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Introduction

China’s distribution landscape has witnessed a significant transformation over recent years. The National Bureau of Statistics of China reveals that the total sales value for the country's wholesale trade reached 28,870.1 billion yuan in 2011; domestic distributors, led by state-owned enterprises (SOEs), captured 19.7% of that total revenue, a huge market share.

Eyeing that significant data and the likely potential in the burgeoning consumer market, many manufacturers and retailers have moved to expand their distribution networks and improve their supply chain efficiencies.

The Chinese government has also launched a series of initiatives to support the distribution sector, with a view to boosting domestic consumption. Clearly, opportunities abound. Nonetheless, given the vast geographical span and huge regional differences, distribution in China remains a complicated challenge.

Part I of this report provides an overview of China’s distribution sector and Part II focuses on the distribution of footwear and toys in China.
Part I

Overview

In China, goods have to pass through multiple tiers of distributors before reaching the hands of consumers. There are different parties involved in these supply chains, being agents, distributors, wholesalers and sub-distributors. Given the complexity of the China market, companies distribute via several different models depending on their needs (see Exhibit 1). The majority adopt a combination of distribution models.

Exhibit 1: Product distribution in China

<table>
<thead>
<tr>
<th>Brand owners, Manufacturers</th>
<th>Agents</th>
<th>Distributors, Wholesalers, Sub-distributors</th>
<th>Retailers</th>
<th>Consumers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brand owners, Manufacturers</td>
<td></td>
<td>Distributors, Wholesalers, Sub-distributors</td>
<td>Retailers</td>
<td>Consumers</td>
</tr>
<tr>
<td>Brand owners, Manufacturers</td>
<td></td>
<td></td>
<td>Retailers</td>
<td>Consumers</td>
</tr>
<tr>
<td>Brand owners, Manufacturers</td>
<td></td>
<td></td>
<td></td>
<td>Consumers</td>
</tr>
</tbody>
</table>

Source: Fung Business Intelligence Centre
Types of distribution channel

Distributors and agents

Distributors and agents are authorised by the brand owners or manufacturers. Typically, they do not involve themselves in manufacturing and retailing of products to be distributed. Some are obliged to buy out products, thereby carrying inventory risk; others do not need to buy out goods but receive a certain sum in commissions.

Currently, domestic distributors account for the lion’s share of China’s wholesale trade. They have an edge over their foreign counterparts in terms of established infrastructure, government-related “guanxi” and networking reach. Foreign agents and distributors, on the other hand, have introduced an international perspective and advanced management experience.

Wholesale markets

Wholesale markets have played a significant role in channeling products from small- and medium-sized manufacturers into the hands of urban and rural consumers. According to the National Bureau of Statistics of China (NBS), wholesale markets with a transaction value of over 100 million yuan numbered 5,075 in 2011, up by 2.7% yoy. Exhibit 2 shows the growth factors of these wholesale markets.

Exhibit 2: Wholesale markets in China

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of wholesale markets with transaction value over 0.1 billion yuan</th>
<th>Floor area (square metre)</th>
<th>Transaction value (billion)</th>
<th>yoy growth rate</th>
<th>yoy growth rate</th>
<th>yoy growth rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>4,121</td>
<td>198,146,314</td>
<td>4,408.5</td>
<td>6.3%</td>
<td>9.6%</td>
<td>18.7%</td>
</tr>
<tr>
<td>2008</td>
<td>4,567</td>
<td>212,252,204</td>
<td>5,245.8</td>
<td>10.8%</td>
<td>7.1%</td>
<td>19.0%</td>
</tr>
<tr>
<td>2009</td>
<td>4,687</td>
<td>232,303,299</td>
<td>5,796.4</td>
<td>2.6%</td>
<td>9.5%</td>
<td>10.5%</td>
</tr>
<tr>
<td>2010</td>
<td>4,940</td>
<td>248,323,113</td>
<td>7,270.4</td>
<td>5.4%</td>
<td>6.9%</td>
<td>25.4%</td>
</tr>
<tr>
<td>2011</td>
<td>5,075</td>
<td>262,345,039</td>
<td>8,201.7</td>
<td>2.7</td>
<td>5.7%</td>
<td>12.8%</td>
</tr>
</tbody>
</table>

Source: 2011 Statistical Yearbook of China Commodity Exchange Market

Wholesale markets are often viewed as disorganised, selling low-end and unbranded products. However, in recent years, some large-scale wholesale markets have upgraded themselves with effective management, modernised facilities and better brand positioning. For instance, Yiwu’s China Commodity City (CCC) was the first wholesale market in China to obtain ISO 9001 and ISO 14001 certification, indicating that it had met international quality standards. Yiwugou (www.yiwugou.com) is the online platform operated by CCC where suppliers and buyers can gather information and complete their transactions.
It is widely expected that China's wholesale markets will continue to be a highly significant distribution channel.

**Direct sales by manufacturers**

With China’s improving logistics infrastructure, some established brand owners and manufacturers have set up their own wholesale and retail facilities. Indeed, these enterprises view distributing their own products as an effective means of keeping abreast of the latest market developments.

