China Retail Industry Development
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Chapter I China Retail Industry Development

Overview

1. China macro economic summetry and factors influencing consumer goods retail industry

For many years running, the year of 2015 sees the first time when GDP growth falls below 7%, under which the traditional manufacturing industry continues to decline, the tertiary sector surpasses the secondary industry by GDP contribution, and emerging consumption continues to rise. At the launch of the "Thirteenth Five-Year Plan", the central government put forward a new reform path for China—supply-side structural reform and the transformation towards an economy whose growth is driven by domestic demand, both of which provide a direction for the development of China’s retail and consumer industries. In the process to deepen reform, to accelerate innovation and to realize consumption upgrade, the changes in China’s demographics and the constant innovation and application of internet technology will exert significant influence upon the overall industry.

(1) Economic Factors

Economic development has entered the New Normal stage, in which supply-side reform promotes structural adjustment

Economic growth in China has sl owed down year by year, and the economic has entered into the new normal stage development marked by growth in stability. Major economic work conferences repeated the future focus would be on expanding the total market on a moderate scale while strengthening the supply structure reform and improving the supply system quality and efficiency, so as to achieve mutual support and promotion between stable growth and structural adjustment, and to enhance the momentum for continuous economic growth. Domestic demand expansion and consumption upgrade will act as strong support for the future growth of consumer retail industry.

Change has occurred in the economic growth model and new drivers are taking shape

The previous “troika” driving GDP growth—investment, consumption and export-- are presenting a changing development trend. Export’s contribution to GDP growth has becoming weaker and weaker since the 2008 financial crisis, to only 0.1% in 2014; total GDP growth contributed by capital also declined from the 8% peak in 2009 to 3.6% in 2014, foming a gradually weakening influence year by year; only consumer growth constitutes relative stability, and is expected to become the main force for future economic growth. Looking forward, with the promoting factors including income growth, urbanization, and consumption upgrade, consumption will become the key momentum to drive economic growth.

(2) Social Factors

Demographics

Aging population is a well-recognized national problem, which is becoming increasingly dramatic at a steady pace. CAGR of population aged 65 and above has maintained over 3.5%, computed by which the population aged 65 and above will reach 170 million by 2020. According to the estimation of the national aging people service office, the old-age industry in China will be reaching RMB8 trillion and RMB22 trillion in 2020 and 2030,
respectively, and will be contributing to a respective 6% and 8% to GDP growth. And the impact of aging population upon consumer retail market cannot be overlooked. Another remarkable issue lies on the nation-wide population mobility. According to the sixth national population census, population mobility is discovered in different regions on various extents, among which the largest population outflow is from Anhui province, and the largest inflow is to Guangdong province, with a net outflow of 8.9 million and a net inflow of 20 million, respectively. Such a trend would cause greater unbalance among regional economies, which in turn will give impact on the consumer retail market.

Urbanization
Urbanization represents one of the main directions for the future economic growth, and will also become a key path to drive economic growth. In China, the urbanization rate increased from 43% in 2005 to 54.77% in 2014, adding approximately average 20 million’s urban population. During the “Thirteenth Five-year Plan”, it will play an even more important role. According to the National New-type Urbanization Plan (2014-2020), the resident population urbanization rate will reach 60%, and the main targets for urbanization in the next five years including that about 100 million eligible workers who have left agricultural work and other resident population are able to settle down in cities and towns, shanty towns and urban village can be rebuilt for 100 million people, and 100 million people in the middle and western part of China will become urban resident in the nearest cities and towns. And consumption demand from the above plan is expected to become another important power to push the overall consumption growth and to stand as an important part in consumption upgrade.

Middle class expands with increasing per capita disposable income
Steady growth of per capita disposable income in the recent years has led to an increasingly expanding middle class group. According to forecast by the Economist’s think tank, by 2020 there will be 472 million population of middle class group, which will take the largest proportion in the total population, and private consumption is also expected to realize exponential growth.

