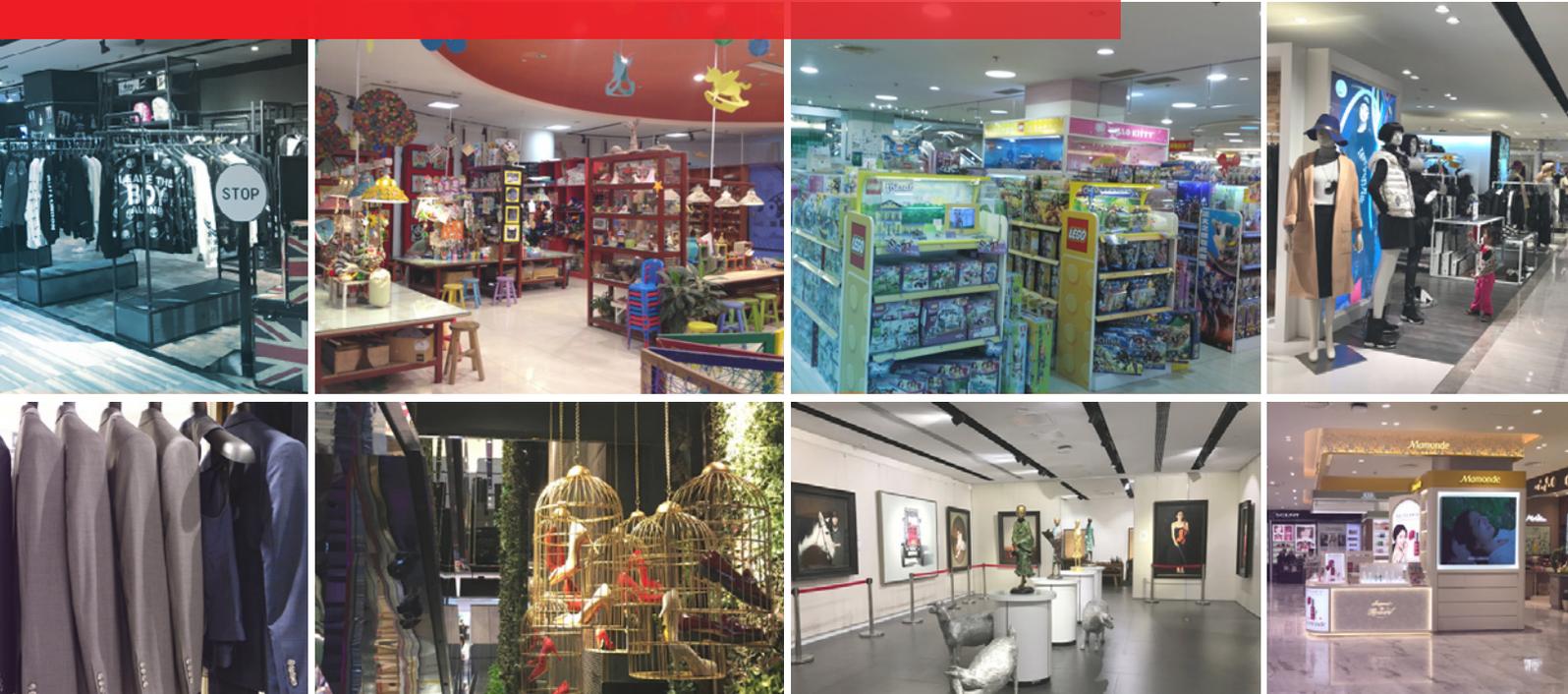


# China's Department Stores Report 2016-17

- Trends, Outlook and Implications  
March 2017



FUNG BUSINESS INTELLIGENCE







## Introduction

China's department store sector has entered a "deep-water zone" of business transformation and reached a tipping point in 2016. Increasing numbers of department store operators have actively explored new business models and retail formats with online-and-offline (O2O) retailing as the cornerstone. Alongside, a new round of elimination of underperformed players, adjustments and reorganization of the sector has begun. In the "New Retail" regime, embracing technologies and developing new business models to fully connect physical stores, online platforms and logistics services have become industry consensus.

For the second consecutive year, Fung Business Intelligence joined forces with China Commerce Association for General Merchandise (CCAGM) to produce the *China's Department Stores Report 2016-17*. The report analyses the macroeconomic data, collects financial reports from 85 domestic department stores to gauge the sector's business performance in 2016, as well as conducts a survey with over 60 department store operators to identify their latest developments and strategies. The report also discusses the key trends and major challenges faced by the sector, and makes policy recommendations to facilitate the development of the sector. Finally, the report addresses the future outlook of the department store sector in China's "New Retail" regime. We would like to express our heartfelt thanks to all department store operators, industry experts and practitioners who have supported us and participated in the preparation of this report.



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## Executive Summary

2016 was a critical year for China's department store sector. "Transformation" was no longer a buzzword for the sector but a common practice department stores embraced in the "New Retail" regime. The department store sector has undergone restructuring, with underperformed players faded away while the strong players continued to grow in scope and capabilities. Overall speaking, the department store sector witnessed a slowdown in sales in 2016, but it showed some signs of gradual improvement with growing net profits and lowering operating costs.

Key trends and developments of China's department store sector include:

- **O2O being a crucial transformation element in the "New Retail" regime**

Over the years, many department store operators have been actively deploying online-and-offline (O2O) strategies to ensure seamless integration of all channels – brick-and-mortar, online, mobile and social. Many operators have demonstrated growing sophistication with regard to O2O adoptions, with digitalization of retail outlets, launching O2O platforms, creating lifestyle scenes and introducing entertainment elements at physical stores being the key strategies. Some leading department store operators such as Wangfujing Group and Golden Eagle Retail Group are already on their transformation journey towards being an O2O retail enterprise.

- **Partnering with key Internet players to roll out O2O initiatives**

To stay competitive and grasp the opportunities created by the "New Retail" regime, some forward-thinking department store operators have proactively formed strategic alliances with Internet giants to roll out O2O initiatives. Intime Retail Group and Bailian Group are cases in point. For department store operators, forming partnerships with Internet companies could allow them to leverage the huge traffic sources as well as Big Data and logistics capabilities of Internet companies to provide better O2O services.

- **Enhancing uniqueness; focusing on product quality and service offerings**

Due to the serious problem of homogenization of department stores, many department store operators have started to revamp their stores by introducing special themes and exciting elements, and expanding services offerings with a hope to better cater to the needs of different consumer segments. Providing more experiential elements and enhancing customer service become crucial means to attract more customers to the stores and prolong the duration of their stay.

- **Accelerating transformation and introducing new business model**

In the "New Retail" regime, unique positioning with differentiated products is the key to success. Many department store operators have increased efforts to introduce new brands to the market, increase the proportion of merchandise direct sales and develop private labels, hoping to enhance the diversity of their merchandise. Other transformation strategies adopted by the department store sector include – creating buyer team and setting up self-owned multi-label stores; forming closer relationships with suppliers to strengthen the supply chains; tapping into other retail formats and business sectors; and launching pop-up stores.

- **Cross-sector integration and partnerships open up new opportunities**

Today's new market dynamics have prompted department store operators to gear up and fully equip themselves. Increasing numbers of department store operators have formed partnerships and alliances with leading sector players to build synergies, create stronger business ecosystems, access to new technologies and talents, expand business areas, and enhance overall competitiveness. The alliance between Beijing Wangfujing Dongan Group and Sanpower Group to cooperate in areas such as sourcing, private labels development, supply chain management and data sharing is a significant example.

- **Overseas department stores looking for opportunities in the China market**

Some foreign department store operators remain optimistic towards the future growth prospect of the China market and continue to expand their scope of business in China. Selected examples include Macy's China, U.K.-based department store House of Fraser, Galeries Lafayette and Hong Kong-based I.T. Fashion Group, as well as Hong Kong-based Lane Crawford Department Store.

In the "New Retail" regime, the transformation of China's department store sector is inevitable. While the department store sector is entering into the advanced phase of transformation and reinvention, a new market scene and competitive landscape are taking shape. At the same time, the government has launched a number of supportive measures to guide the development of the sector over recent years. Moving forward, with strong government support towards the development of the retail sector, department store operators should react quickly and explore their own strengths to pursue a positive future. We believe the continuous transformation and innovation of the department store sector will create a rosy scene for China's retail market.

# I. Market Overview



Despite the gradual improvement in China's macroeconomic environment and relatively stable growth of the retail market in 2016, China's department store sector still exposed to considerable threats and pressure. A number of key sector players have witnessed a significant slowdown in sales, dwindling margins and massive scale of closure of underperformed stores. Nonetheless, with the government's continual supportive measures and positive policy stance towards the development of the retail sector, department store operators are set to gain full momentum towards achieving success in their transformation process.