For example, a growing number of manufacturers have started selling directly to retailers in the fast-moving consumer goods sector (FMCG). Currently, Procter & Gamble, the US-based multinational FMCG company, sells through modern channels directly into key Chinese cities. The domestic footwear giant Belle and leading mainland food and beverage brand Master Kong are other cases in point.

**Warehouse-style supermarkets**

Warehouse-style supermarkets have become another effective channel to distribute products on the mainland. Sam’s Club, a division of Wal-Mart Stores, is a typical example. It adopts a membership system and sells goods in bulk at wholesale prices to its members, with both enterprises and individuals welcome to participate. Sam’s Club today operates a total of eight stores in Shenzhen, Guangzhou, Fuzhou, Shanghai, Beijing and Dalian. The Online Sam’s Club (www.samsclub.cn), launched in 2010, offers a highly-promising internet option.
**Online distribution**

Online distribution is increasingly a priority. Many companies have opened online shops on B2C platforms – such as Tmall and JD.com – to widen their customer reach or for more effective promotion. However, most platform operators are actually online transaction facilitators that do not engage in real distribution businesses; they charge suppliers membership fees for listing on their websites and do not involve themselves in the actual businesses they show.

An increasing number of wholesale markets (among the more traditional channels), have also built an online presence. Exhibit 3 shows the top 20 apparel wholesale markets in China as in 2011 and the level of their online presence. Seven of the top 20 wholesalers operate an online marketplace where deals can be negotiated and sealed without visiting offline stores.

Despite rapid growth over recent years, online distribution in China is not without its challenges. Many buyers are still reluctant to place large orders online, with the threat of possible fraudulent activities and credit defaults.
Exhibit 3: Top 20 apparel wholesale markets in China and their online presence, 2011

<table>
<thead>
<tr>
<th>Rank</th>
<th>Wholesale Market</th>
<th>Online presence</th>
<th>Website</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>China Changshu Clothing Market</td>
<td>✗</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Shijiazhuang Xinhua Trade Center</td>
<td>✓</td>
<td><a href="http://www.ecxhjm.com">http://www.ecxhjm.com</a></td>
</tr>
<tr>
<td>3</td>
<td>Zhejiang Tongxiang Puyuan Sweater Market</td>
<td>✗</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Kunming Luoshiwan International Trading Center Phase I</td>
<td>✓</td>
<td><a href="http://lsw.net.cn">http://lsw.net.cn</a></td>
</tr>
<tr>
<td>5</td>
<td>Shandong Jimo Apparel Wholesale Market</td>
<td>✓</td>
<td><a href="http://www.cnjmsc.com">http://www.cnjmsc.com</a></td>
</tr>
<tr>
<td>6</td>
<td>Fujian Shishi Clothing City</td>
<td>✓</td>
<td><a href="http://www.ssfszc.com">http://www.ssfszc.com</a></td>
</tr>
<tr>
<td>7</td>
<td>Zhejiang Luqiao Small Commodities Wholesale Market</td>
<td>✗</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Haining Leather City</td>
<td>✗</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Kunming Luoshiwan International Trading Center Phase II</td>
<td>✓</td>
<td><a href="http://lsw.net.cn">http://lsw.net.cn</a></td>
</tr>
<tr>
<td>10</td>
<td>Hangzhou Sijiqing Apparel Market</td>
<td>✓</td>
<td><a href="http://www.sjq.cn">http://www.sjq.cn</a></td>
</tr>
<tr>
<td>11</td>
<td>Liaoyang Dengta Tongerbao Haining Leather City</td>
<td>✗</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Guizhou Shixi Market</td>
<td>✗</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Shandong Linyi Wholesale Market</td>
<td>✗</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Hangzhou Yifa Clothing Mall</td>
<td>✗</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Xinjiang Bianjiang Hotel Trade Complex</td>
<td>✗</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Jinan Luokou Clothing Wholesale Market</td>
<td>✗</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Harbin Make Way Group</td>
<td>✗</td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Fuzhou Tainong Clothing City</td>
<td>✗</td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>Guangzhou Baima Clothing Market</td>
<td>✓</td>
<td><a href="http://www.baima.com">http://www.baima.com</a></td>
</tr>
<tr>
<td>20</td>
<td>Shanghai Xinqipu Costume Market</td>
<td>✗</td>
<td></td>
</tr>
</tbody>
</table>

Source: 2011 Statistical Yearbook of China Commodity Exchange Market, Fung Business Intelligence Centre
Latest developments

Distribution still plays an important role; but participants have to constantly reinvent themselves amid huge competitive pressures

As mentioned earlier, retailers have started dealing directly with key suppliers and expanding online sales, so disintermediation has become a hot topic. Nonetheless, we believe any expected demise of distributors in China is off the mark.

First, China’s retail market is still highly fragmented, with the top 100 retailers achieving just 9.3% of market share in 2012. Secondly, the wide geographical span of China offers extensive room for development to distributors, especially in some inner regions and in the rural hinterland. Furthermore, as brand principals seek to manage their fixed costs, there is still a great deal of room for distributors to grow.