(3) Policy
Under the background of continuous downturn in the traditional industry, consumption has become a new momentum driving the national economic growth. In the recent years multiple policies and attempts to promote consumption have been released, from the legalization of cross-border e-commerce, selective two-child policy, rural area consumption promotion to the recent hot topics including housing reform, new-type urbanization reform and consumption upgrade, all of which have become key forces to drive consumption. Supportive policy can be expected in the future, and policy towards the consumer retail market presents favourable.

(4) Technology
The internet and the mobility have changed from a trend to the key elements to dominate the market development. “Internet +” has penetrated into each section of the industry development, and the popularity of smart phones and terminals also helps the retail and consumer goods enterprises achieve more expansive customer coverage. The internet and the mobile terminal play together and to some extent have changed the purchase model of the customers. From the perspective of the sellers, under the market background where the customers are taking a strong position, the internet of things and big data are able to better help the companies understand the market and consumer changes, while to realize improved management. All of these technical inputs will help the enterprises win stronger competitive advantages in the future.
2. Overview on Development of China’s Different Retail Sub-sectors

To have an in-depth study on the development of retail sub-sectors in China, in 2015, Deloitte joined hands with China Chain Operation Association conducted a survey to 208 retail enterprises, whose key financial ratios including operating income, net profits, costs were diagnosed and analyzed. The interviewees were mainly from the top 100 chain stores, and other representative enterprises and store fronts were particularly selected. Among all the enterprises interviewed, there were 103 supermarkets and ultra-supermarkets, 41 convenience stores, 66 department stores and shopping malls, as well as 24 specialty stores.

(1) Analysis of Different Retail Sub-sectors

Total retail sales growth of social consumer goods continues to slow down, leading to mounting pressure on physical retail stores

The year of 2015 witnesses a downward trend with total sales of social consumer goods, about 1.3% decline in growth year on year compared with 2014. Under the dual shocks from overall slower growth and e-commerce players, sales by physical store runners are also under great impact. Not only sales growth slows down continuously from 11% in 2010 to 8% in 2014, but its market share in the total retail of social consumer goods has declined from 11% in 2010 to 8% in 2014. Expansion roadmap of the top 100 players is also slowing down, marked by slowed growth of frontstores from 9.8% in 2010 to 4.2% in 2014. In 2014, 23% of enterprises presented negative net number of newly-added frontstores, and 7% of the enterprises had the same number of physical stores with the previous year. Rising operating cost further reduced the enterprise’s bottom line, leading to differentiated operating performance. In general, rent and labor cost maintains high growth of 7.0% and 7.7%, respectively. Confronted with cost increase and slower sales growth, the enterprises need to pay more attention to operating efficiency and strategies.

Enterprises felt net profits decline, presenting diversified operating performances

Under the background of overall industrial growth slowdown, enterprises diverge in operating conditions and earnings realized, among which 27% of the companies suffer negative growth while plenty of them successfully achieve positive figures. This implies that, even confronted with market downturn, high cost and huge shocks on physical store retailing from e-commerce players, good operational strategy, careful operation and cost management, as well as customer marketing can still forge outperformance of an enterprise and a place in the market to set its own feet.

Significant effect of scale from cross-regional operations

A national enterprise enjoys large scale, which is approximately 2 times of that of a cross-province company and 8 times that of a local provincial player. Scale effect and mature operational and management scheme bring these national enterprises operating profits. No matter in terms of sales revenue growth and gross margin, national enterprises outperform the regional players.

Enriched retail pattern forged by multi-type business activities

With consumption structure upgrade, consumer spending levilazation and the rise of mobile internet sales, retail enterprises are trying different forms of commercial activities in an attempt to build a dimensional retail pattern and realize maximum added-value through playing operational advantages. According to statistics, 60% of the enterprises have adopted multi business activities, including supermarkets, department stores, shopping malls, convenience stores, and e-commerce channels. Based on changing consumer demand, enterprises make adjustment of their own operating standards, goods
structure and sales promotion strategy, and form multi business activities. Although various advantages within, they should be careful on such a scheme. According to survey data, both in terms of profitability and company growth, enterprises adopting single business activity outperform those using multi business activities.