## 1. Department store sales growth continues to slow

### (1) Sales performance of key department stores operators

The China Commerce Association for General Merchandise (CCAGM) conducted a survey with 85 key department store operators from November to December 2016 to obtain information on their financial and operating results in 2016. The survey gives a panoramic and representative view of the industry's performance as the majority of these department store operators are leading enterprises and typical operators in China's department store sector.

In terms of business scale, 89.41% of the sampled enterprises had annual sales of 100 million yuan or above; among them, 61.18% had annual sales over 1 billion yuan and 16.47% in excess of 10 billion yuan. Exhibit 1 shows the number of sampled department store operators by annual sales in 2016.

**Exhibit 1. Annual sales of 85 sampled department store operators, 2016**

Annual sales in 2016 (million yuan)	Number of surveyed enterprises	Percentage of total sample	Cumulative percentage
Total	85	100%	-
10,001 or above	14	16.47%	16.47%
5,001-10,000	9	10.59%	27.06%
2,001-5,000	14	16.47%	43.53%
1,001-2,000	15	17.65%	61.18%
501-1,000	6	7.06%	68.24%
101-500	18	21.18%	89.41%
100 or below	9	10.59%	100%

Source: CCAGM; compiled by Fung Business Intelligence

According to the survey, total sales proceeds of the 85 sampled department store operators increased 5.45% year-on-year (yoy) to 656,689.5 million yuan in 2016 and core operating profits down 0.69% yoy to 15,376.3 million yuan. Total expenses and operating expenses dropped 3.16% and 5.70% yoy to 22,563.4 million yuan and 11,519.1 million yuan respectively. Net profits soared 12.00% yoy to 4,003.7 million yuan and ratio of sales surged noticeably by 10.00% yoy. Year-end total assets of the sampled department store

operators amounted to 150,426.7 million yuan, up 25.62% yoy. In terms of operating area, the 85 sampled department store operators registered a total operating area of 15,137,669.2 square metre (sqm) in 2016, an increase of 1.76% yoy. The average number of employees of the sampled department store operators dropped 5.06% yoy to 200,062 (Exhibit 2).

### Exhibit 2. Operating results of 85 sampled department store operators, 2016

		2016	2015	Yoy changes
Total sales proceeds	(million yuan)	656,689.5	622,760.7	5.45%
Core operating profits	(million yuan)	15,376.3	15,483.4	-0.69%
Total expenses	(million yuan)	22,563.4	23,300.3	-3.16%
Operating expenses	(million yuan)	11,519.1	12,215.8	-5.70%
Net profits	(million yuan)	4,003.7	3,574.8	12.00%
Ratio of sales (ROS)	(%)	1.64%	1.49%	10.00%
Year-end total assets	(million yuan)	150,426.7	119,746.4	25.62%
Year-end net asset value	(million yuan)	63,500.9	35,974.2	76.52%
Average number of employees		200,062	210,726	-5.06%
Operating area	(sqm)	15,137,669.2	14,876,204.0	1.76%

Source: CCAGM; compiled by Fung Business Intelligence

As shown in Exhibit 3, more than half of the sample (55.3%) witnessed a drop in sales revenue in 2016, while 44.7% of the sampled department stores enjoyed positive yoy sales growth. Among those who have registered positive sales growth, only 5.88% enjoyed exceptional sales growth of more than 20% yoy in 2016; around one-quarter of the sampled department stores recorded a single-digit yoy growth of less than 10% in 2016.

### Exhibit 3. Yoy changes in sales revenue of 85 sampled department store operators, 2016

Positive growth		44.7%
YoY changes in sales revenue	Percentage of total sample	Cumulative percentage
>5%	7.1%	7.1%
>10%	8.2%	15.3%
>20%	5.9%	21.2%
Negative growth		55.3%
YoY changes in sales revenue	Percentage of total sample	Cumulative percentage
<-10%	37.6%	37.6%
>-10%	17.6%	55.3%

Source: CCAGM; compiled by Fung Business Intelligence

## (2) Trend of persistent store closures

China has entered a new era of consumption upgrade, demand for high-quality and innovative products and services increased tremendously. Some traditional department stores failed to meet the changing needs of the market and resulted in dropping foot traffic. This, together with persistent competition from e-commerce players and declining sales growth, have led to the closures of more department stores in 2016, compared with the previous year. Recent significant closures include the shutdown of Pacific Department Store in Huaihai Road, Shanghai. U.K.-based Marks & Spencer also announced in November 2016 its plan to close all of its ten stores in China. It is expected that closure of underperformed stores will continue in the coming year, while the pace of new store opening will slow down.

Selected department stores closures in China are shown in Exhibit 4.

### Exhibit 4. Selected department store closures in China, 2016.

Department Store	City	Closing month
Parkson Department Store	Chongqing	March 2016
	Xian	June 2016
	Chongqing	August 2016
	Jiangxi	October 2016
	Beijing	October 2016
Rainbow department store	Shenzhen	February 2016
Novo Department Store	Chongqing	February 2016
	Hangzhou	July 2016
Jiuguang Department Store	Shenyang	March 2016
	Dalian	September 2016
New World Department Store	Beijing	January 2016
Pacific Department Store	Shanghai	December 2016
Maoye Department Store	Shenyang	June 2016
Tianhe Department Store	Guangzhou	August 2016
Mo Mall	Chengdu	February 2016
Hualian Department Store	Chengdu	June 2016
	Chengdu	October 2016

Source: Linkshop.com.cn; compiled by FBIC

## **2. Regional differentiation is obvious**

From the regional point of view, the department store sector in China is getting more and more differentiated in terms of sales performance and operation capabilities. Sales growth of department stores in first-tier cities and the more developed eastern region have rebounded, while that in third-tier cities have still been lingered at low single-digit growth. In terms of transformation initiatives and effectiveness, the first-tier cities and the eastern coastal areas took the lead. In lower-tier cities, people's purchasing power is rising gradually; yet, with oversupply of commercial properties, the flourishing e-commerce and the weak consumer sentiment in high-end consumption, department store operators in the lower-tier cities are facing heavier pressure and stronger competition.

## **3. New consumption pattern and empowered consumers to reshape the retail landscape**

Nowadays, with greater access to the Internet and information, consumers are more equipped and knowledgeable than ever. The burgeoning middle class and the empowered Chinese customers take an important role in fueling the country's economic growth. They are driving business decisions and reshaping the retail landscape and ecosystem. Many department store enterprises have started to connect with customers across different channels – physical stores, online, mobile and social, while maintaining the overall customer experience.

## **4. The emergence of “New Retail” propels the department store sector to adapt and reinvent**

China's retail market has seen a great deal of change as it entered the “New Retail” regime – an explosive growth of new retail formats, particularly the community-based small-format stores, dominated by convenience store chains, specialized stores, small-scale supermarkets and fresh produce grocery stores; massive mergers and acquisitions (M&As) activities between online retailers and physical enterprises; and the deployment of O2O business strategies by retailers to enhance shopping experience. Many department stores especially the sector leaders have reacted promptly and proactively to the new and vibrant market scene in the “New Retail” regime, and are getting ready to meet the challenges of transformation.

## **5. Favorable policies to drive the industry's momentum to reinvent and upgrade**

In recent years, the government has issued a number of supportive measures to facilitate the development of the retail sector. Supply-side reform and the *13th Five-year Plan for the Development of Domestic Trade and Circulation* are some examples of positive policies to promote consumption and economic growth. China's department store sector is set to benefit from the continual government support and enjoy strong momentum to reinvent and upgrade.

### **(1) Supply-side reform to solve retail supply-demand mismatch**

In China, the supply structure has long been failing to meet the demand structure. Serious supply-side problems such as excess capacity, repetitive products, lack of safe and high-quality products in the market have appeared for years. Nevertheless, with the government's increasing efforts to resolutely push forward the supply-side reform since 2015, the supply structure is set to better match the demand structure, and lead to greater choice and better quality of products. This in turn will boost the overall profitability and drive consumption, and is thus beneficial to the retail market.

### **(2) Portrait the outlook of the retail market in the *13th Five-year Plan for the Development of Domestic Trade and Circulation***

The Ministry of Commerce and nine other ministries jointly released the *13th Five-year Plan for the Development of Domestic Trade and Circulation* in November 2016, which sets out key tasks to guide the development of domestic trade and circulation in the next five years. The Plan encourages integrated development of commerce, tourism, culture and recreation with emphasis on experience and service, as well as the use of big data, Internet of things (IoT), and other information technologies to facilitate targeted marketing and provide personalized services and experiences. Enterprises are encouraged to strengthen brand awareness, increase the added value of their products and enhance soft power to meet the demand of an upgraded consumption structure.

