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*Xia Chen –
“Going Down”
New Channels of Penetration in China’s Home Appliances Industry*



Contact Information

Beijing

Yong Zhang

Senior Associate
+86-10-6563-8300
yong.zhang@booz.com

Hong Kong/Shanghai

Edward Tse

Senior Partner
+852-3650-6100
+86-21-2327-9800
edward.tse@booz.com

Shanghai

Andrew Cainey

Partner
+86-21-2327-9800
andrew.caine@booz.com

Adam Xu

Principal
+86-21-2327-9800
adam.xu@booz.com

Rui Li, a Booz & Company consultant, also contributed to this Perspective.

EXECUTIVE SUMMARY

*The Chinese government's "Home Appliances for the Countryside Scheme"¹ and "Old-for-New Home Appliance Subsidy Program"² have greatly promoted the sales of home appliances in China in the last three years. Already well-established in tier 1 and 2 cities, home appliance manufacturers are now starting to penetrate vigorously into tier 3 and 4 cities and rural areas companies call this phenomenon *Qu Dao Xia Chen* or simply "Going Down". Differences in customer structure and consumption patterns in these lower-tier markets highlight the importance of sales channel reform. China's home appliance market is seeing four main types of innovative channel penetration: 1) self-owned channels; 2) home appliance chain stores; 3) co-channels built with distributors; 4) e-channels.*

SELF-OWNED CHANNELS

China's leading home appliance chain stores such as Gome and Suning have been experiencing slow growth in tier 3 and tier 4 cities. This has prompted some home appliance manufacturers to build self-owned channels to grow their markets, and to enhance overall control.

Haier has been the most successful in building self-owned channels in lower-tier markets—including rural areas as well as tier 3 or 4 cities—through its home appliance chain store brand Goodaymart, established in 2006. In June 2011, the Haier Electronics Group Co., Ltd. purchased Goodaymart outright from the parent Haier Group Corporation for RMB 240 million. By the middle of 2011, Haier covered 92% of the rural market with a nationwide

distribution network comprising more than 9,000 exclusive stores in tier 3 and 4 cities, and 1,500 Goodaymart franchise stores selling 90% Haier products and 10% other brands. The government's "Home Appliances for the Countryside Scheme" highlighted the value of the Goodaymart channel, which now contributes 30% of Haier's overall sales. Investment from Carlyle Capital in 2011 has further enhanced Goodaymart's market position and enabled it to grow into a most successful wholesale and retail channel in tier 3 and 4 cities.

While expanding its network, Haier is optimizing its product portfolio. In order to further penetrate into the lower-tier markets, Haier has launched Leader, a mid-to-low end brand tailored for its Goodaymart

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stores, which includes washing machines, air conditioners, refrigerators and televisions. Haier is also making great efforts to transform Goodaymart into a diversified distribution channel which embraces more products from other manufacturers, elevating the proportion of other brands in the product mix from 10% to at least 50%.

Other players are following suit in building self-owned channels. After re-entering the Beijing market, Little Swan now plans to set up 20 exclusive stores there, to be followed by 80 more. It aims to scale up its overall size to 1,000 outlets nationwide by the end of 2012. Chigo and Skyworth are collaborating

to establish 5,000 stores around the country this year, focused on a low-carbon lifestyle. This strategic partnership offers a great example of the potential complementarity between white goods and black goods. AUX, a leading domestic A/C manufacturer, has a blueprint to expand its domestic channels with 3,000 new stores by 2013. However, the biggest ambition in constructing self-owned channels is likely to be demonstrated by Changhong, which has set a target of launching 10,000 chain stores in China within 3 years.

Building self-owned channels allows the leading home appliance players to extend their penetration into lower-tier markets and enhance their control over the operation

and management of their end-sales, but it requires a substantial initial investment and makes new demands on range of product lines and channel management capabilities.

HOME APPLIANCE CHAIN STORES

Leading retailers such as Suning and Gome dominate the markets in tier 1 and 2 cities, but their penetration in the lower-tier markets is low. A number of smaller home appliance chain stores are now rapidly emerging as leaders in tier 3 and 4 cities and rural areas.

These new players are of two main types. The first are region-wide chain stores which have usually evolved from regional distributors and penetrate first into tier 1 and 2 markets in the region and then into tier 3 and 4 markets. Promptly responding to the sudden growth of the home appliances market in rural areas, they have been setting up and expanding self-owned retail stores or developing franchise stores, and identifying new areas of growth

with the aid of centralized management of brand, procurement and price. The second type is nationwide chain stores such as Tofind and Wan Ma Ben Teng. Home appliance manufacturers have been investing in these chains to boost their coverage of tier 3 and 4 markets.