**Diversification gradually unveiled among different business activity forms**

Against the background of overall industrial slowdown, different business activity forms present different trends. Shopping mall and convenience store realize stable growth, outperforming that of large supermarket, supermarket, department store and specialty store. With advantages in large size, strong inclusiveness and focus on customer experiences, shopping malls are regarded as “haven” for offline retailing and have achieved good growth in the recent years. Of course, it should be noted that shopping mall construction pursued simultaneously by lots of enterprises also brings about fierce competition and mounting pressure for profits generation, therefore going for diversification, branding and chain operation stands as the inevitable trend for shopping malls in the future. With limited investment, short mature period, convenience in terms of space, time and services as well as closeness to consumers, convenience stores will be retaining rapid growth in the coming several years, realizing further development in mature markets while gradually exploiting the blank markets.

**More efforts on online channel construction expected to bring about further increase in market share of online business**

In 2015, 82% of China’s top 100 chain stores went for e-commerce, and 54% have their self-built platforms. With more efforts by physical store operators to build online channels, full-channel operation will become the new normal in the future.

**Proprietary brands exert limited influence, presenting huge potential in brand construction**

42% of the supermarket enterprises sell self-brand products, whose sales account for 6.4% of the total sales. Among the convenience store samples, sales of proprietary products account for 13% of the total sales, surpassing all other business forms except for specialty stores. Brand difference becomes an important aspect for convenience stores to compete. 78% of department stores sell self-brand products, accounting for 2.1% of the total sales. As for specialty stores, sales of the self-brand products account for 50.5% of the total sales, being the highest among all business forms, which is related to product composition of the specialty stores.

(2) **Analysis on the development of different business forms by domestic and foreign-owned enterprises in China**

Local supermarkets become a new rising force and foreign-owned ones show declining competitiveness

In the recent two years, changes in retail channels and markets to some extent slow down the sales growth and margin growth of the physical retail stores, under which large supermarkets come across large shocks in such a trend. In the overall downturn industry, due to strategy problem and insufficient understanding of the Chinese consumers, plents of foreign-owned supermarkets choose to close stores and exit some local markets and try to use various strategies in response to the market changes; in contrast, the local supermarkets with China Resources Vanguard, Yonghui, and RT-Mart from Taiwan as representatives carry out reforms and upgrade in many aspects and retain relatively rapid growth against the overall downdward industrial trend.
Foreign-owned convenience stores still show dominance and local ones display ups and downs

After several years’ development, the industrial pattern of the convenience store sector has experienced significant changes. Market share of alldays KEDI declines from the previously peak of 25% to 8%, and such decline has been going for 7 years in a row; since onboarding, FamilyMart’s market share in China increases step by step, and in 2014 it enjoyed the second largest market share; 7-eleven, king of Japan’s convenience stores, has realized stable market share in the recent years, ranking no.3 in 2014; Meiyijia wins the largest market split, whose 2014 share doubled that of 2008. All these convenience store players occupy nearly 45% of the total market share, and the remaining 6 players account for a market share of no more than 7% and remain relatively stable.

Adjustments occur in the department store sector, with some foreign players exiting the Chinese market

In the general retail recession, department stores feel the largest shocks. According to investigation of China Commerce Association for General Merchandise (CCAGM), in 2015 although 80 member enterprises realize a yoy 9.3% growth in product sales and a growth of 10.42% in the overall business area, due to constant rising cost and expenditures, the total profits decrease by 12.05% compared with 2014, leading to a profit margin of only 1%. With the freeze of the overall department store sector, different performances are generated by different plans. Among the department stores participating in the CCAGM survey, the number of enterprises which show increased sales is slightly larger than those experiencing declined sales, being 43 and 37, respectively; meanwhile, there are 17 enterprises whose increase is over 10% and 17 players whose decline surpasses 10%. Such increase and decrease presented reflect divergence of sales number by these 80 department stores. It should noted that, there are 7 department stores realize over 20% growth in sales, displaying their progression made in terms of performance improvement.