### **(3) *The Opinions on Facilitating Innovation and Transformation of the Physical Retail Industry* provide a clear framework to guide the transformation of the department store sector**

In recent years, the Chinese government has strongly supported various forms of commercial collaborations and integration of physical entities and e-commerce companies. To facilitate the innovation and transformation of physical retailers, the General Office of the State Council issued the *Opinions on Facilitating Innovation and Transformation of the Physical Retail Industry* in November 2016. The Opinions offer policy suggestions in areas such as adjusting commercial structuring, facilitating cross-sectoral collaboration, improving the business environment and strengthening policy support.

Through providing a better business environment and creating a more stable macro-economic environment, the above policies would facilitate the healthy growth and sustainable development of the department store sector.

## II. New developments and key trends



Against the backdrop of “new normal” of slower economic growth and keen market competition, China’s department store sector has exposed to considerable threats and pressure. On the one hand, some department store operators have struggled with lackluster sales, rising operational costs and dropping profitability, resulting in the closure of underperformed stores. On the other hand, rapidly changing consumer habits and behaviors have forced operators to adapt and change. Increasing numbers of department store operators have sought to transform and upgrade themselves, and explore new business models and business practices, with O2O as the cornerstone. Under the “New Retail” regime, developing new business models with new innovations and breakthroughs has become industry consensus.

## 1. O2O being a crucial transformation element in the “New Retail” regime

The term “New Retail” has been widely discussed over the past year. Under the “New Retail” regime, the line between online and offline businesses is blurring. E-commerce is no longer online only; many online activities can be translated into offline purchases, and vice versa.

Over the years, many department store operators have been actively deploying O2O strategies to ensure seamless integration of all channels – brick-and-mortar, online, mobile and social. Many operators have demonstrated growing sophistication with regard to O2O adoptions, with digitalization of retail outlets, launching O2O platforms, creating lifestyle scenes and introducing entertainment elements at physical stores being the key strategies.

According to a recent survey conducted by the CCAGM and the Fung Business Intelligence<sup>i</sup>, 46.9% of department store operators have already started their e-commerce business (Exhibit 5) – among them, 75.9% have established wholly-owned transactional website, 20.7% have leveraged third-party e-commerce platforms and at the same time established wholly-owned transactional website, while 3.4% only leveraged third-party e-commerce platforms (Exhibit 6).

### Exhibit 5. Penetration of e-commerce business among surveyed department store operators

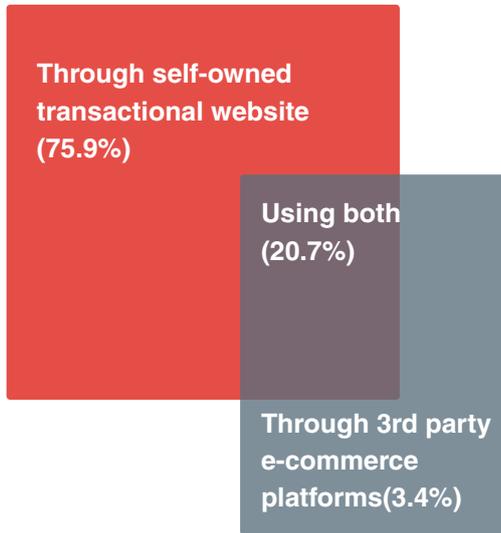


Source: “Department store survey 2016”. CCAGM and Fung Business Intelligence

<sup>i</sup> A quantitative survey was conducted by the China Commerce Association for General Merchandise (CCAGM) and the Fung Business Intelligence among 64 key department store operators in China during November and December, 2016.

**Exhibit 6. Forms of e-commerce business among surveyed department store operators**

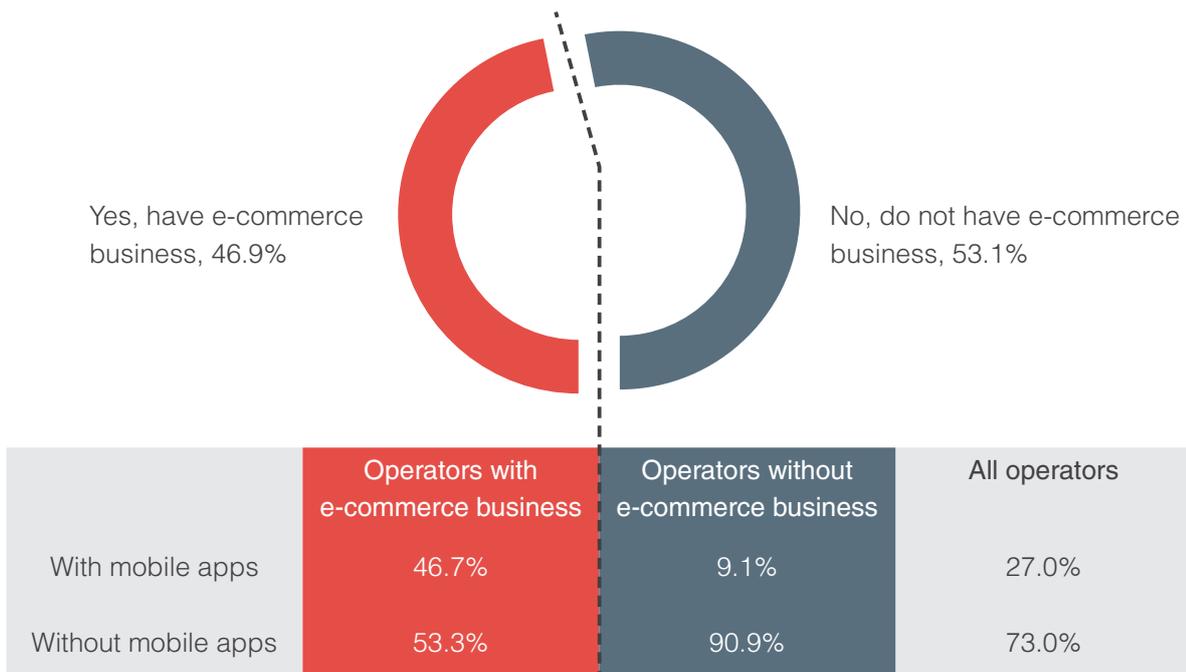
Among those who have started their e-commerce business...



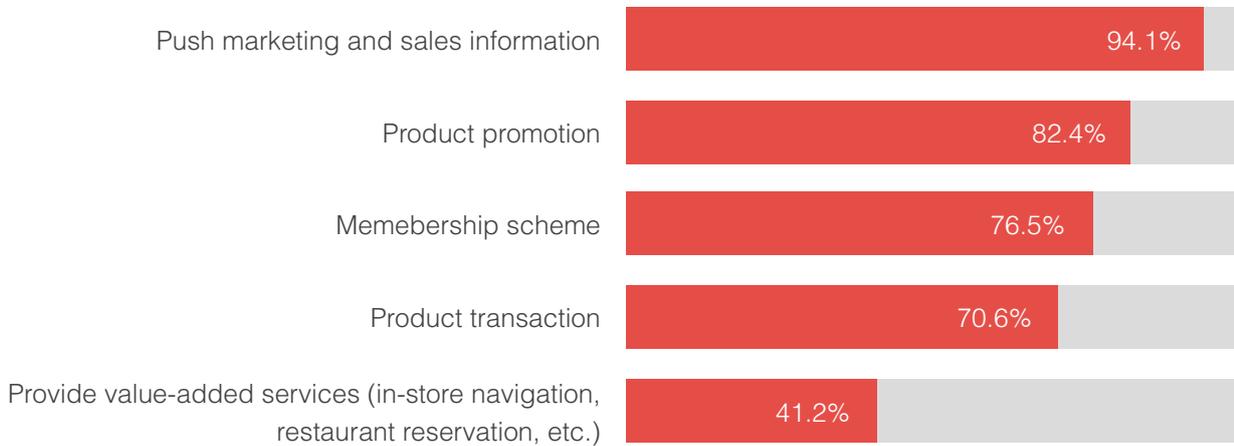
Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

Besides, 27% of the surveyed department store operators have launched mobile apps (Exhibit 7); they used the apps mainly for pushing marketing and sales information to customers, promoting merchandise and providing members with value-added services (Exhibit 8).

**Exhibit 7. Proportion of surveyed department store operators with and without mobile apps**



Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

**Exhibit 8. Major function of mobile apps of surveyed department store operators**

Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

The essence of O2O retailing is to create a consistent and engaging experience at every stage of the shopping journey whether in a physical store, on the web, or on the mobile devices. Some leading department store operators are already on their transformation journey towards being an O2O retail enterprise. Wangfujing Group is a case in point. It established an O2O centre by merging its marketing department, e-commerce company and O2O project team in November 2016. By integrating its offline resources with e-commerce business, Wangfujing Group hopes to strengthen its capabilities in drawing and retaining customers<sup>1</sup>.