Exhibit 4 profiles the wholesale trade for selected consumer products in China as in 2011. The market size of wholesale distribution is growing at a stellar pace, as seen by the double-digit growth of these sectors for that year.

<table>
<thead>
<tr>
<th>Pastry, Confectionery and Sugar</th>
<th>Textiles</th>
<th>Apparel</th>
<th>Footwear and Hats</th>
<th>Cosmetics and Personal Care Products</th>
</tr>
</thead>
<tbody>
<tr>
<td>84.2</td>
<td>35.2%</td>
<td>542.5</td>
<td>21.0%</td>
<td>588.9</td>
</tr>
</tbody>
</table>

Source: National Bureau of Statistics of China

Despite these successes, distributors must constantly reinvent themselves and expand their business offerings (such as providing market analyses, inventory management and goods tracking services) in order to both survive and thrive.

Government steps up efforts to promote development of the distribution sector

The government has been working on a number of fronts to promote the development of the distribution sector, and Exhibit 5 shows a slew of measures announced recently.
### Exhibit 5: Major government policies related to the distribution sector

<table>
<thead>
<tr>
<th>Date</th>
<th>Name of guiding opinion</th>
<th>Launched by</th>
<th>Details</th>
</tr>
</thead>
</table>
| August 2011 | Opinions of the General Office of the State Council on the Policy of Accelerating the Development of the Logistics Industry | MOFCOM, MOF, PBC               | Premier Wen Jiabao highlighted eight measures to promote the development of the logistics industry in the committee meeting of the State Council in June 2011:  
- Reduce the tax burden on logistics enterprises  
- Enhance policy support on land use in favour of the logistics industry  
- Promote a better operational environment for trucking services  
- Improve the management of logistics enterprises  
- Encourage integration of logistics facilities and resources  
- Promote the innovation and application of logistics technology  
- Strengthen financial support for the logistics industry  
- Support the development of agricultural products logistics.  
The State Council promulgated The Opinions in August 2011. On top of the eight measures mentioned, an additional measure was to:  
- Enhance coordination among stakeholders within the logistics industry. |
| October 2011 | Opinions on Expanding Consumption during the 12th Five-Year Plan Period                   | MOFCOM, MOF, PBC               | The government set the following targets during the 12th FYP period:  
- Total retail sales of consumer goods to reach 32 trillion yuan, with an annual growth rate of 15%  
- Retail sales of online retailing to reach 2 trillion yuan, with an annual growth rate of 35%  
- Consumption to reach 35 trillion yuan, with an annual growth rate of 15%  
- Consumption rate to reach 50%.  
Major tasks include:  
- Facilitate rural distribution  
- Promote non-store retailing  
- Promote credit card consumption  
- Encourage multi-format retailing  
- Support direct sourcing  
- Promote “green” consumption and to safeguard consumption safety. |
| January 2012 | Guiding Opinions on Promoting the Development of Commercial Franchising during the 12th Five-Year Plan Period | MOFCOM                          | The government set the following targets during the 12th FYP period, to:  
- Increase the number of franchisees and the scale of franchise operations  
- Improve industry standards  
- Support the development of large franchise businesses.  
Major tasks include:  
- Revise and improve the Regulations for the Administration on Commercial Franchising  
- Support the application of business information systems. |
| August 2012  | Opinions of the State Council on Further Reformation of the Distribution Sector and Acceleration of the Development of the Distribution Sector | The State Council               | The Opinions aim at establishing a modern distribution system, reducing the ratio of the total logistics cost to GDP, enhancing the competence of large-sized distribution enterprises, adopting modern information technology, and improving the market environment. Major tasks include to:  
- Strengthen the distribution network such as urban-rural transportation and in-town delivery.  
- Improve supply chain efficiency  
- Improve logistics facilities, e.g., large-sized distribution centres and agricultural cold chain facilities  
- Enhance the level of informatisation in the distribution sector, e.g., adopting the internet of things, cloud computing, the global positioning system and e-barcodes. |
| September 2012 | 12th Five-Year Plan for Domestic Trade Development                                      | The State Council               | The government set the following targets during the 12th FYP period:  
- Total retail sales of consumer goods to reach Rmb 3 trillion, with an annual growth rate of 15%  
- Value-added of the wholesale, retail, accommodation and catering sectors to reach Rmb 7 trillion, with an annual growth rate of 11%  
- Total transactions within the e-commerce market to reach Rmb 18 trillion, with an annual growth rate of 30%.  
Major tasks include to:  
- Promote coordinated development among different regions, as well as among rural and urban areas  
- Develop a modern distribution system in China  
- Stimulate the development of consumer service sectors such as household services and mass catering  
- Enhance the modernisation of the distribution sector to facilitate technological progress; support the development of e-commerce; promote the franchise operations; stimulate the development of logistics services, and foster the development of green, low carbon distribution practices  
- Strengthen the monitoring of market situations to improve the reserve mechanism for important commodities and the emergency mechanism for ensuring the adequate supply of daily necessities  
- Create an environment for fair competition to combat the production and transaction of pirated and counterfeit goods; improve credit information system and services, and strengthen the supervision of product quality and safety  
- Reduce barriers to market entry to further open up markets to foreign enterprises and to support coordinated development of domestic and foreign trade. |
| January 2013 | Comprehensive Work Plan Regarding Cutting Distribution Expenses and Improving Distribution Efficiency | The State Council               | The Work Plan aims at reducing distribution costs and improving distribution efficiency. Major tasks include to:  
- Reduce utility bills for enterprises in selected sectors  
- Reduce operation costs for wholesale markets in selected sectors  
- Regulate the fees of services such as installation and maintenance fees of electricity and telecommunications systems  
- Formulate regulations to promote fair transactions between suppliers and retailers  
- Reduce toll fees  
- Step up efforts in monitoring prices  
- Offer favorable fiscal and taxation policies to selected enterprises and sectors  
- Secure land resources for distribution enterprises  
- Improve and facilitate logistics efficiency  
- Establish a comprehensive system for collecting data and statistics. |

