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Navigating the Labyrinth: Sales and Distribution in Today's China

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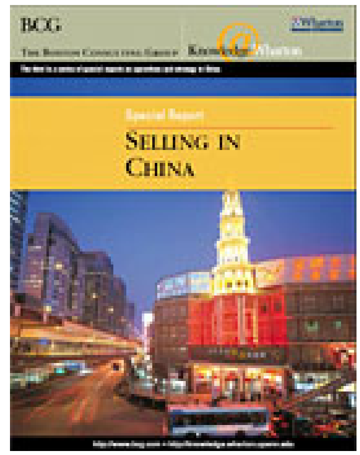

For a hundred years or more, Western businesses have dreamed of selling to the vast Chinese market. With sights set on the country's 1.3 billion consumers, they are finally getting their chance, but experts from Wharton and Boston Consulting Group say that firms should not underestimate the skills they will need to develop in order to compete there -- particularly as they try to expand outside China's largest 30 or 40 cities into the country's more than 500 other large markets.

The reason: While the big-box retail giants are starting to build modern, recognizable distribution systems in the nation's largest markets, China's goods and services are still mostly supplied via the labyrinthine networks of state-owned distribution companies and small, private wholesalers.

Jim Hemerling, a senior vice president for Boston Consulting Group in Shanghai, says that distribution remains one of the biggest challenges companies face as they try to expand across the country -- but also one of the biggest opportunities. "It presents an opportunity for competitive advantage because it's so difficult," he says.

A Complex, Multi-tier System

Reaching consumers through modern retailers is a somewhat familiar process to Western manufacturers, yet even the more standardized hypermarkets such as Carrefour are not quite the same as they are in other economies. "Dealing with the large hypermarkets is more similar than different, but even the hypermarkets have adapted their store formats for China," says Hemerling. Carrefour, for instance, has created large "wet markets" in their China stores to cater to the Chinese preference for fresh produce and fish.

The second way goods get to customers is through a complex, multi-tier distribution system that is still emerging from years of state control. Depending on the category, says Hemerling, 30% to 60% of the market is still served by complex tiers of wholesalers, particularly in the smaller, less advanced markets.

David Jin, a partner at BCG in Shanghai, says that distribution in China's old planned economy was historically through a tiered structure in which layers of tightly controlled distributors passed goods from the province, to the city, to the township. While some of these distributors have now privatized, others are still state-owned. State-owned distributors retain important advantages in industries such as pharmaceuticals, where tight regulation has kept distribution somewhat protected, according to Jin.

In less-regulated sectors such as consumer goods distribution, competition is greater. Here, the example of multinationals such as Procter & Gamble is having an impact on the older distributors, notes Jin. "These [companies'] best practices have some spillover effect onto the other distributors, so gradually they're influencing the market," he says.

Small distributors are also used to moving goods through a third and even fourth tier of distribution, especially to reach into China's smallest 500 cities and its countryside, according to Jin. Goods are either sent through an old official network or through more informal paths. In some categories, small distributors meet in a physical location in some area of a large city, buy a shipment of goods from a larger distributor and then drive their load back to another market in their own city. These distributors will in turn either sell the goods to multi-outlet retailers or to other groups of smaller distributors, who deliver the goods to local stores and "mom and pop" retailers.

Most of these distributors are unlike the value-added distribution firms with which modern manufacturers are familiar. Small and lacking in information technology to manage their inventory, most of these distributors are likely to be passive resellers, intent on passing the goods along from one distribution tier to the next for a very small margin, according to BCG experts.

Not surprisingly, gaining understanding and control in these fragmented networks has proven an easier task for domestic companies than foreign ones. "When Western companies get to tier three or tier four cities [cities of 500,000 to 3 million] they just cannot compete effectively," says Jin. Local firms and companies out of Taiwan and Hong Kong have used this knowledge to their advantage. Chinese mobile phone handset manufacturers, for example, have gained market share over foreign rivals such as Nokia by developing distribution through these smaller markets. Lenovo, the Chinese company that bought IBM's ThinkPad unit, has built up a formidable share against Dell in this way as well, by opening local stores even as Dell tried to stick to the direct-sales model that has worked well in more advanced markets.

While most BCG and Wharton experts agree that over time the vestigial wholesale system is likely to be squeezed out through competition, Hemerling says the price of standing aside until that happens may be too high for many Western companies. "Ten years is a long time to wait. You give up a lot of business and you lose the opportunity to establish your brand during that time," he says.

Building a Sales Organization

By all accounts, creating a sales and distribution network in today's China isn't easy. "It's definitely more chaotic, it's definitely more difficult to deal with, and you need to have more people on the ground because of it," says Z. John Zhang, a marketing professor at Wharton.

One of the biggest challenges is simply mapping the flow of goods through these distribution networks, according to Hemerling. In the past, Chinese manufacturers would often send goods to a distributor with no real idea which customers those goods eventually reached. For a foreign company, Hemerling says, understanding where those goods are flowing is critical because different distribution channels often reach different customer segments.

Creating a sales network is essential in the smaller markets. The tier three and tier four markets are less sophisticated than the largest cities -- perhaps five to ten years behind, Wharton and BCG experts say. With a smaller group of modern retailers available, local knowledge is needed to navigate effectively in many categories, and an extensive sales force is often necessary if the supplier wants to retain control of the product. Sales people are needed to identify the best distributors and work closely with them to make sure that products are displayed properly and pricing practices are followed, according to Hemerling.