Golden Eagle Retail Group is another leading department store operator which has actively embraced O2O strategies. In 2016, Golden Eagle linked up all its channels, including retail stores, mobile app, WeChat social network platform and the "Electronic VIP Card" in order to create a seamless shopping experience for customers<sup>2</sup>.

## 2. Partnering with key Internet players to roll out O2O initiatives

To stay competitive and grasp the opportunities created by the “New Retail” regime, some forward-thinking department store operators have proactively formed strategic alliances with Internet giants to roll out their O2O initiatives. Intime Retail Group and Bailian Group are cases in point.

### ***Case study 1: Intime Retail Group formed partnerships with Alibaba Group***

Intime has formed strategic partnerships with Alibaba since 2013. Since then, the two companies have worked together on a number of O2O initiatives, including the introduction of Tao-brands to Intime's physical stores, the launch of Intime's first online supermarket on Tmall Supermarket (chaoshi.tmall.com), and the adoption of Alibaba's one-stop shopping and location-based mobile app “Miao Street” in all Intime physical stores. Apart from these collaborations, Intime also adopted the “same price strategy” between its Tmall flagship store and offline stores so as to enhance customer shopping experience.

To put the “New Retail” concept into action, Intime and Alibaba joined forces to launch a lifestyle-themed homeware store “House Selection” in Hangzhou, the capital city of Zhejiang, in December 2016. House Selection aims to bring seamless O2O shopping experience for shoppers by enabling “offline shopping for online transaction” – customers can enjoy hassle-free shopping by directly scanning the products for self-service transactions. After making the purchase, consumers can enjoy door-to-door express delivery. In January 2017, Alibaba Group announced to privatize Intime Retail Group. Upon the successful privatization of Intime, Alibaba will obtain 74% stake of Intime, and take over Intime's physical networks across the country, including 29 department stores and 17 shopping malls. This signifies Intime's determination to implement O2O strategies, and ride on Alibaba's resources and support to fully integrate its online and offline businesses.

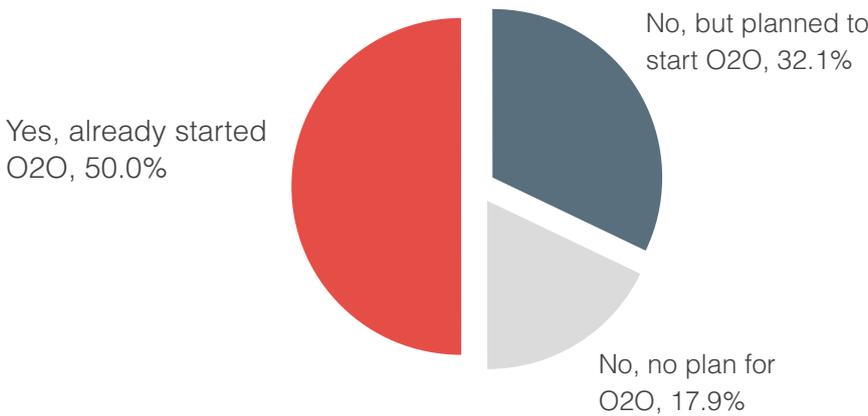
### ***Case study 2: Bailian Group and Alibaba Group announced strategic alliance***

The strategic alliance between Bailian Group and Alibaba is another significant case to illustrate the close collaboration between department store operator and e-commerce giant in the “New Retail” regime. On 20 February 2017, Bailian Group and Alibaba Group announced the formation of a strategic partnership to explore new forms of retail opportunities across each other's ecosystem. The two companies will leverage big data capabilities to achieve integration across brick-and-mortar stores, merchandise, logistics and payment tools with the aim to deliver a better overall customer experience.

For Bailian, partnering with Internet companies such as Alibaba is a fast way to reinvent and revamp its businesses, as well as to roll out O2O strategies amid the challenging times facing traditional retailers. Although Bailian has launched its O2O e-commerce platform “iBailian” through its online transactional website “bl.com”, as well as a mobile app “iBailian App” and a WeChat public account, these platforms are unable to draw much customer traffics. The partnership will hopefully enable Bailian to leverage Alibaba's huge traffic sources as well as its Big Data and logistics capabilities to provide better O2O services.

Indeed, the trend of forming partnerships with leading Internet players has been revealed in our survey. 50% of the surveyed department store operators have partnered with Internet players to deploy O2O strategies. 32.1% of the department store operators have yet to start deploying O2O strategies but are planning to do so (Exhibit 9 and Exhibit 10).

**Exhibit 9. Deployment of O2O strategies of surveyed department store operators**



Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

**Exhibit 10. Major forms of O2O strategies of surveyed department store operators**



Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

### **3. Enhancing uniqueness; focusing on product quality and service offerings**

In recent years, the problems of homogenization of department stores have become more serious, resulting in dwindling margins and price wars amongst competitive players. To enhance uniqueness, many department store operators have revamped their stores by introducing special themes and exciting elements, and expanding services offerings with a hope to better cater to the needs of different consumer segments.

#### **(1) Endeavor to provide more experiential elements**

In 2016, a variety of experiential elements appeared in department stores across the country. Many department stores have placed strong emphasis on upgrading lifestyle and service offerings, and adding experiential elements such as food and beverages (F&B), children's playground, cinemas, leisure facilities, etc. to their physical stores. It has become a crucial transformation strategy for department store players to draw customers' patronage and drive sales.

For instance, Rainbow Department Store opened three new stores in 2016 – Shenzhen Junshang 3019 Store, Rainbow Xinsha Shopping Centre and Zhuhai Rainbow Department Store. In order to bring innovative shopping experience to customers, the new stores are decorated in different special themes and lifestyle scenes; they encompass a wide range of leisure and entertainment elements, including F&B, bookstores, boutique supermarket, KTV, beauty salon, DIY workshops, etc. In addition, latest technology for self-checkouts is being used in its supermarket. Consumers can scan the barcode of the merchandise with their Rainbow mobile app for self-checkouts.

Selected examples of lifestyle and shopping experience enhancement by other department store operators are shown in Exhibit 11.

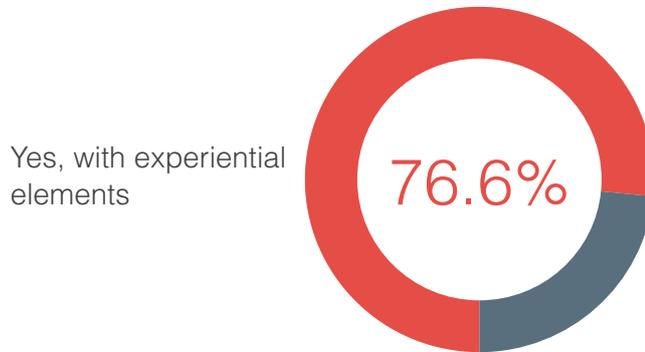
### Exhibit 11. Selected examples of lifestyle and shopping experience enhancement by department store operators in 2016

Department Store	Experiential elements
Golden Eagle Department store	Golden Eagle Department store transformed all its department stores into "Complete lifestyle centres" by expanding categories that enjoy greater growth potential, including sports, leisure and children-related categories. As of June 2016, it allocated 32.4% of the total operation area to lifestyle and experiential-related categories; total revenue of lifestyle and experiential-related categories reached 149.2 million yuan, up 38% yoy.
Maoye Department store	As of 30 June 2016, the company has transformed more than 10 stores into shopping centres. Areas for F&B, entertainment and leisure facilities have been enlarged, resulting in a surge in foot traffic and higher rental revenue. Rental income from the transformed stores increased by 57% yoy.
New World Department Store	New World Department Store enlarged the area for F&B to approximately 30% of the gross operation area. The company has also partnered with Tao-brands such as Inman to open six experiential stores in different branches; prices are the same online and offline.
Modern Plaza	Modern Plaza transformed itself from a traditional department store to a lifestyle centre. It opened a boutique cinema with 33 different houses with special themes in May 2016.
Reel Department Store	With the opening of "Zhongshu Books" bookstore (which claimed to be China's most beautiful bookstore) in August 2016, Reel Department Store successfully created a strong cultural and artistic atmosphere and attracted higher customer traffics.

Source: Company websites; various Internet sources; compiled by Fung Business Intelligence

The keen efforts of department store operators to increase experiential elements in their stores have fully been manifested in our survey. 76.6% of the surveyed department store operators have added experiential elements in their stores (Exhibit 12). Among them, over 90% have added two or more experiential elements, such as F&B, kids-related facilities, lifestyle services and entertainment (Exhibit 13 and Exhibit 14).