Region-wide home appliance chain stores usually evolve from provincial-level distributors with a competitive edge in their in-depth understanding of local markets and the resources of retailers. Huiyin Household Appliances, which was publicly listed in 2010, is a good example. Its network mainly covers the lower-tier cities and rural markets of Jiangsu and Zhejiang, with 63 self-operated stores and 224 franchise stores at the end of 2010. Its business model encompasses

self-operated chain stores, franchise chain stores, after-sales service chain stores and distributors.

Huiyin first launches self-operated stores downtown in lower-tier cities to enhance brand awareness, then sets up localized franchise stores in rural areas with the highest population density, exploiting word of mouth to help increase the penetration of its expanding network.

Other active players in this field include Mingzhu Appliances, which is focused on air conditioner sales in Jiangsu, and has an annual revenue of RMB 800 million; Jiangxi Siping Appliances, which has about 80 self-operated stores and 100 franchise stores with total annual sales of RMB 1.3 billion; Palcent, which operates

about 300 self-operated and franchise stores in lower-tier markets in Zhejiang; and Dongqiao Appliances, which has annual sales of RMB 900 million in Ningxia.

As to the nationwide chain stores covering tier 3 and tier 4 markets, Tofind, founded by Feilong Electric in 2009, is a leading player. It creates tailored channels by integrating factory-direct sales and distribution for small and medium businesses in tier 3 and 4 markets. Its business focus on lower-tier markets determines its criteria for supplier selection. It cooperates with manufacturers targeting mid-to-low end markets, such as Hyundai A/C, Yuetu, Cuori, and Heart & Heart (the latter two are manufacturers of small home appliances). Taking Gome and Suning

as role models, Tofind has plans to set up 24 marketing centers and large-scale logistics bases nationwide, targeting itself to become the No.1 home appliance player in rural markets.

Chain stores like these possess unique knowledge about their local markets and are able to select brands and product portfolios to suit them. This insight is extremely valuable for home appliance manufacturers. Other advantages—including high coverage, channel management experience, and potential for rapid expansion with modest initial investment—are attracting many manufacturers attempting to enter lower-tier markets.

CO-CHANNELS BUILT WITH DISTRIBUTORS

Building a sales channel jointly with distributors allows home appliance manufacturers more control over the channel, while leveraging distributors' customer relationships and insight into local markets. Gree, for example, collaborates with local distributors in each province to create sales JVs. It has rigid selection criteria for qualified distribution partners: a strong presence in the local market, and more than 70% of revenue generated by sales of Gree products. It dispatches its products to the local sales JVs at a uniform price, but allows the sales JVs to moderately realign their prices to distributors according to local market conditions. Gree thus maintains its control over pricing, while leaving enough flexibility of operation for its distributors to ensure reasonable profits. It also requires tier 1 distributors to replenish their inventory only from its sales JVs, in order to try to eliminate the possibility of channel conflict. Gree currently operates over 10,000 sales outlets around China, and has recently launched an HVAC interactive experience center in Panyu.

Another A/C giant, Midea, has also been working with distributors since 2007 to set up nearly 5,000 exclusive stores around China at all tiers. It provides these exclusive stores with a variety of support: finance (including a decoration allowance of between RMB 20,000 and 50,000, to ensure integrated presentation standards),

training, promotion specialists, differentiated sales policies, and favorable trading terms. It also uses commissioners to assist distributors in the conduct of daily operations, and provides service support in after-sales network development, technical support, and spare parts supply.

Samsung is another leader in this channel, having now set up over 1,000 stores in alliance with its distributors, and aiming to double that number. The share of its sales revenues contributed by major chain stores such as Gome and Suning is only around 20%.

The leading distributors are likewise increasing their presence in lower tier markets through such collaboration. For example, in May 2011, Suning discussed the possibility of deepening strategic partnership with Xinfei, with an eye to leverage Xinfei's good brand awareness and reputation in tier 3 and 4 markets to allow it to increase the number of store / impact in these markets, and, in return, boost the sales volume for Xinfei.

In summary, by building sales channel with distributors, the home appliance manufacturers successfully bypass the problem caused by expensive entrance fees, increase their control over channel, and better leverage the distributors' insight into the local markets.