3. Main Trends in China’s Retail Industry

(1) Consumer dominance is becoming a trend

With social development and technical progress, consumers are winning unshakable initiative

Social development, technical progress, and rapid increase and partial excess in consumption capacity gradually allow consumers to win the initiative and the right of choice in the market, and the supply-driven market has changed into a consumption-driven market. Different from the traditional retailing, under the emerging retail model, consumers enjoy huge numbers of options and at the same time are able to influence the suppliers to obtain their desired products and services. The change of retail model involves the change of a series of factors including disposable income, demographic structure, preference, market structure, and technical innovations, and the inevitable result is that consumers begin to grasp the power of disclosure.

The focus of consumption is changing from simple material satisfaction to the satisfaction brought by both the product and the experience

Consumer behavior is becoming more and more complex. In the past, consumption was more about to satisfy a person’s own demand for the goods, but now people’s attention is partially shifting from the goods to the experiences brought about by the purchase behavior. Tailored sensational experiences with features are becoming a key factor influencing people’s expenditure decision. Even sometimes differentiated services accompanying identical products can exert greater influence on people’s purchase behavior.
(2) **Science drives reform**

**Internet has become the main trend**

Internet is becoming one of the main consumption channels for consumers. From historical data, it can be found that the overall online retail transaction volume and the total social consumer goods retail sales by online transaction are rising year by year, and the total transaction volume in 2020 is estimated to reach RMB10 trillion, accounting for over 16% of the total social consumer goods sales. Meantime, internet appears in almost all sections of consumption activities. From demand generation to product selection and to real purchase, the internet is playing a more and more important role. According to Deloitte’s research, in each section a consumer uses the internet nearly or over 50% of the time. Such a high proportion implies that the internet based transaction can reflect more than the transaction volume.

**Mobile shopping becomes a main topic and mobile e-commerce brings new opportunities the retail industry**

According to iResearch statistics, in 2015 mobile online shopping transaction size in China hit RMB2.1 trillion, a year on year growth of 123.8%. Among the overall online shopping market, the mobile terminal accounts for 55.5%. Since 2015, the main e-commerce platforms and many traditional brand enterprises have paced up the deployment of the mobile terminals by offering enriched mobile terminal business and improving the terminal services. With further improvement and penetration with advance of mobile payment technology, in 2016 the mobile transaction volume in China will take a larger share in the overall Chinese online shopping market.

**Big data is expected to offer well-rounded support to the retail industry**

Physical store retail constitutes a key part of communication with consumers and displays uncompetable advantages. What the physical store retail passes to consumers is not limited to the product itself, but more about the experiences of being served and spending at a physical store. Physical stores are able to have real contact with the consumers, in which consumers need to appear at a specific place to complete the consumption behavior, and each actual purchase experience by the consumers offer large amounts of individual data. Compared with the statistics generated by multiple single purchase through online shopping, information collected by physical store retailers is more personalized and accurate. The internet of things can connect the real world and the digital world, so that the data system of physical retailers can be greatly enhanced. The internet of things makes the physical entity a data collector, by which the physical store retailer obtains not only simple statistics of client information and transaction records, but a series of data about the consumers’ consumption habits, behavior pattern, and expending preferences.
(3) Whole-channel integration has become the mainstream
The retail industry is turning towards whole-channel arrangement, and a whole-channel business model is being gradually improved. Marked by going online of feiniu and YUNHOU, which is online platform of RT-Markt and BBK, many well-known retail enterprises extremely engaged in online business development. With online players’ cooperation with physical retail players, represented by Alibaba’s strategic investment in Intime and Suning, full integration of online and offline channels take place in a collective manner. With Alibaba’s huge equity investment of RMB28.3 billion and Jingdong Mall’s RMB4.3 billion strategic investment in Yonghui, the retail industry is soon to embrace an era driven by online and offline activities. With increase of the giants’ investments, improvement of the whole-channel value chain and maturity of the mobile payment method, enterprises are carrying out full-scale transformation to solve problems including resource barriers, profit distribution between online and offline sales, and marketing and promotion, etc.