**Exhibit 12. Proportion of surveyed department store operators that have added experiential elements in stores**



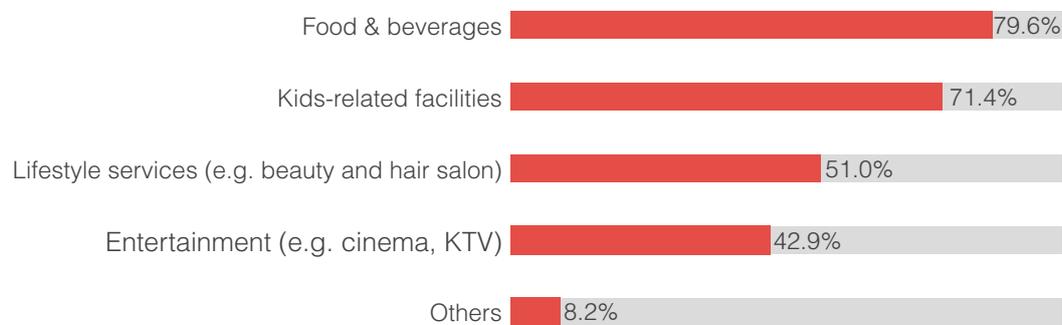
Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

**Exhibit 13. Number of experiential elements added by surveyed department store operators**

Number of experiential elements added	Among operators who have added experiential elements...
1	9.3%
2	30.2%
3	25.6%
4	32.6%
5	2.3%

Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

**Exhibit 14. Types of experiential elements added in-store by surveyed department store operators**



Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

## (2) Proliferate customer service to a new level

Apart from improving the overall shopping experience of customers by introducing more experiential elements, many department store operators have stepped up efforts to enhance customer service quality and enrich the content of VIP customer services so as to improve their core competencies.

To better understand the needs and preferences of customers, New World Department Store launched a “Chief Officer Experience Program” in August 2016. Store managers and senior management are required to spend no less than 30 minutes a day to conduct interviews with customers to collect their opinions on how the department store can better meet their needs. The program has thus far interviewed more than 10,000 customers, and collected a vast number of suggestions on how the department stores can improve further<sup>3</sup>.

Maoye Department Store has also placed great emphasis on improving customer service in 2016. It has upgraded its Customer Relationship Management (CRM) system to facilitate targeted marketing. The operators launched promotions, discounts, in-store facilities, and customization service that are exclusive to members<sup>4</sup>.

## 4. Accelerating transformation and introducing new business models

In the “New Retail” regime, unique positioning with differentiated products is the key to success. Increasing numbers of department store have increased efforts to introduce new brands to the market, adopt merchandise direct sales and develop private labels. By adopting these new business models, department store operators hope to gain competitive advantage and build a versatile product range to meet the diversified needs of customers.

### (1) Increase the proportion of merchandise direct sales and develop private labels

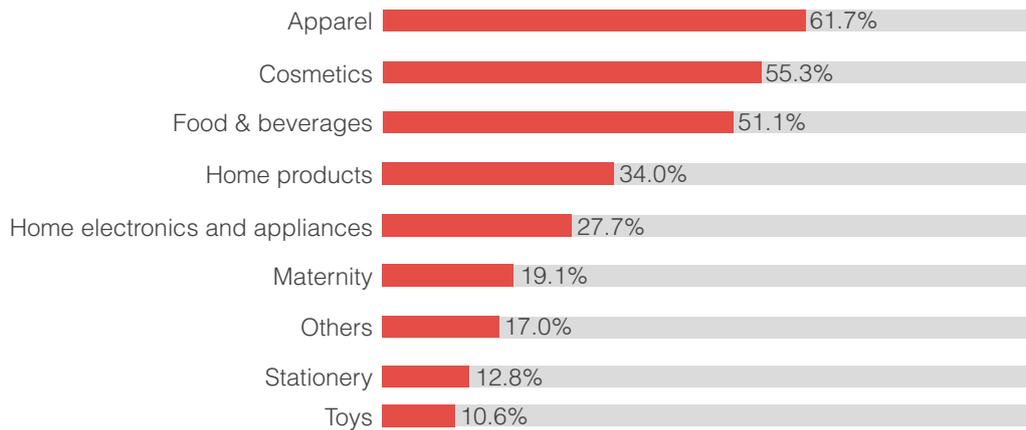
#### *Increase the proportion of merchandise direct sales*

Recognizing the drawbacks of the concessionary model, many department store operators have been actively exploring the operation model of merchandise direct sales, developing their own private labels or being the exclusive distributor of brands. In our survey, over 76% of the department store operators have engaged in merchandise direct sales business (Exhibit 15 and Exhibit 16).

#### **Exhibit 15. Penetration of merchandise direct sales among surveyed department store operators**



**Exhibit 16. Major product categories of merchandise direct sales of surveyed department store operators**



Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

It is noteworthy that majority of the surveyed department store operators (62.5%) designated less than 10% of products for merchandise direct sales (Exhibit 17).

**Exhibit 17. Contribution of merchandise direct sales to total revenue among surveyed department store operators**

Proportion of merchandise direct sales	Among operators with merchandise direct sales...
5% or less	45.8%
5.1% - 10%	16.7%
10.1% - 15%	8.3%
15.1% - 20%	14.6%
20.1% or above	14.6%

Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

Examples of merchandise direct sales business and private label development of selected department stores are shown in Exhibit 18.

**Exhibit 18. Selected department stores that have engaged in merchandise direct sales and private label development**

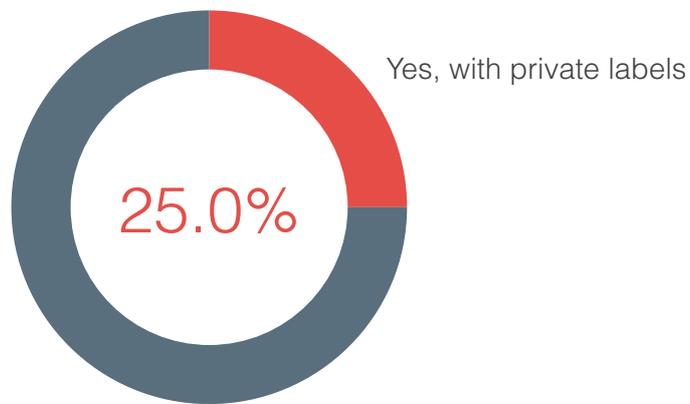
Department Store	Merchandise direct sales and private label development
Hefei Department Store	<p>To speed up its transformation towards merchandise direct sales business, in 2016, Hefei Department Store enhanced the operation capabilities of women's apparel and gold and jewellery, which are operated under the merchandise direct sales model. Its supermarket has also endeavoured to increase the proportion of merchandise direct sales and private label products.</p> <p>By the first half of 2016, merchandise direct sales and private labels reached a total sales value of 410 million yuan, up 14.5%yoy.</p>
New World Department Store	<p>New World Department Store recently established an in-house procurement team responsible for direct product procurement and acquisition of brand distribution rights. The company hopes to expand its direct sales business to more categories, including lifestyle products, fashion apparel and F&amp;B.</p> <p>Earlier in 2015, the company obtained the sole distributor rights of Italian high-end fashion brands MOSCHINO, LOVE MOSCHINO and REDValentino in China.</p>
Anhui Andeli Department Store	<p>Over 80% of its merchandise are sourced by the company's in-house buyers. The proportion of merchandise direct sales of large home electronics reached 100%, small home electronics goods reached 80%, leather shoes reached 100%, while apparel and jewellery reached 70% to 80%.</p>
Golden Eagle Department Store	<p>To enrich distinctive merchandise offerings, Golden Eagle Department Store has formed close relationships with brand suppliers from different countries, including Germany, France, Korea and Australia.</p> <p>The company has also been eager to develop private labels. In 2016, it developed a series of premium quality men's shirts under the brand name "Aquila Doro Uomo". As of June 2016, its private label products were sold in 242 counters across its branches nationwide. Total sales generated by merchandise direct sales and private labels reached 168.5 million yuan, up 20.1% yoy.</p>

Source: Company websites; various Internet sources; compiled by Fung Business Intelligence

Develop private labels

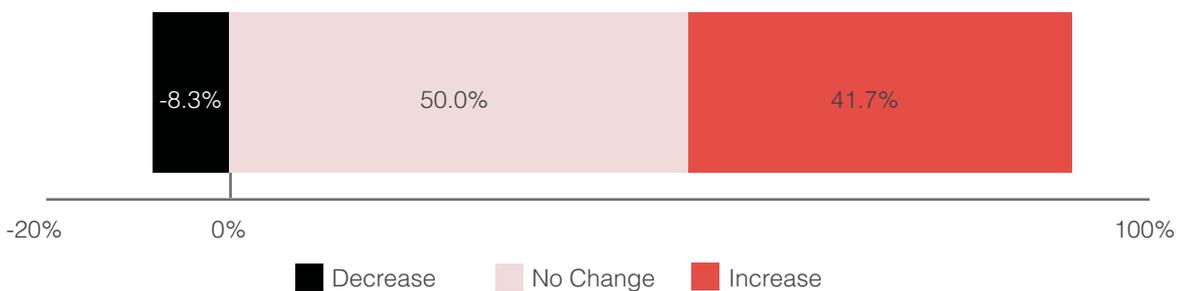
According to our survey, one-fourth of the department store operators have launched their own private labels (Exhibit 19). Of which, 41.7% of the surveyed department stores said they have increased the proportion of private labels in the past year (Exhibit 20).