MOFCOM: Ministry of Commerce; MOF: Ministry of Finance; PBC: People’s Bank of China  
Source: Government websites:  
1 http://scyxs.mofcom.gov.cn/aarticle/zcfb/201110/20111007798680.html;  
2 http://www.mofcom.gov.cn/aarticle/b/d/201110/20111007788024.html;  
3 http://www.mofcom.gov.cn/aarticle/b/d/201201/20120107921658.html;  
4 http://www.mofcom.gov.cn/aarticle/b/d/201202/20120207963815.html;  
5 http://www.gov.cn/zwgk/2012-08/10/content_22520743.htm;  
6 http://www.gov.cn/zwgk/2013-01/15/content_2312686.htm
Brands set their sights on tier 3 and 4 cities and rural markets, but immediate returns are not guaranteed

Today, increasing numbers of brand owners and retailers are attracted by the booming consumer market in China’s tier 3 and tier 4 cities. Indeed, the retail sales growth in China’s lower-tier cities was more resilient in 2012 than in tier 1 and tier 2 cities.

The rural market is not to be ignored either. The government has launched a series of initiatives, such as the “household appliances to the countryside” campaign, in an effort to boost rural consumption. Looking ahead, inland regions and the rural market are expected to continue with better growth momentum, and distributors are expected to respond to these changes. Nonetheless, expansion into these regions is costly for many distributors and does not guarantee immediate returns in the short run.

Overseas participation expected to climb, yet entering China is no easy task

Foreign firms have significantly increased their presence since the sector was opened up to overseas investors in 2004. Eyeing the huge potential of China’s expanding consumer market, many foreign distributors view China as one of their top investment destinations.

Yet, it is getting more difficult for foreign brands to build a national distribution network in China. When consulted, some of the established distributors operating national networks agreed that competition is fierce and investing in or acquiring an existing network is the most efficient way to establish national distribution network. However, this might not suit all brands, due to the very large financial implications.

More diversified distribution models appear

China’s distribution models are now more diversified, with the emergence of multi-channel retailing and distribution. Many retailers have embarked on multi-channel strategies to lower operating costs and achieve wider customer reach. Online, telephone and television retailing and catalogues sales are all becoming increasingly popular. For example, some traditional wholesalers, such as the Guangzhou Baima Clothing Market, have established online trading platforms.

The concept of the omni-channel emerges

An omni-channel is a seamless approach to providing “customer experience” through all available shopping channels. It allows consumers to shift sequentially between channels or simultaneously access many channels to perform different tasks. For instance, a customer can place orders both online and offline. After placing orders, customers can choose home delivery, or pick up orders at an offline store in person.

With the emergence of the omni-channel, distributors need to equip themselves with the appropriate hardware, including possibly a bespoke IT system, and software (particularly service offerings) to embrace the new concept.
Challenges

China is a key market for most companies looking for growth. Nonetheless, over successive years, many companies have learnt important (sometimes costly) lessons when entering the China market. Major challenges are summarised below:

Disintermediation

Disintermediation, or the removal of intermediaries in a supply chain, represents a real threat to distributors. Some big-name retailers such as Wal-Mart Stores and Carrefour have set up their own departments or units in China to source directly from manufacturers. By contrast, some established suppliers such as Haier Group have set up their own retail outlets. The rapid development of e-commerce is posing an equal threat to distributors as well.

Renowned brands are less willing to grant national distributorship rights in certain sectors

Instead of hiring distributors, many brand owners in China prefer to have their own sales and distribution arms in some sectors (such as FMCG and apparel) for a better grip on the market. Even if they hire distributors, they prefer to grant non-exclusive distributorship rights to foster competition and expand their distribution networks.

Industry malpractices

Questionable practices are seen to be commonplace in China. For instance, price differentiation of the same product in different regions can lead to opportunistic but harmful arbitrage strategies. Counterfeiting is another problem, due to poor enforcement of the anti-piracy law and general disrespect for intellectual-property rights.
Inconsistent commercial regulations

Practitioners in the distribution field have expressed their concern over inconsistent commercial regulations and different interpretations and enforcement of regulations around the country. For example, entrance fees and promotion expenses that are legitimate in some cities are considered to be bribery in others.