Controlling product placement and pricing will also involve working with local retailers -- which probably won't be easy. "Retailers are very powerful and they are pretty tough to deal with," says Zhang. "They charge back a lot of things to you -- so for instance, when they do their price promotions, they let you pay the bill."

The restrictions U.S. companies face against certain kinds of practices may prove an obstacle to expanding through these traditional channels. "Certain things that are proven to be successful practices in China may not be something that many Western companies want to use," Zhang says. For instance, kickbacks are sometimes necessary to get a product through the door.

Sometimes, Zhang notes, these cultural differences can work to the foreign company's advantage. "In some cases you do get respect from these local businesses.... If a retailer knows you can't break a certain rule, they won't squeeze quite as much." Yet there are limits: "I think there is always a balance between the flexibility versus the rigidity, and if you're too flexible, obviously they will try to squeeze you more. But if you are too rigid, of course, then there's going to be a problem there, too," he adds.

According to Zhang, in many cases retailers simply rent store space to a vendor and let the manufacturer supply its own sales people. Sun Yan, a Beijing-based consultant for Boston Consulting Group, says that this practice began as a way for domestic manufacturers of new products to break into stores, but the stores have extended the model to multinationals. She adds that this practice can be challenging to multinationals, which frequently have strict headcount limits. Although the new sales people are often contract workers employed by a state-owned company, according to Sun, companies face a huge managerial challenge as they try to expand from an organization that may have been only three small offices in the largest cities to a multi-tiered structure with thousands of employees.

For one thing, finding and training capable people is not always easy. Turnover in these fast-growing markets is also likely to be high: "Because of the supply and demand on the talent," says Jin, "even if you train the people, other companies come in and they just hire them away."

As difficult as they can be to manage, companies are finding that such large sales organizations do have some benefits. Sun says that a good sales force can do a much better job introducing new features in a product and cross-selling. Such a force can also act as an important source of market data, since sales people can be used to collect consumer and competitor information right in the store.

At present, there seems to be no way around building such an organization. Traditional retailers are still the dominant sales channel in many categories. Western hypermarkets such as Carrefour and Wal-Mart are just beginning to expand deeper into China. Sun says that e-commerce and direct mail are still largely a phenomenon of the coastal cities, and Amway-style direct selling remains legally restricted.

Despite the fact that modern retail is growing at 50% per year, BCG analysts estimate that modern retailers reach only one quarter of the 500 million consumers who live in or near the 3,000 largest cities and towns. BCG estimates that 80% to 85% of rice crackers, 75% of soft drinks and 65% to 70% of television sets are still sold through traditional channels.

Reaching the Heartland

Even when agreements between distributors and retailers are all set, the process of moving goods from one place to another remains a daunting task. Marshall Meyer, professor of management at Wharton, says that logistics represent about 20% of China's gross domestic product -- compared to about 10% for the US. It's actually cheaper, he says, to ship goods from Shanghai to New York than from Shanghai to one of China's interior cities or the countryside.

A great deal of the transportation infrastructure is still either in transition from the old state economy or is under construction. The train system is state-owned, according to Zhang, and access often depends on who you know within the system rather than business needs. However, a lot of infrastructure is also still being built. Hemerling says that the country built a strong north-south network about ten years ago, and is now at work on its east-west highways.

Most goods are shipped by smaller trucks. Hemerling says that vehicle sales numbers tell the story of a gradual shift to hub-and-spoke delivery systems as the highway system is extended across the country. Today, the number of large, long-haul trucks being sold is increasing, compared to mid-size trucks. Sales of small trucks and vans, the kind needed to get around in the smaller cities and in the countryside, are also rising, he says. But the closer distribution gets to the village, the more basic it's still likely to be: When goods reach the countryside, Zhang says, they are often transferred to people on bicycles, motorcycles, or in small cars.

Meyer says that local governments sometimes add their own obstacles to keep goods from reaching a market. Local provinces -- many of which have politicians that serve on the boards of local, state-owned companies -- may levy internal tariffs on companies trying to move goods from outside the province. Sometimes, too, townships will put up tollgates, almost at random intervals along the highways, simply to boost local revenue, according to Meyer. He adds that when he asks Chinese friends whether this is legal, they laugh and tell him that authorities periodically request that local governments take their gates down; the gates come down, but six months or a year later, they come back.

Impressions from the Past

When it comes to understanding the best options for reaching consumers in today's China, Western companies are often encumbered by impressions of what doing business in China was like in the recent past.

Sun says a number of multinationals already operating in China haven't realized how quickly the market is growing. "Many companies still ... haven't realized they need to grow coverage, to increase control. They're still happy with their coverage of the ten or twenty coastal cities, and oftentimes the market data is misleading because the market research hasn't reached into these areas," she says.

But companies that try to take advantage of this opportunity without understanding its complexities are also likely to be frustrated, Wharton and BCG experts say.

Over time, distribution around the country will undoubtedly grow more robust. An anticipated growth of third-party logistics providers will likely add more efficiency: China is still underserved by such providers, according to Hemerling, but services such as FedEx and UPS are starting to extend their presence. Logistics management software offered by Manugistics and other leading software developers is also growing more widely available, he says.

And soon, foreign companies will be permitted to operate their own transportation networks. "That will cause a huge change in the distribution landscape," Jin says. "Their distribution model, their know-how, will definitely have an influence on the local distribution market."