**Exhibit 19. Percentage of surveyed department store operators with and without their own private labels**



Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

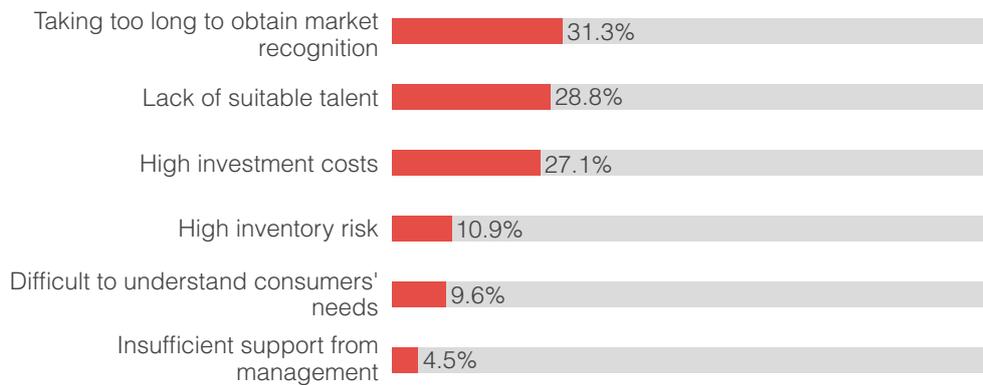
**Exhibit 20. Percentage change in owning private labels compared to the previous year Among operators with their own private labels...**



Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

Nonetheless, many operators reflected that developing private labels is not easy. 31.3% of the surveyed department store operators said it took too long for the market to get familiar with the private labels, while 28.8% thought that lack of talents has constrained the development of private labels (Exhibit 21).

### Exhibit 21. Major challenges of developing private labels



Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

## (2) Create buyer team and set up self-owned multi-label stores

To enhance uniqueness and differentiate themselves from their peers, some department stores have created their own buyer and sourcing team; some have even set up multi-label stores selling directly-sourced products. These multi-label stores usually comprise a large variety of unique brands and merchandise; they can retain customers and prolong duration of each stay.

Beijing Hualian Group's SKP Beijing is a case in point. In recent years, the company has transformed itself from a traditional department store to a boutique department store which features unique and exclusive designer brands, and multi-label stores as anchor shops. SKP Beijing has also established its own self-operated "SKP Select" concept store, and set up a professional buyer team which is responsible for sourcing, retail operation and visual display. The SKP Select concept store sells merchandise of over 200 new and up-and-coming designer brands, including Alexander Wang, MM6, Opening Ceremony, Public School, Self Portrait, etc<sup>5</sup>.



SKP Select at SKP Beijing

Another significant example is Bailian Group's Oriental Department Store (Xuhui branch). The store underwent upgrading and transformation in 2016. With a new brand name "Huaihai 755", the new store has adopted the "buyer model" for the first time, and became a "buyer incubator" for Bailian Group<sup>6</sup>. It has set up a professional buyer team, and recruited experienced buyers from Lane Crawford and Galeries Lafayette. In the new store, there is a dedicated area to display overseas products sourced by the buyer team, especially the latest fashion items bought at large fashion events.

Rainbow Department Store is another department store operator which is keen to build its own buyer team and develop multi-label stores. It has set up a "buyer platform", known as "Rain" to coordinate all of Rainbow Department Store's self-owned multi-label stores, including fashion multi-label store "Rain&Co", womenswear multi-label store "Rain&Color", kidswear multi-label store "Rain&Kids", and home products multi-label store "Rain&Home"<sup>7</sup>.

### **(3) Form collaborations with suppliers and brands; strengthen domestic and foreign supply chains**

Increasing numbers of department store operators have formed stronger partnerships with players along the supply chain in order to build synergies, reduce cost and outperform their competitors.

In 2016, Golden Eagle Retail Group sourced directly from its foreign upstream partners, including German department store KARSTADT and pharmacy chain STERN APOTHEKE. It also strategically cooperated with healthcare brands such as BLACKMORES from Australia and GNC from the U.S. to launch experiential counters in selected Golden Eagle's stores<sup>8</sup>. The stores not only showcase the products of these brands, but also enable direct customer interactions and provide after-sales services to customers.

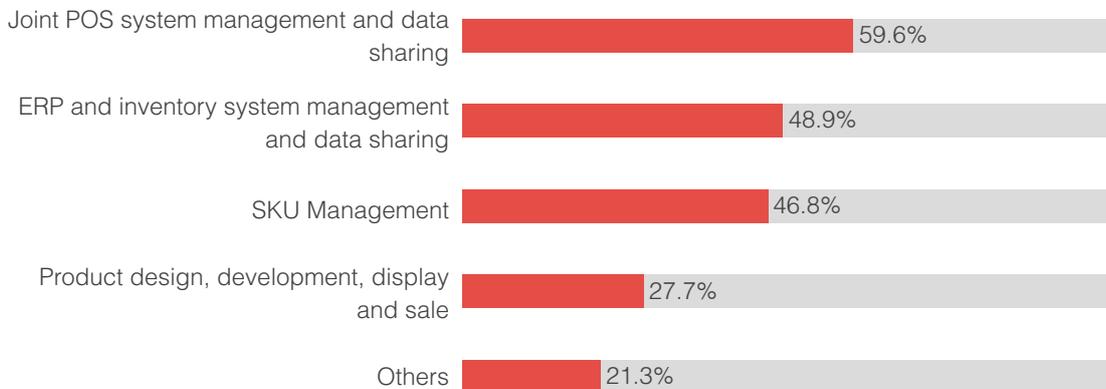
According to our survey, 73.4% of the department stores claimed to have stronger collaboration with suppliers and brands in recent years (Exhibit 22). Most of the collaborations are in the form of joint point-of-sale (POS) system management and data sharing (59.6%), and Enterprise Resource Planning (ERP) and inventory system management and data sharing (48.9%), followed by SKU management (46.8%) (Exhibit 23).

**Exhibit 22. Percentage of surveyed department store operators that have collaborated with suppliers and brands**



Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

### Exhibit 23. Types of collaboration between surveyed department store operators and upstream suppliers or brand owners



Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

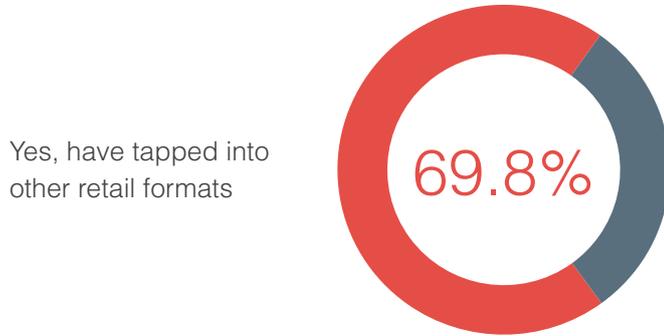
#### (4) Diversify retail formats, tap into other business sectors

Over the years, more and more department store operators have sought to expand their scope of business and diversify their retail business.

According to our survey, 69.8% of the department store operators have tapped into other retail formats (Exhibit 24). Of which, the majority of operators have tapped into one (47.7%) or two (31.8%) other retail formats (Exhibit 25). Supermarkets/hypermarkets and shopping malls are the two most common retail formats that department store operators have ventured into, representing 70.5% and 47.7% respectively (Exhibit 26).