Strained relationships between players along the supply chain

Retail chain operators in China have been expanding rapidly to give them more bargaining power over their distributors. They are also placing on them more stringent requirements. Imposing cumbersome charges on distributors and extending payment periods are practices often seen.

Cost increases

Climbing costs of doing business in China are of key concern. The country’s distribution sector is labour-intensive – and labour costs are escalating fast, especially in the larger cities. Some distributors say that high logistics costs, particularly for transportation and warehousing, severely impact their businesses. Moreover, the surging rental costs for prime retail sites further eat into whatever profits there are.
Implications for investors

Distribution businesses in China face a complicated set of tasks. Companies which focus on setting up new operations or expanding their existing ones are advised to keep a close eye on the following factors:

**A more challenging environment**

With many foreign brands eager to tap the China market, distributors can still play a highly significant role into the future since they offer established distribution networks that would be costly for brand owners or manufacturers to develop themselves.

However, squeezed margins and consolidation among players can certainly be expected. Distributors should increase service offerings and provide more value-added services in response to progressively demanding manufacturers and retailers.

**Increasing cost of doing business in China**

Industry players are expected to continue experiencing mounting cost pressures as operating costs trend upwards. In our interviews with distributors, even some large firms admit that climbing costs have severely impacted their businesses.

Along with rising rental and labour costs and heavy toll charges, investors have to be aware of other expenditures incurred in running businesses in China. A typical example is the contribution to social insurance schemes. All enterprises in China are required to participate in these and pay social insurance premiums.

**Adopting a combination of distribution models, given the emergence of new channels, especially online**

To tap the China market, enterprises should consider adopting a combination of distribution models. Directly-owned operations ensure better control over brand image and pricing strategies, while distributors provide an extensive network at a lower cost over the near term.

New distribution channels – particularly online – are becoming increasingly popular. The online channel is particularly favoured by apparel distributors and retailers. However, this might not be so attractive to certain sectors such as confectionery. The omni-channel strategy is also gaining attraction.
Developing business in a more sustainable manner

Since brand owners and manufacturers rely less on distributors once they become established, the latter need to look for new brands which require expertise and an established infrastructure, to help distribute these products in China.

To develop a more sustainable partnership with brand owners or manufacturers, distributors should consider cooperating through joint ventures, if not actually acquiring brands. As for improving distribution channels, consideration should be given to establishing or acquiring a retail network to ensure overall distribution control.
Part II

In this section, we take a closer look at the distribution of two key product categories, footwear and toys. Information has been collected from public sources as well as through interviews with academics and industry practitioners.
Footwear

Key Insights

- The retail market size of the footwear sector in China was 290.9 billion yuan in 2012, representing the rate of yoy growth at 11.7%. The 2012-2017 CAGR is expected to be 8.8%.
- Brand owners and manufacturers continue to adopt a combination of directly-operated stores and franchise stores.
- Brand owners and manufacturers are expected to increasingly prefer to manage their stores directly at strategic or profitable locations, while leaving other locations to distributors or franchisees.
- Online retailing is a rising star, representing a sizeable portion of the market. Yet, this channel is more for marketing and promotion, complementing offline channels rather than generating profit.
Distribution model

- Exhibit 6 shows the major distribution models for footwear in China and the characteristics of each of these models.
- The majority of brand owners and manufacturers adopt a combination of both directly-operated and franchise stores.
- Very often, they manage the stores in key cities directly, while franchising other stores in other cities.
- It is also observed that a considerable number of brand owners and manufacturers have opened online shops. Daphne and Aokang are cases in point.
### Exhibit 6: Major distribution models for footwear in China and their characteristics

<table>
<thead>
<tr>
<th>Model</th>
<th>Description</th>
</tr>
</thead>
</table>
| **Model I** | Brands with the following characteristics tend to hire agents to distribute their products:  
- Those with smaller turnover; or  
- Those which do not want to invest heavily at the initial stage; or  
- Those which have limited knowledge of the China market; or  
- Those which have no connection with distributors in China.  
- However, Model I will tend to fade out in the near future. When brands grow in size and become more established in China, they choose to approach distributors directly (Model II) or manage their stores directly (Model III). |
| **Model II** | A majority of footwear brand owners or manufacturers expand their distribution network by authorising franchisees to distribute shoes for them, primarily due to China’s wide geographical span. |
| **Model III** | Some brand owners tend to sell their products without the help of distributors. They prefer setting up their own directly-operated stores. Very often, they open these stores at strategic and profitable locations.  
- Directly-operated stores are more efficient when compared to franchise stores. Normally, the average sales per store for the former is higher than for franchise stores. Directly-operated stores are also managed in a more effective manner in terms of visual merchandising, image control and price control.  
- However, it is relatively more costly to run directly-operated stores because of the higher capital expenditure (CAPEX) and higher rental costs in key cities. |
| **Model IV** | One typical example of Model IV is online retailing.  
- Online retailing is clearly on the rise and has become an important distribution channel for footwear.  
- Many renowned brands such as Daphne and Aokang have embarked on online retailing on the mainland. Nonetheless, this channel is mainly for marketing and promotion, complementing the offline channel rather than generating profits. |