E-CHANNELS

With the increasing penetration of the Internet into less developed areas of the country and an extremely rapid growth of mobile applications in the last two years, more and more consumers are today using online resources to compare price, product information, delivery time, and payment method before making purchase decisions. The emergence of e-commerce is starting to transform buying patterns in the home appliances market. As sufficient logistics capabilities develop, buying online offers the advantages of abundant information, convenience, and lower prices.

Leading e-tailer Taobao launched its 3c T-mall, a B2C online marketplace dedicated to home appliances, in 2009. 3c's revenues exceeded RMB 5 billion in 2010, seeing annual growth rates of 830% on televisions, 1,570% on kitchen appliances, and 1,100% on other home appliances. 360buy, the largest B2C online retailer in China, is also achieving impressive sales in white goods. Tapping into the home appliances market since the second half of 2008, 360buy reported revenue of RMB 360 million from home appliances in 2009, and RMB 1.6 billion in 2010, up from only RMB 30 million in 2008. It has developed partnerships with almost all the major players in the home appliances sector,

and aims to achieve RMB 5-6 billion sales revenue in this sector in 2011, to which Haier will contribute RMB 600 million.

Other e-tailers are also growing very fast and becoming an important force of home appliance distribution, e.g. 360buy, Neweggs and Coo8, these e-tailers are further changing the landscape of distribution to lower tier cities for home appliance.

Guangdong-based TCL set up a dedicated e-commerce center in 2010, with full pricing power and an R&D capability allowing it to be extremely flexible in its business model. Haier, the earliest e-commerce pioneer in the home appliances sector, had set up an e-commerce company as early as March 2002, but this only played the role of a product exhibition center until 2008, when a true online business, eHaier, was founded. eHaier reached sales of RMB 330 million in 2010. Ryoji, a Shaanxi-based green home appliances manufacturer, signed a national online retail agreement with online mall 500CCC.com in September 2011. Other giants, including Gree and Midea, have also established partnerships with leading online retailers such as Taobao and 360buy, aiming to capture market share through the emerging e-channel.

CONCLUSION

The diversification of channel innovation in new market penetration is an inevitable trend in China's home appliances sector. As well as piloting novel forms of channel penetration, home appliance manufacturers should focus on aligning their channel models with existing capabilities and their overall development strategies to optimize growth potential.

Despite such advantages as fewer layers, lower costs, and higher efficiency, home appliance manufacturers have concerns about the online channel, including impact on price in offline channels and possible market disorder caused by the lack of territorial restrictions on the Internet platform. Most of them are as yet only “testing the waters” of this promising new channel.

Endnote

¹ The “Home Appliances for the Countryside Scheme”, launched by the Ministry of Finance and the Ministry of Commerce and Ministry of Industry and Information Technology in Dec. 2007, provides government subsidies of 13% of purchase price to buyers of home appliance products in the countryside.

² The “Old-for-New Home Appliance Subsidy Program”, launched by the National Development and Reform Commission (NDRC), the Ministry of Finance, the Ministry of Commerce, the Ministry of Industry and Information Technology, and the Ministry of Environmental Protection in June 2009, provides government subsidies to encourage China replacing old, energy-wasting home appliance products with new energy-saving ones.

About the Authors

Edward Tse

is Booz & Company's senior partner and chairman for Greater China, specializing in definition and implementation of business strategies, organizational effectiveness, and corporate transformation. He has assisted several hundred companies—headquartered both within and outside China—on all aspects of business related to China and its integration with the rest of the world.

Andrew Caine

is a Booz & Company partner and also the firm's managing director for Greater China. He has over 20 years of management consulting experience in Asia and Europe, and has been working in Asia since 1997. He advises local and multinational clients in consumer product, retailing, health and financial services industries on all aspects of strategy, organization, and capability building in China, Korea, and the rest of Asia.

Adam Xu

is a Booz & Company principal based in Shanghai, focusing on Consumer and Retail. He has extensive experiences of helping the client to achieve the growth in China, from China entry, growth strategy and partnership model to such functional topics as the go-to-market operating model, trade spend and customer management.

Yong Zhang is a Booz & Company senior associate based in Beijing, focusing on Consumer and Retail. He has more than five years consulting experience helping clients in China on different topics such as new market entry, business growth strategy, corporate governance & organizational transformation. Before as a consultant, he also has over 10 year corporate management experience in marketing, sales and corporate strategy in FMCG and retail industry.

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