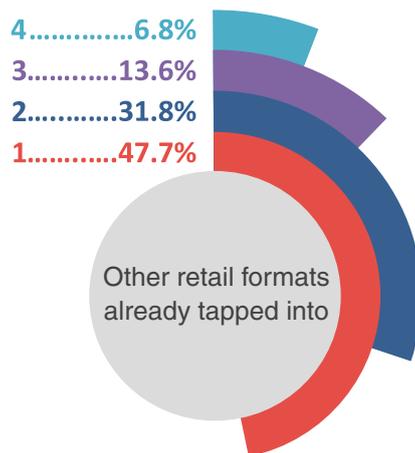
For those operators who operate only in the department store format, 40.4% plan to expand their current scope of business and start to engage in other retail formats (Exhibit 27). 59.1% of the operators said they plan to tap into one or two (22.7%) other retail formats (Exhibit 28). Shopping malls and factory outlets are the most popular choices (Exhibit 29).

Exhibit 24. Percentage of surveyed department store operators that have tapped into other retail formats



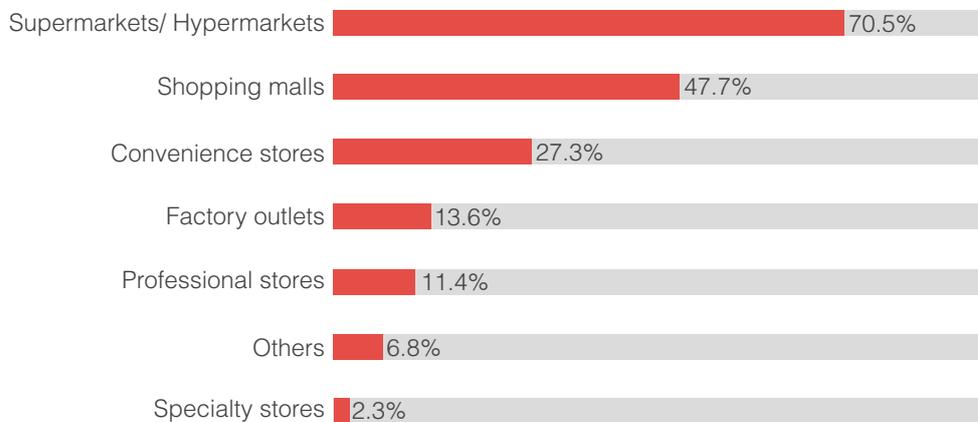
Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

Exhibit 25. Number of other retail formats surveyed department store operators have tapped into



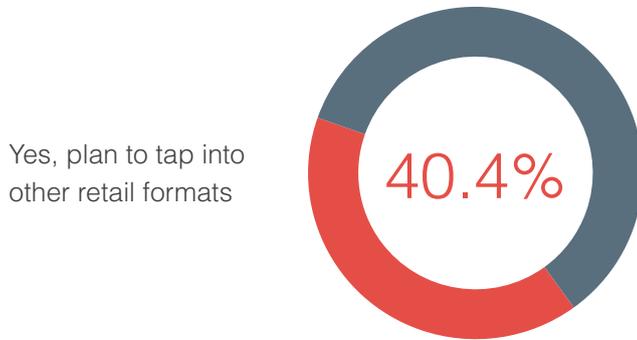
Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

Exhibit 26. Retail formats surveyed department store operators have already tapped into



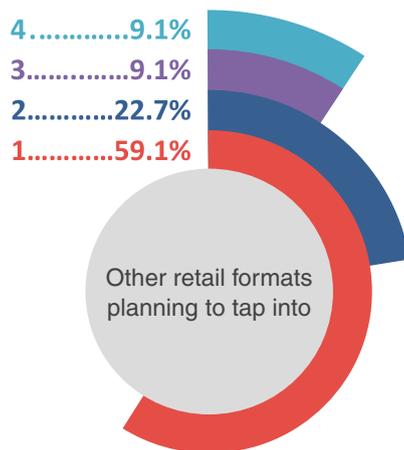
Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

Exhibit 27. Percentage of surveyed department store operators plan to tap into other retail formats



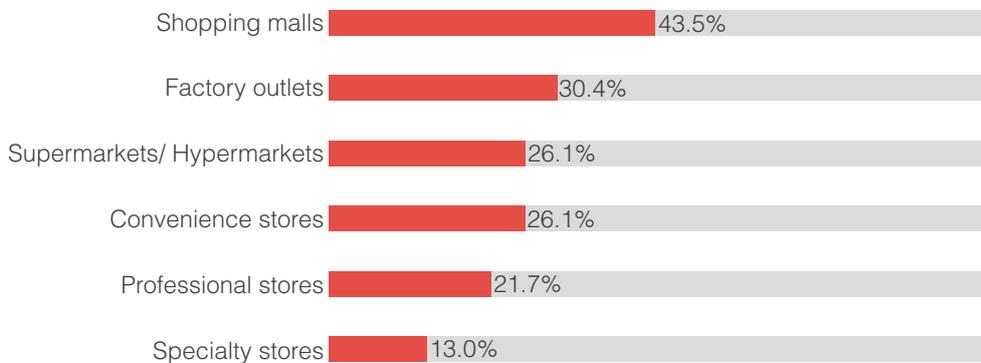
Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

Exhibit 28. Number of other retail formats surveyed department store operators are planning to tap into



Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

Exhibit 29. Retail formats surveyed department store operators plan to tap into



Source: "Department store survey 2016". CCAGM and Fung Business Intelligence

To strengthen their core competencies, many operators have engaged in multiple retail formats, such as supermarket, hypermarket, convenience store and shopping mall. For example, Parkson Department Store has been diversifying its businesses over recent years. In 2016, the company set up a self-owned boutique supermarket, Parkson Supermarket. In 2017, the company will open a beauty concept store, Parkson Beauty to sell beauty and skincare products with personalized beauty advice offered to customers.

Another example is Bailian Group. The Group has also ventured into different retail formats, especially shopping mall and factory outlet over recent years; it has also announced development plans for the two segments:

- *Regional development of shopping malls* – the Group will further develop more prominent community-based shopping centres in Shanghai and Yangtze River Delta region in the future.
- *National expansion of factory outlets* – the Group has devised a nationwide expansion plan, and identified Changsha, Jinan, Chengdu, Hefei and other places to be the new factory outlet destinations. The Group targets to build 15 factory outlets nationwide by 2020.

As of the end of 2016, Bailian Group has 24 department stores, 16 shopping centres and five factory outlets<sup>9</sup>.

## **(5) Launch pop-up stores and concept stores**

In the past year, the trend of setting up pop-up stores has mushroomed in the department stores sector. With interesting and innovative settings, shop designs and merchandise, pop-up stores can enhance shopping ambiance and customer experience, and thus get more foot traffics and generate higher short-term revenue. It has become a popular channel for department store operators to attract and engage customers. According to RET Property, a Chinese commercial real estate research centre, pop-up stores could bring an extra 10% to 15% of sales turnover for shopping malls and department stores<sup>10</sup>.

In 2016, Intime Department Store has cooperated with different brands to set up pop-up stores or concept stores. In September, Intime Department Store's Hangzhou Chengxi branch collaborated with British motor vehicle brand, Mini Cooper to launch a pop-up store for three days only to promote the brand. In December, Intime Department Store set up a multi-label luxury concept store in its Hangzhou Wulin branch. In January 2017, the company partnered with a popular blogger Tongdaodashu to launch a pop-up store in its Hangzhou West Lake branch.

As part of its China market expansion strategies, Galeries Lafayette has also partnered with different overseas brands to roll out pop-up stores. Examples of brands that have collaborated with Galeries Lafayette include Japanese luxury brand Comme des Garçons, snowboarding brand Burton and French affordable luxury brand Longchamp. Through regularly bringing in exclusive overseas brands in the form of pop-up stores, Galeries Lafayette has successfully established its unique positioning of a stylish and trendy department store.

## 5. Cross-sector integration and partnerships open up new opportunities

Today's new market dynamics have prompted department store operators to gear up and fully equip themselves. An increasing number of department store operators have formed partnerships and alliances with leading sector players to build synergies, create stronger business ecosystems, access to new technologies and talents, expand business areas, and enhance overall competitiveness.

For instance, Beijing Wangfujing Dongan Group and Sanpower Group formed a strategic partnership in May 2016<sup>11</sup>. The two companies will work together in areas such as sourcing, private labels development, supply chain management and data sharing. Business assets from Sanpower's overseas acquisition, such as House of Fraser, Brookstone and Hamleys, will be incorporated into the business of Wangfujing Dongan Group.

Another example is Parkson Group. In August 2015, Parkson Group joined hands with Korea's E-Land Group to form a joint venture (JV) in Shanghai to build large-scale department stores. The JV company unveiled the Parkson Newcore Citymall in January 2016. The mall features a Korean-themed outlet concept, comprising numerous Korean fast fashion brands, discount stores and branded off-price stores. As of June 2016, Parkson Newcore Citymall enjoyed more than doubled sales as compared to pre-transformation<sup>12</sup>.