Source: Fung Business Intelligence Centre
Distribution landscape

*Market share by distribution channels*

- Exhibits 7 & 8 show the market share (for retail sales) by various distribution channels in China’s footwear sector over the past five years.
- Specialist retailers and department stores have been the two major distribution channels in the country over the past five years, taking up almost two-thirds of total footwear distribution.
- In 2012, specialist retailers’ market share stood at 36.2%, up by 2.3 percentage points when compared to 2008.
- Department stores’ market share was 36.0% in 2012, dropped slightly from 36.6% in 2008.
- Online retailing is clearly a rising star – it accounted for 8.0% of market share in 2012, spiking sharply from only 0.1% five years ago.

**Exhibit 7: Market share (retail sales) in China by distribution channel for footwear, 2008-2012**

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Store-based retailing</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grocery retailers</td>
<td>19.3</td>
<td>19.3</td>
<td>19.4</td>
<td>19.4</td>
<td>18.0</td>
</tr>
<tr>
<td>Non-grocery retailers</td>
<td>80.5</td>
<td>80.4</td>
<td>79.6</td>
<td>76.8</td>
<td>73.9</td>
</tr>
<tr>
<td>- Department stores</td>
<td>36.6</td>
<td>36.8</td>
<td>37.5</td>
<td>37.8</td>
<td>36.0</td>
</tr>
<tr>
<td>- Specialist retailers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Apparel specialist retailers</td>
<td>22.5</td>
<td>22.5</td>
<td>23.6</td>
<td>23.8</td>
<td>24.6</td>
</tr>
<tr>
<td>Leisure and personal goods</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Specialist retailers</td>
<td>11.4</td>
<td>11.5</td>
<td>11.6</td>
<td>11.6</td>
<td>11.6</td>
</tr>
<tr>
<td>- Other non-grocery retailers</td>
<td>10.0</td>
<td>9.6</td>
<td>6.9</td>
<td>3.6</td>
<td>1.7</td>
</tr>
<tr>
<td><strong>Non-store retailing</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Home shopping</td>
<td>0.2</td>
<td>0.3</td>
<td>1.0</td>
<td>3.8</td>
<td>8.1</td>
</tr>
<tr>
<td>Internet retailing</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

*Source: Euromonitor International*
Consider various factors such as market positioning and costs of distributing products via different distribution channels. Different segments of the footwear sector distribute via various channels or combinations of channels, as they have distinct features and different customer group profiles. Exhibit 9 exemplifies a mid-market footwear brand. Normally, such a brand owner would prefer distributing products via established chain grocery retailers, department stores, shopping malls and online shops. On the other hand, a high-end footwear brand owner would usually prefer to sell in department stores or shopping malls; selling through grocery retailers seems unlikely to be attractive, however.
Exhibit 9: Characteristics of distribution channels in China for mid-market footwear

<table>
<thead>
<tr>
<th></th>
<th>Grocery retailer*</th>
<th>Department store/Shopping mall</th>
<th>Online shop</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market segment</td>
<td>Low to mid market</td>
<td>Mass; mid to high end</td>
<td>Wide range: From low to high end</td>
</tr>
<tr>
<td>Cost</td>
<td>Lower</td>
<td>Highest</td>
<td>Relatively low if operating via established platforms; high if self-operating</td>
</tr>
<tr>
<td>[e.g. participating in promotional activities]</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of retail outlets</td>
<td>Small</td>
<td>Small</td>
<td>-</td>
</tr>
<tr>
<td>Turnover</td>
<td>Lower</td>
<td>Higher</td>
<td>Varies</td>
</tr>
<tr>
<td>Delivery to distribution centres</td>
<td>Yes</td>
<td>No</td>
<td>Yes if operating via established platforms; no if self-operating</td>
</tr>
</tbody>
</table>

* Grocery retailer in this exhibit refers only to large chained hypermarkets and supermarkets

Source: Fung Business Intelligence Centre

Estimated cost structure for footwear distribution in China

- The cost structure varies considerably, depending on the type of footwear and market positioning of the brand. An industry average is not considered meaningful.
- Exhibit 10 presents an estimated cost structure for mid-market footwear distribution in China.