(4) Cross-sector cooperation leads the new direction of the retail industry
In the past two years, many retail giants tried various crossover cooperations. Alibaba established Cainiao to participate in the logistics sector, and also bought Youku and Tudou to provide video entertainment services; Jingdong joined hands with Citic to have a try of internet finance while working together with Tencent to build up a creative life platform. More and more cross-sector cooperation driven by the popularity of mobile interconnection is becoming an obvious trend for the retail industry’s future development. One of the main direction for cross-sector cooperation belongs to the upstream and downstream segments within the same or relevant industries so as to achieve diversified synergy. Under the consumer-driven scheme, the economic model with the consumers as the core is promoting the formation of a consumer ecosphere. The popularity of internet and mobile interaction greatly improves the openness of the consumer ecophere and enriches the content, which allows the possibility of various cross-sector combination.

(5) The rise of crossborder e-commerce
In 2015, the transaction size of crossborder e-commerce in China amounts to RMB5.4 trillion, marking a yoy growth of 28.57%, which has slowed down than the previous level. From the perspective of import-export structure of the Chinese ecommerce players in 2015, export accounts for 83.2% and import 16.8%. At present, the crossborder import business in China is still at its preliminary stage. Due to increasing demand for overseas goods by Chinese consumers, the import segment has presented stable growth in the past three years. However, the new set of tax policy on crossborder ecommerce retailing launched in April, 2016 not only clarified the new scheme of crossborder retail imports taxation, but raised new requirements on the goods’ clearance process and categories, which to some extent brought impact on the retail import business growth.
Crossborder ecommerce becomes a new growth point
In 2015, the transaction size of crossborder e-commerce in China amounts to RMB5.4 trillion, marking a yoy growth of 28.57% and accounting for 21.96% of the total national import and export, which has further improved. Thanks to the favourable national policy and the free-trade zone development, the crossborder ecommerce transaction size and its proportion in the import-export trade volume will be feeling rapid growth. The export ecommerce players have began to take shape through rapid development over the recent years. Supported by globalization, logistics system improvement, policy support and the rise of emerging models, they will still see fast development. In terms of business mode, B2B remains to dominate the crossborder players, accounting for over 90%. As the crossborder trading entities are becoming smaller and smaller in size while the paths of a product from the factory to the consumer are becoming increasingly diversified, the crossborder orders tend to be fragmented and in a smaller amount, and the B2C transaction is expected to further increase in the future. However, since B2B transaction volume is large and the orders remain stable, in the foreseeable future, the B2B model will remain as the most important one for Chinese enterprises to explore the overseas markets.

Simultaneous Rapid Development of Import and Export
In 2015, the overall crossborder e-commerce players achieved growth of 28.57%, among which the import transaction realizes growth of over 50% to RMB0.56 trillion and the export transaction has increased by 31.79% to RMB3.64 trillion. With years of rapid development, ecommerce players focusing on export business have already taken shape, and driven by multiple favourable elements, import trade experienced sudden explosion in the recent years. Yet influenced by the new policies, their future development still presents uncertainty. From its rise to 2014, crossborder import has retained growth of over 50% throughout, and it realized growth of 47.95% in 2015. Huge domestic demand stands as the main driver of rapid crossborder importance development. Prior to 2016, there were 8 pilot service stations established for crossborder transaction ecommerce customs declaration within China, including Shanghai, Chongqing, Hangzhou, Ningbo, Zhengzhou, Guangzhou, Shenzhen and Tianjin. For the development of crossborder ecommerce, more cities are expected to obtain the license to carry out relevant business, leading to more diversified development focuses and models.

E-business Giants Put More Efforts to “Cross the Border”
There are more than 5000 crossborder ecommerce platforms and over 200,000 relevant enterprises in China, 80% of which are from regions with traditional foreign trade foundation such as Guangzhou and Ningbo. Crossborder giants represented by Alibaba, Jingdong, Amazon have all carried out a series of activities themed in crossborder ecommerce strategy and paced up their overseas ecommerce roadmap to occupy the market share. Yihaodian, Dangdang, and Vipshop also follow steadily to engage in crossborder ecommerce business. Moreover, ymatou, mitao, mia.com, and mgpyh.com, all of which are exemplary crossborder ecommerce companies is gradually cutting a fiture and building their own brand features in the vertical subdivisions including maternal and child supplies, cosmetics, and apparel and accessories, etc.
Blooming crossborder import market favored by the capital market
Although Tmall, Jingdong and Amazon occupy a combined 90% share of the Chinese ecommerce market, for the crossborder ecommerce subdivided segments, there is high market uncertainty in share split. Plenty of emerging platforms have obtained certain share relying on unique business strategy and competition advantages. Many emerging enterprises have completed multiple rounds of financing in the past one or two years. It can be said that the crossborder ecommerce sector has become a highland actively sought after by the capital market. From the perspective of finance transaction, in 2014 Mitao, mia.com, womai.com and haimi.com all obtained funding of over USD10 million, and at the beginning of 2015, ymatou even received USD100 million in its round-B financing, followed by USD10 million financings to yangmeng, axiagu, and aomygod. Even faced with threats from Taobao and Jingdong, enthusiasm of the capital market is not dampened. But with increasing numbers of competitors and strong intervention of the ecommerce tycoons, there is growing concern on the market shuffle of the crossborder ecommerce industry.

