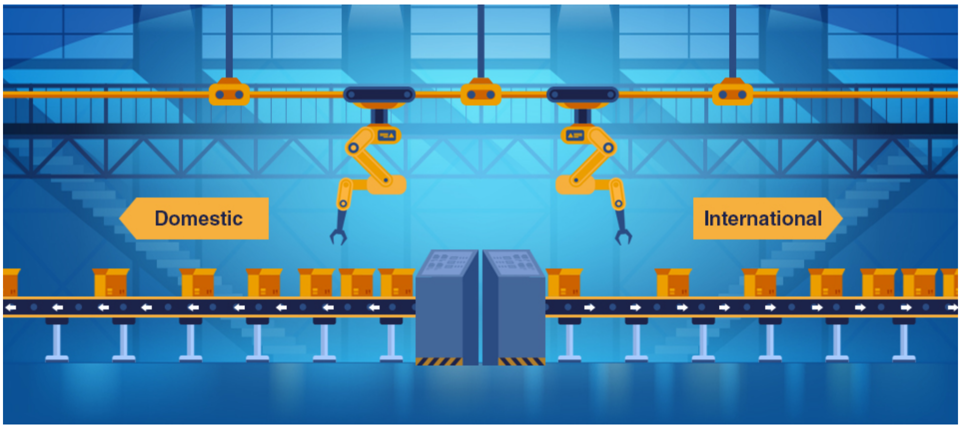
Dual Circulation Series

Issue 2

– Integrating domestic and foreign trade

Export manufacturers turning to domestic market - When one door closes another opens



Since the outbreak of the COVID-19 pandemic, the global economy and supply chain has been significantly shaken. The World Trade Organization forecasts that world trade will fall by between 13 to 32 percent in 2020[1]. As global demand continues to weaken and borders remain closed, numerous industries have been significantly affected.

The export industry, in particular, is one of the industries that has been significantly hit. Large numbers of existing orders have either been delayed or cancelled since the pandemic transpired. Companies also remain extremely cautious and conservative with new order placements. In addition, intensifying geopolitical entanglements between China and the U.S. has further injected a cloud of uncertainty into the global economy.

To better help position itself to withstand global uncertainty and an increasingly hostile external environment, China recently announced the "dual circulation" strategy which emphasizes growing its domestic market and boosting domestic demand to achieve long-term sustainable growth. You may refer to Issue 1 of our "Dual Circulation" series to gain a better understanding of what "Dual Circulation" means and the rationale behind it.

In the current and future issues, Fung Business Intelligence will take a deeper look into the transformation of China's export industry as the world enters a new era of trade. We will examine the challenges and issues export-oriented businesses face in the current market, and the barriers they need to overcome to transform their business. We will be looking at some of the key initiatives rolled out by leading e-commerce platforms to help export manufactures connect with domestic consumers, and will also be talking to and interviewing industry experts as well as export-oriented factories to better understand the current pain points they face, what they have been doing to transform their businesses, and the support they need to help them better navigate the ever-changing global economic landscape.

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[1] https://www.wto.org/english/news_e/pres20_e/pr855_e.htm

Global trade and export market to slow down due to structural and external factors

Processing trade played a vital role in China's economy since China opened its door to the world more than four decades ago. At its peak, processing trade accounted for over 50% of China's total trade in 1998. In 2019, processing trade accounted for 25% of China's total trade[2].

Over the decades, both China's domestic economy and the global economy has undergone profound changes. Internally, following decades of high-speed growth driven by exports and investments, Chinese authorities have been making efforts in the past decade to shift China's economic development to a more balanced one driven by consumption, investment, and exports. Instead of quantity, China is looking for quality growth. Its goal is to upgrade its position along the value and supply chain and to better equip and position itself for long-term sustainable growth. Externally, the global economic downturn exacerbated by COVID-19, geopolitical tensions and rising protectionism have all led to a decrease on the global demand side.

Taking into consideration both internal and external factors, many export manufacturers are keen to enter the domestic market and reduce their dependence on the export market. In fact, this has been something the Chinese government has encouraged, and export manufacturers have already done or considered since the financial crisis in 2008. Many of them realise that they cannot rely on the export market alone to achieve long-term sustainable growth. However, the roadmap to the domestic market is not a straightforward one and there are still a number of challenges and issues export-oriented businesses face. In the following sections, we will take a closer look at how the export and domestic selling models differ, and the key challenges and barriers export manufacturers face when entering the domestic market.

[2] http://www.mofcom.gov.cn/article/i/jyjl/e/202004/20200402954392.shtml

Different business nature of export vs domestic trade

Due to the difference in business nature, it is often hard for export manufacturers to transition themselves to domestic trade. We have summarised in Exhibit 1 how export and domestic trade differ in terms of their business model, order size, order cycle, inventory risk, and settlement/payment methods.