## 6. Overseas department stores looking for opportunities in the China market

Despite the fact that China's department store sector has witnessed a trend of store closures over the past few years, some foreign department store operators still remain optimistic towards the future growth prospect of the China market and continue to expand their scope of business in China. Following the debut of Macy's China through Tmall in 2015, several other foreign department stores have entered or expanded their presence in China. A prominent case is House of Fraser. Acquired by Chinese conglomerate Sanpower Group in 2014, House of Fraser opened its first store in China in Nanjing, the capital city of Jiangsu province, in December 2016. The store is operated under a "merchandise direct sales + buyer" model, with more than 20 exclusive and self-owned brands.

Some other foreign department store operators have also expressed their intentions to further expand in the country. Examples include Galeries Lafayette and I.T. Fashion Group, the two companies plan to jointly launch five stores in China in the next three years. Lane Crawford Department Store also plans to kick-start their China expansion plan in 2017.

### III. Major problems and challenges, and policy recommendations



## 1. Problems and challenges

### (1) An urge for further innovation in consumer experience

In general, many traditional department stores are still operating in a single retail format with old-fashioned store settings and limited merchandise offerings. However, the growing middle class, particularly the growing, influential Chinese millennials (the post-1980s and post-1990s generations) are typically more digital-savvy and discerning on service quality, convenience and experience. They also demand personalized products and services. Department store operators ought to adapt and reinvent to incorporate more innovative options on lifestyle, leisure, entertainment and experiential elements to their stores so as to meet the needs of this important consumer group.

### (2) Operation efficiencies need to be improved

In recent years, many department store operators have placed their emphasis of transformation on improving trade mix, brand portfolios, store layout and facilities while the need to enhance the efficiency of operation system has been neglected. Indeed, improving the efficiency of the operation system should be a basic goal of department store sector's future development. Department store operators should consider leveraging advanced technologies to further consolidate and upgrade the retail operation systems. This, in turn, would contribute to the enhancement of business model, customer service efficiency, and reduction of operation cost.

### (3) Department store operators under heavy financial pressure to finance transformation projects

For many department store operators, particularly the traditional department stores, insufficient funding is a critical barrier to transformation and upgrading. Many transformation projects involve physical stores' hardware upgrade, adding experiential elements and facilities, software enhancement, adoption of new technology, and renovation or reconstruction of retail space; all these require a huge sum of capital. For department store operators who are already struggling with increasing costs, dropping sales, and squeezing profits, transformation projects could impose further financial pressure on them.

#### (4) Institutional mechanism restricting development

Nowadays in China, the department store sector is largely dominated by state-owned enterprises; this is especially the case in top-tier cities such as Beijing, Shanghai and Wuhan. These state-owned enterprises have taken up significant market share but their institutional nature and organization culture could be a drawback in today's fast-changing retail market. State-owned enterprises are generally characterized by inefficient management, lack of business incentives and workforce being too large. Very often, they respond and react slowly to the changes in the market. There is an urgent need for mixed-ownership reform in the department store sector, which would be beneficial to the transformation and upgrading of the entire sector.

## 2. Policy recommendations

- **Ensure continuity and stability of policies** – over recent years, the Chinese government has issued a series of policies to support the development of domestic trade and the circulation industry. These policies would accelerate business innovation and facilitate the upgrading and transformation of the traditional retail sector. It is hoped that these policies and measures could be more concrete and specific when implemented, with strict accountability system and enforcement. It is essential to ensure that these policies maintain high quality, continuity and stability.
- **Create a trustworthy and fair business environment** – a sound, trustworthy credit system for business is needed. Fostering great integrity and self-discipline among sector players is key to the orderly development of the department store sector. Ensuring a fair business environment in the market is deemed necessary.
- **Fiscal support from the government** – the government should consider offering grants and subsidies to assist the transformation of the department store sector. In particular, necessary financial assistance should be given to innovative players who are willing to take the lead to transform and reinvent. Meanwhile, the government should also consolidate resources to develop public digital infrastructure so as to support the full O2O integration of enterprises.

# IV. Implications and conclusions



In the "New Retail" regime, the transformation of China's department store sector is inevitable. A new round of elimination of underperformed players, adjustment and reorganization of the sector has begun. While the department store sector is entering into the advanced phase of transformation and reinvention, a new market scene and competitive landscape are taking shape. Moving forward, department store operators should react quickly and explore their own strengths to pursue a positive future.

## **1. New opportunities in the “New Retail” regime**

Against the background of consumption upgrading, especially the emerging middle class increasingly looking higher-quality products and better shopping experience, department store operators should think outside the box to actively promote innovations and embrace new technologies to drive the growth of business. They should also fully venture into O2O retailing with full connections across physical stores, online platforms and logistics services. O2O is and will continue to play a crucial role in driving the development of the department store sector.

## **2. Back to the basics of retailing**

The essence of retailing is all about providing desirable goods and service offerings to a specific target market. To succeed in today's highly competitive marketplace, it is imperative for department store operators to enrich products and services offerings and to differentiate themselves. Operators should also provide personalized services and unique brands and products to attract consumers. Increasing numbers of department stores now adopt the hybrid model of "merchandise direct sales, private labels and concessionary". This new type of business model is set to become mainstream in the coming years.

Since last year, the Chinese government has vigorously promoted the supply-side reforms to transform the economy into a consumption-driven economy. Supply-side reforms will guide the retail sector to improve the supply of goods, facilitate import of new products into the market, and improve the quality of products. With the government's continual supportive measures and positive policy stance towards the development of the retail sector, department store operators are set to gain full momentum towards the transformation and upgrading of their businesses.

### 3. Survival of the fittest

In retrospect, China's department store sector has gone through numerous challenges in 2016, including intensified competition, serious homogenization and rising costs. The sector has witnessed a further differentiation of operators' performance – on the one hand, underperformed department store operators have gradually faded out with store closures, if not withdrawn from the market due to mounting financial pressures or making losses; on the other hand, the sector leaders tended to outperform and gain a stronger foothold in the market with improved supply chain efficiencies, operation and logistics capabilities, and big data proficiencies. The sector is getting more polarized than ever.

Despite the current market headwinds, in the long run, China's department store sector is expected to see tremendous growth potentials. Increasing disposable income, rapid urbanization and rising living standards will continue to drive the growth of China's retail sector. According to the *13th Five-year Plan for the Development of Domestic Trade and Circulation*, total retail sales of consumer goods are estimated to reach 48 trillion yuan by 2020, growing annually by around 10% on average. Looking forward, we believe the continuous transformation and innovation of department store sector will bring about a new and rosy retail scene in China's market.

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## About the Organizations

### CHINA COMMERCE ASSOCIATION FOR GENERAL MERCHANDISE

Founded in January 1990, China Commerce Association for General Merchandise (CCAGM) is a non-profit social organisation endorsed by the Ministry of Civil Affairs, under the guidance of the Stated-owned Supervision Administration Commission and the Ministry of Commerce. The CCAGM has nearly 800 members, encompassing large-and medium-sized domestic department stores, enterprises engaging in retail, wholesale, and manufacture of daily industrial products, and enterprises which provide related services to the department store industry. Its members come from 31 provinces, autonomous regions and municipalities in the country, covering all forms of ownerships. The CCAGM has 60 corporate members, including City Department Store Industry Association, Trade Association and Trans-regional Department Store Company Union Organisation, linking more than 15,000 indirect members.

After 20 years of growth and development, the CCAGM has completed the transformation of its work model from one that was influenced by the planned economy to one influenced by socialist marketing economy. In 2009, the CCAGM was appraised as a 4A social organisation by the Ministry of Civil Affairs.

### FUNG BUSINESS INTELLIGENCE

Fung Business Intelligence collects, analyses and interprets market data on global sourcing, supply chains, distribution, retail and technology.

Headquartered in Hong Kong, it leverages unique relationships and information networks to track and report on these issues with a particular focus on business trends and developments in China and other Asian countries. Fung Business Intelligence makes its data, impartial analysis and specialist knowledge available to businesses, scholars and governments around the world through regular research reports and business publications.

As the knowledge bank and think tank for the Fung Group, a Hong Kong-based multinational corporation, Fung Business Intelligence also provides expertise, advice and consultancy services to the Group and its business partners on issues related to doing business in China, ranging from market entry and company structure, to tax, licensing and other regulatory matters.

Fung Business Intelligence was established in the year 2000.

### THE FUNG GROUP

The Fung Group is a privately held multinational group of companies headquartered in Hong Kong whose core businesses are trading, logistics, distribution and retailing. The Fung Group employs 45,100 people across 40 economies worldwide, with total revenue of over USD24.8 billion as of December 2015. Fung Holdings (1937) Limited, a privately held business entity headquartered in Hong Kong, is the major shareholder of the Fung group of companies.