Exhibit 10: Estimated cost structure in China for mid-market footwear distribution

Source: Fung Business Intelligence Centre
Key Insights

- The retail market size in China of traditional toys including dolls, action figures and plush toys was 43.1 billion yuan in 2011, recording a yoy growth rate of 16.4%. The industry is projected to grow at a CAGR of 12.4% over the period from 2011 to 2016.
- Large brand owners and manufacturers in the country expand their distribution networks by authorising distributors to handle toys as well as sell to retailers directly; small and local brand owners and manufacturers prefer selling their products directly to retailers in adjacent regional markets without the help of distributors.
- Online retailing is gaining popularity. Yet, this channel is predominantly for marketing and promotion and complementing the offline channel rather than for generating profit.
- Since June 2007, toys require the China Compulsory Certification (CCC or 3C) affixed with the 3C mark by a Designated Certification Body before they can be imported or sold in China. Generally, the whole certification process will take several months. In some cases, it could take several years.
### Exhibit 11: Major distribution models in China for traditional toys and their characteristics

<table>
<thead>
<tr>
<th>Model</th>
<th>Participants</th>
<th>Description</th>
</tr>
</thead>
</table>
| Model I | **Brand owners, Manufacturers** — Agents — **Distributors, Wholesalers, Sub-distributors** — **Retailers** — **Consumers** | - Brands with the following characteristics tend to hire agents to distribute their products:  
  • Those with smaller turnover; or  
  • Those which do not want to invest heavily at the initial stage; or  
  • Those which have limited knowledge of the China market; or  
  • Those which have no connections with distributors in China.  
- However, Model I will tend to fade out in the near future. When brands grow in size and become more established in China, they choose to hire distributors directly (Model II) or sell to retailers directly (Model III). |
| Model II | **Brand owners, Manufacturers** — **Distributors, Wholesalers, Sub-distributors** — **Retailers** — **Consumers** | - Quite a number of toy brand owners or manufacturers, especially larger ones, expand their distribution network by authorising distributors to handle toys for them, primarily due to China’s wide geographical span. |
| Model III | **Brand owners, Manufacturers** — **Retailers** — **Consumers** | - Large brand owners or manufacturers also sell to retailers directly.  
- Small and local brand owners or manufacturers tend to sell their products in adjacent regional markets without the help of distributors. |
| Model IV | **Brand owners, Manufacturers** — **Retailers** — **Consumers** | - A typical example of Model IV is online retailing.  
- Online retailing is clearly on the rise and has become an important distribution channel for toys.  
- Some renowned brands such as Lego have embarked upon online retailing in China. Nonetheless, this channel is more for marketing and promotional purposes for the time being. |

*Source: Fung Business Intelligence Centre*
Distribution model

- Exhibit 11 shows the major distribution models for traditional toys in China and the characteristics of each of these models.
- Large brand owners and manufacturers expand their distribution networks by authorising distributors to send out toys as well as to sell to retailers directly.
- By contrast, small and local manufacturers prefer selling their products directly to retailers in their adjacent regional markets – without distributors. For example, many small toy manufacturers in Chenghai, home to one of China’s top toy industry clusters, sell their products to Guangdong retailers directly.
- Another observation is that some brand owners such as Lego have opened online shops. Some prominent chain specialists such as Toys “R” Us have also launched their online shops.

Distribution landscape

Market share by distribution channel

- Exhibits 12 & 13 show the market share (by retail sales) of various distribution channels for traditional toys in China over the past five years.
- Department stores and grocery retailers have been the two major distribution channels in China over the past five years, accounting for about two-thirds of toy distribution in the country.
- In 2011, department stores’ market share was 43.3%, rising slightly by 0.5 percentage points when compared to 2007.
- Grocery retailers’ market share was 33.0% in 2011, up from 32.6% in 2007.
- Online retailing is gaining popularity. It accounted for 2.5% of market share in 2011, surged from only 0.5% five years previously. This is probably due to internet penetration, and to the fact that increasing numbers of young parents are receptive to online shopping.

Exhibit 12: Market share (by retail sales) of distribution channels in China for traditional toys, 2007-2011

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Store-based retailing</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grocery retailers</td>
<td>32.6</td>
<td>32.6</td>
<td>32.8</td>
<td>33.0</td>
<td>33.0</td>
</tr>
<tr>
<td>Non-grocery retailers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Department stores</td>
<td>42.8</td>
<td>43.0</td>
<td>43.1</td>
<td>43.2</td>
<td>43.3</td>
</tr>
<tr>
<td>- Specialist retailers</td>
<td>12.5</td>
<td>12.5</td>
<td>12.9</td>
<td>13.0</td>
<td>13.0</td>
</tr>
<tr>
<td>- Other non-grocery retailers</td>
<td>11.6</td>
<td>11.4</td>
<td>10.5</td>
<td>9.1</td>
<td>8.2</td>
</tr>
<tr>
<td>Non-store retailing</td>
<td>0.5</td>
<td>0.5</td>
<td>0.7</td>
<td>1.7</td>
<td>2.5</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Euromonitor International
Exhibit 13: Market share (for retail sales) by distribution channels in China for traditional toys, 2007 and 2011

**Major Footwear Distribution Channel in China, 2007**

- Grocery Retailers: 32.6%
- Department Stores: 42.8%
- Specialist Retailers: 12.5%
- Other Non-Grocery Retailers: 11.6%
- Non-Store Retailing: 0.5%

**Major Footwear Distribution Channel in China, 2011**

- Grocery Retailers: 33.0%
- Department Stores: 43.3%
- Specialist Retailers: 13.0%
- Other Non-Grocery Retailers: 8.2%
- Non-Store Retailing: 2.5%