Crossborder ecommerce becomes a key direction for transformation of the physical retailing
If the traditional ecommerce has dominated around half of the physical retailing’s placeground, then the crossborder ecommerce has further grasped the physical retailers’ living space in part of the subdivided market. Under such condition, physical retailers are also actively engaged in transformation. For physical retail operators, stepping into the crossborder ecommerce business can not only achieve multi-channel development but improve the product system. Therefore, since 2014 there have been constant trials by physical retailers to carry out crossborder ecommerce business. In the later half of 2014, the “SJGO” platform affiliated to Chongqing Department Store went alive for crossborder ecommerce business; On July 1 2015, ewj shop selling Hong Kong goods and affiliated to China Resources Vanguard opened business in the shipping center port building of the Qianhai Free Trade Zone, selling 500 kinds of goods directly provided from Hong Kong including cosmetics, articles of everyday use, imported foods and fresh food, and then in September, an “ewj zone” experience zone was opened in Sha Tau Kok; on July 21, Rainbow Department Store formally launched its “Rainbow to your home” business from offline to online services as well as its “crossborder ecommerce experience store” from online to offline arrangement, which marked the second transformation of Rainbow Department Store since its full-channel strategy was implemented; in September, international giants like Metro kicked off a set of reforms centered on ecommerce and had its first try in crossborder ecommerce activity by cooperation with Jingdong. To better forge the full-channel model and reduce purchase cost, On November 4, 2015, during the 17th China Chain Operation Association, 23 domestic retailers with BBK as the leader joined hands to establish a global associated purchase alliance for international direct purchase, leading to the first super platform intergrating online and offline purchase resource chains. As expected, this platform can help the physical retailers reduce the purchase cost, avoid the middle retailers while save logistics cost and shipping time.
Problems and risks related to crossborder ecommerce

After nearly two years’ rapid development, operating model of the crossborder ecommerce industry has gradually taken shape. Promoted by the government policies, this sector is expected to feel sustained rapid growth in the future, yet there are still certain risk and uncertainties involved. As a crossborder ecommerce player needs to cross the markets, countries, cultures and customs, their stable development is also accompanied by various problems and risks:

- Crossborder supply chain management. Most troubles arise from two segments: overseas supplier management and crossborder logistics implementation. Due to no direct access to high-quality foreign suppliers or exclusive agency contract, many ecommerce platforms for import goods display weak ability to obtain overseas supply of goods and probably not able to purchase the first-hand goods. Therefore, high cost and fakes have brought significant impact on the entire ecommerce sector. At the same time, in terms of logistics arrangement, although the domestic tariff-free zone policies as well as the improvement of overseas warehouse and self-built logistics have brought about better changes, the cost related to overseas warehouses and self-built logistics as well as the unclear attitude of the foreign governments towards overseas warehouse all constitute potential risks in crossborder business.