Exhibit 1: Business nature of export vs domestic trade

Item	Export manufacturing	Domestic sales
Business model	Mainly involved in the manufacturing phase of the value and supply chain only. Some have been involved in R&D and design, but few have branding, distribution, marketing, and after-sales service capabilities, which are crucial for selling in the domestic market	Requires full involvement in the entire value and supply chain
Order size	Large volume of orders placed for selected SKUs with the exporter months in advance	Typically consist of smaller orders spread across a larger number of SKUs on a more frequent basis. More costly for companies as it is harder to achieve economies of scale in production
Order cycle	Longer order cycle and turnaround time	Shorter order cycle and turnaround time
Inventory risk	Products are produced according to orders given by the buyer. Buyer assumes inventory risk	Orders are typically placed after products are produced. Seller assumes inventory risk
Settlement/ Payment methods	Usually on open account with ample supply chain financing facilities available, e.g. letters of credit (LCs), factoring, etc.	Usually on credit, with account periods ranging between 30 days up to 6 months

Common challenges faced by export-oriented businesses

In addition to the difference in business nature, export manufacturers also face a number of challenges and institutional barriers when entering the domestic market. Some common ones encountered include:

01 No domestic selling rights

- Export-oriented businesses without domestic selling rights need to obtain approval from multiple government authorities for relevant licenses before they can sell their products in the domestic market. The approval process takes considerable time

02 Different labelling, testing and certification requirements

- Export-oriented businesses are not familiar with domestic standards
- Due to different labelling, testing, and certification standards applied in the export and domestic markets, goods that meet export but not domestic standards cannot be sold locally
- The cost of testing and certification can be costly and time-consuming
- CCC certification, which is a compulsory testing standard in China currently applied to 103 products in 17 categories (e.g. electrical appliances and toys) that directly affects the personal safety and health of consumers and the environment, is required before the products can be sold domestically

03 Increased tax burdens

- Exported goods are entitled to tax refunds which is not applicable to domestic sales
- Businesses need to pay duty for imported raw materials and value-added tax for goods sold domestically

04 Lack of financial and credit support

- Domestics sales are usually conducted on credit terms. It is a common practice for buyers to pay from anywhere between 30 days up to 6 months of the invoice date. This means that a large amount of working capital will be tied up for the manufacturers/suppliers, posing liquidity, settlement, and credit risk challenges
- Unlike export sales where letters of credit and other supply chain financing solutions and insurance facilities are readily available, financing means are more costly and difficult to obtain for domestic trade

05 Lack of intellectual property rights and branding knowledge

- Export-oriented businesses may not be allowed to sell goods originally intended for export in the domestic market due to IP issues
- Most exporters do not have their own brands or IP rights to sell in China
- The trademark registration process in China is a time-consuming process which could take around a year on average to complete

06 Domestic consumers' preferences and expectations differ from that of the export market

- Export manufacturers lack knowledge on the perceptions, preferences, and behaviours of domestic consumers
- Products intended for the export market might not sell well in the domestic market due to different consumer needs and preferences, e.g. existing products specifications need to be altered or modified to meet the needs of the domestic market
- Domestic consumers are very savvy and are constantly looking for the next "new and innovative" product. Export manufacturers will have to build up and strengthen their design and branding capabilities to hold on to these customers

07 Lack of domestic market knowledge and selling experience

- Competition in the domestic market is intense. The domestic market is also a lot more fragmented than the export market, with a lot of small to medium wholesalers/distributors operating in the domestic market, especially in the lower-tier cities.
- Export manufacturers lack understanding of the domestic selling model
- Need to build up their own domestic distribution channel/network and sales team from scratch
- Need to extend their capabilities beyond manufacturing and build both upstream and downstream capabilities which they lack experience in
- Mobile and e-commerce sales accounts for a much higher percentage in the domestic market than the export market. Innovative sales, marketing, and promotional initiatives, e.g. live-streaming, selling via KOLs etc. are commonly adopted by operators in the domestic market which export manufacturers are not familiar with

It is not a straightforward process for export manufacturers to transition into domestic sales. They need to adapt and adjust their business, expand their knowledge, and venture into unfamiliar areas of work such as design, branding, marketing, sales and distribution etc., to successfully connect with domestic consumers. Also, they will often need to make additional investments to produce products that meet the preferences of local consumers, as well as meet the Chinese testing, certification, and labelling standards. They may also suffer a certain extent of financial loss during the transition period due to the different business nature of export and domestic trade.

In the next issue, we will take a look at the support measures and policies the government has rolled out this year to help export-oriented businesses overcome the barriers and challenges of selling in the domestic market.

Fung Business Intelligence

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

Headquartered in Hong Kong, it leverages unique relationships and information networks to monitor, research and report on these global issues with a particular focus on business trends and developments in China. Fung Business Intelligence makes its data, impartial analysis and specialist knowledge available to businesses, scholars and governments 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 consulting 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.

Fung Group

Fung Holdings (1937) Limited, a privately-held business entity headquartered in Hong Kong, is the major shareholder of the Fung Group of companies, whose core businesses operate across the entire global supply chain for consumer goods including sourcing, logistics, distribution and retail. The Fung Group comprises over 34,000 people working in more than 40 economies worldwide. We have a rich history and heritage in export trading and global supply chain management that dates back to 1906 and traces the story of how Hong Kong and the Pearl River Delta emerged as one of the world’s foremost manufacturing and trading regions. We are focused on both creating the Supply Chain of the Future to help brands and retailers navigate the digital economy as well as creating new opportunities, product categories and market expansion for brands on a global scale.

Listed entities of the Group include Global Brands Group Holding Limited (SEHK: 00787) and Convenience Retail Asia Limited (SEHK: 00831). Privately-held entities include Li & Fung Limited, LH Pegasus, Branded Lifestyle Holdings Limited, Fung Kids (Holdings) Limited, Toys “R” Us (Asia) and Suhyang Networks.

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