Source: Euromonitor International

**Characteristics of various distribution channels**

- When selecting an appropriate distribution channel for its products, a brand owner or manufacturer has to consider various factors such as market positioning of products and the costs of distributing products via different distribution channels.
- Various segments of the toy sector distribute via different channels or combination of channels as they have distinct features and varying customer group profiles.
- For instance, distributing products via hypermarkets and department stores is generally more costly since these channels require tenants to participate in regular promotional activities.
- Exhibit 14 exemplifies the case of a mid- to high-end toy brand. Normally, such a brand owner considers distributing products via established chain grocery retailers, specialist retailers, department stores, shopping malls and online shops.
### Exhibit 14: Characteristics of distribution channels in China for mid- to high-end toys

<table>
<thead>
<tr>
<th></th>
<th>Grocery retailer*</th>
<th>Specialist retailer**</th>
<th>Department store/Shopping mall</th>
<th>Online shop</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Segment</td>
<td>Mass</td>
<td>Low to high end</td>
<td>Mid to high end</td>
<td>Wide range: From low to high end</td>
</tr>
<tr>
<td>Cost [e.g., participating in promotional activities]</td>
<td>Higher</td>
<td>Lower</td>
<td>Higher</td>
<td>Relatively low if operating via established platforms; high if self-operating</td>
</tr>
<tr>
<td>Number of retail outlets</td>
<td>Fair</td>
<td>Largest</td>
<td>Larger</td>
<td>-</td>
</tr>
<tr>
<td>Turnover</td>
<td>Lower</td>
<td>Lower</td>
<td>Highest per store</td>
<td>Varies</td>
</tr>
<tr>
<td>Delivery to distribution centres</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>Yes if operating via established platforms; no if self-operating</td>
</tr>
</tbody>
</table>

* The grocery retailer in this exhibit refers only to large chain hypermarkets and supermarkets

** Examples include infant channels and toy specialty stores

Source: Fung Business Intelligence Centre
China Compulsory Certification (CCC or 3C)

- Implemented in August 2003, 3C is a unified compulsory product certification for products that have an impact on the health and safety of people, animals and plants, on environmental protection and on public safety.
- Factory audit is an integral part of the certification. Generally, the whole certification process will take a few months. In some cases, it might take up to a few years.
- Products listed in the 3C catalogue must be granted the relevant certificate, affixed with the 3C mark by a Designated Certification Body before they can be imported or sold in China.
- Currently, a total of 23 product categories are subject to 3C as of June 2013:

<table>
<thead>
<tr>
<th>Electrical wires and cables</th>
<th>Information technology equipment</th>
<th>Medical devices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Household and similar electrical appliances</td>
<td>Switches for circuits, protective and connection devices</td>
<td>Security and protection equipment</td>
</tr>
<tr>
<td>Fire fighting equipment</td>
<td>Telecommunications terminal equipment</td>
<td>Low-voltage electrical apparatus</td>
</tr>
<tr>
<td>Small power motors</td>
<td>Motor vehicles and safety parts</td>
<td>Wireless local area network equipment</td>
</tr>
<tr>
<td>Electric tools</td>
<td>Motor vehicle tires</td>
<td>Toys</td>
</tr>
<tr>
<td>Welding machines</td>
<td>Lighting apparatus</td>
<td>Decoration and renovation products</td>
</tr>
<tr>
<td>Safety glass</td>
<td>Agricultural machinery</td>
<td>Latex products (June 2013)</td>
</tr>
<tr>
<td>Audio and video equipment</td>
<td>Information security products</td>
<td></td>
</tr>
</tbody>
</table>

Sources: The Certification and Accreditation Administration of the People’s Republic of China

- Toys have constituted one of the categories subject to 3C since June 2007.
- Toy distributors and retailers that used to rely on products from export-oriented factories have suffered badly ever since toys were subject to 3C. That is because their factories preferred to focus on export orders than on the complexity of acquiring 3C certification for their products.
- Fortunately, more export-oriented factories are willing to accommodate 3C requirements, now recognising the huge potential of the China market.
Estimated cost structure for toy distribution in China

- The cost structure varies significantly, depending on such factors as the market positioning of the brand. An industry average is not considered meaningful.
- Exhibit 15 presents an estimated cost structure for mid-market toy distribution in China.

Exhibit 15: Estimated cost structure in China for mid-market toy distribution

<table>
<thead>
<tr>
<th>Brand owners Manufacturers</th>
<th>Distributors, Sub-distributors, Franchisees</th>
<th>Retailers, Sub-franchisees</th>
<th>Consumers</th>
</tr>
</thead>
<tbody>
<tr>
<td>purchase from</td>
<td>purchase from</td>
<td>purchase from</td>
<td></td>
</tr>
<tr>
<td>$45-55</td>
<td>$70-80</td>
<td>$100</td>
<td></td>
</tr>
</tbody>
</table>

Source: Fung Business Intelligence Centre