- Uncertainty in laws, regulations as well as management mechanism. At present, the crossborder ecommerce industry is in lack of a complete system of laws and regulations, leading to high possibility of policy change in the future. The purpose of the early-stage policy is to promote development therefore standardized policy and management model is inevitable in the future. The new policy with crossborder import retailing implemented since April 8 2016 further standardized the development of crossborder import business and acted as constraints to some extent. Under the new policy, imported goods for crossborder retailing are levied tariffs and added-value tax and consumption tax during the import section, and compared with the previous personal postal articles tax implemented, there are tax rate rises and downs for different goods categories. What’s more important, under the new policy imported goods by the crossborder ecommerce players are clearly classified as cargo so that the general trade supervision model should be taken as reference and importing should be strictly carried out according to the positive list, various documents should be provided for the imported goods on the list, the process running period is largely prolonged, and those failing to satisfy the basic approval conditions cannot be imported. As a result, since the new policy’s implementation to April 15, import volume by the three comprehensive pilot zones in Zhengzhou, Ningbo and Hangzhou dropped by 70%, 61% and 65%, respectively. After trade-offs in many aspects, some of the regulations in the new policy are suspended, but impact of the new policy upon the crossborder import cannot be overlooked, and is expected to exert continuous influence on the sector’s future development.
Chapter II Brand Retail Development

1. Development of different consumer markets

(1) Apparels and accessories
Since 2015, factors including rising labor cost, competition from the international fast fashion brands and from low price products produced in Vietnam and Bangladesh, overall operating environment of the apparel and accessories sector does not present positive. Confronted with the above environment, the domestic enterprises follow one after another to adjust the product composition and to improve the terminal marketing strategy, allowing stable growth of the ordinary business growth. In addition, against the background in which prices of raw materials represented by cotton experience continuous downturn, efficiency enhancement brought by mechanization, and constantly improved product structure, the sector’s profitability remains stable.

Urgency in channel transformation and upgrade
The marketing network of most traditional apparel and accessories enterprises consists of company direct sale and franchised outlet, but rapid expansion of ecommerce business brings great impact upon the traditional offline channel model. According to statistics released by EnfoDesk, B2C apparel market transaction size during the 4th quarter in China hit RMB235.57 billion, with a yoy growth of 72.2%. Next, the international fast fashion brands adopt more sales channels to grasp the market share in tier 2 and 3 cities. Since their entering into the Chinese market, Uniqlo, ZARA, H&M paced up to open new stores, enhancing their penetration into tier 1 and 2 cities while expanding to smaller cities and towns, meantime they also realize good performance of online sales. Lastly, inadequate efforts to manage the franchisees lead to mixed qualities of frontstores. Compared with the direct sales stores, the company’s control over the franchised stores are not enough, and the franchisees fail to follow closely with the brand operator for terminal store image management in terms of awareness and initiation, thus partial inconsistent interests between the two sides. Therefore the apparel and accessories enterprises are in urgent need of channel transformation and upgrade.

(2) Food, drinks and tabacoo
Although the consumer demand for food, drinks and tabacoo in China is relatively weak, development opportunities abound in the future. According to BMR statistics, in 2015 sectorial consumption in China reached RMB8.36 trillion, a yoy growth of 7.4% compared to 2014. Influenced by the low domestic consumer demand, the estimated 2016 consumption is about RMB8.89 trillion, a yoy decrease of 3%.

Consumption upgrade: on health and high-end products
Currently the Chinese food and drink market is under upgrade from the traditional consumption towards healthy and high-end products. With increasing per capita income, the rise of the older consumers, the offsprings of the rich and “she” consumers is enforcing consumption upgrade within this sector. From analysis, it is found that healthy and high-end products that can satisfy the consumers’ need, including yogurt, milk, juice, infant formula milk powder, and bottled water, enjoy greater potential and pricing power than the traditional products.
Demand for the products to become more diversified, personalized, and fashionable
With more and more diversified supplies and channels, consumers get to know more and more brands and products, and those foods and drinks in lack of loyalty are confronted with greater number of competitors. New products and new packages are required to meet consumer needs. The enterprises are also required to use innovation and put more efforts in product R&D to have greater control of and penetration into the channels.

