the agreement, arguing instead that they should not be expected to make payment until they receive payment from their customers.

Other issues abound, from conflicts of interests (e.g., where distribution agreements are established providing exclusive coverage followed by distributors stepping across boundaries and using cutthroat tactics to grab business from other distributors) to distributors handling competing products despite promises to the contrary, to distributors continuously exclaiming the need for further discounts to win business. The last, viewing price as the primary point of difference, continues to harm many go-to-market efforts as it diminishes the ability of major brands to establish points of superiority.

Conclusion

Suppliers seek to maximize go-to-market strategies by determining best use of own sales forces and various channel formats. In the consumer space, this means selecting appropriate distribution (wholesalers) to push and sell product to retail. In turn, retail must be expected to enthusiastically support product sales to consumers. The system works when each participant in the process realizes own-goals through this support; active education, training, and encouragement by suppliers seems essential to the process. However, there remain tremendous uncertainties underlying distribution decisions. The roots of tradition and protectionism are deep, requiring suppliers to demonstrate patience and persistence in developing channel systems.

As in any market, there will be winners and losers in the battle for channel supremacy. As well, many mixed models will continue to show promise, with tailored expectations as to the functions required of various participants in value creation. In the meantime, suppliers must have systems in place for objective goal setting, evaluating current performance to goals, identifying skill gaps in channel performance, providing the means to close the gaps, and to reward channels for good performance. Only then can the total channel system be likely to reap expected rewards for suppliers and channel members alike. The numerous challenges and uncertainties existing for both domestic and JV competitors in the exciting high growth China market are simultaneously provoking excitement and great concern. Of certainty, change dynamics are impacting all players with gale force intensity – no one knows for certain what the next face of China’s distribution will be but everyone intends to be part of the action.

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End Notes

[1] As suggested, some regulatory protection of domestic wholesalers (especially SOE players) over direct distribution remains, limiting the ability to skirt inefficient go to market approaches. Additionally, the traditional difficulties inherent in China's less-than-ideal road/rail systems (China Hand, 1996, calls the system "woefully inadequate") has led to the need for extensive local wholesalers/warehouses and limited the development of infrastructure in shipping, trucking, and warehousing, fundamental to efficient long-haul transportation.

[2] Changes can also be expected on additional fronts. For instance, foreign trading houses can now grow profitably by entering the wholesaling industry, leveraging their capital, management skills and global network to secure favorable positions in domestic distribution, importing and sourcing/exporting. As well, major retailers will potentially backward integrate into wholesaling so as to gain greater control and certainty over logistics and to leverage skills and resources for more efficient supply (thanks to McKinsey & Company for insights).