(3) Electronics: PC, TV set, and cellphone
Influenced by the overall domestic economic downturn and the market saturation caused by rapid electronics development during the past several years, the year of 2015 sees a downward growth trend of consumer demand for electronics in China. BMI data show that, in terms of computer hardware, the demand for pc and tablets is slumping, whose sales decreased from USD78.3 billion to about USD75.8 billion in 2015, a yoy decline of 3.2%. In terms of audio and visual equipments, the 2015 sales was USD30.1 billion, a yoy decrease of 2.8%. It’s worth pointing out that, in 2015 the government abolished the 15-year ban on game consoles, which to some extent increased the demand. In terms of mobile devices, the sales grew from USD97 billion in 2014 to USD100.5 billion in 2015, a yoy increase of 3.6%. Due to rapid growth in the previous years, the smart phone market went towards saturation with slower growth since 2014.

Increasing competition with mobile terminal prices
In the recent years due to fiercer price competitions, the consumer electronics market has become increasingly saturated, and the resident expending on such products is also decreasing. In the mobile terminal market, the domestic brand MI surpassed other smart phone manufacturers including Apple, Huawei, and Sony in the fourth quarter of 2014 utilizing its price advantage, up to the third ranking by domestic market share. The general market performance is centered on increasing price competition and decline in sales growth. In the future, it is difficult for the cell phone market to retain the same growth as the past.

PC still shows potential in the western region, the villages an towns market
The markets in the southeastern coastal areas and the tier 1 and 2 cities are relatively saturated in China with limited development space, and in contrast the western areas and the villages and towns habor great development opportunities. The policy factors within cannot be overlooked. The government intends to stimulate electronics consumption in the villages and towns, and the constantly upgrading the strategy of developing the country’s west also brings positive influence on the development of pc business. Second, the constant internet upgrade and many bind service will also drive consumption.

With development of internet technology, internet companies represented by LeTV and MI followed to "step into" the TV circle, which has brought huge impact upon the tradition TV industry in terms of content and price. The tradition competition centered on quality and hardware cannot proceed, and in the future the TV sector will be developing under the model that the low price hardware will be compensated by profits generated from the program content.
(4) Household appliances (white)
In 2014, influenced by the uncertainties rising from the national macro trend and the global economy, the household appliance market experienced slower growth against the low consumption demand. Prior to 2014, the government had subsidy policy to household appliance purchase for a long time, which caused to some extent consumer demand saturation. Starting from 2014, the government ceased such subsidy, which is one of the elements causing slower consumption growth. As for sub-sectors, according to ChinaIoT statistics, accumulatively air conditioners 103.801 million air conditioners are sold in 2015, a yoy decrease of 11.6%; a total of 73.195 million refrigerators are sold, a yoy decline of 2.67%; as for washing machines, a total of 56.138 million pieces are sold, marking a yoy decrease of 0.4%.

Product upgrade becomes the market driver—intelligence dominates
Without government subsidy and the general macro economic downturn, product upgrade becomes the main driver to promote sales volume. The public consumers also turn their attention from the functions to both the functions and the industrial design, leading to the rise of mid and high end household appliances featured in energy-efficient, environmental protection, and humanized design. Intelligent household appliances become the direction to lead the development of the household sector in the future. According to Intelligence Changes the Future—Report on the Status Quo and Development Trend of Intelligent Household Appliances co-released by China Household Electrical Appliances Business Association and All View Consulting, in 2013 the output value of intelligent household appliances in China already hit RMB100 billion, and by 2020 this figure will reach RMB1 trillion, and the output value of terminal devices will hit RMB800 billion. The popularity of smart phones, smart TV, smart washing machine, smart air conditioners and smart refrigerators is expected to be 99%, 93%, 45%, 55%, and 38%, respectively by 2020.

Domestic brands dominate the market
What’s different from other consumer sectors, in competition with foreign brands, the Chinese brands have already grasped the leading position, represented by enterprises including Haier, Midea, Hisense, and Gree etc. With development over the past decade, these domestic brands have operated at certain scale, offering diversified products, with a complete distribution network and certain brand awareness. Added by support from the policy of “appliance to the countryside”, their market penetration in the towns and rural areas is high.

Offline marketing spread into the towns and rural areas while online channels experience rapid development
In terms of channels, the past decade can be said as monopoly dominated by several large retail giants including Suning, GOME and Five Star Appliance; on the other hand, to get rid of control imposed by the retailers, Gree is working hard to establish its own exclusive shops. With intensifying market competition, sales channels continue to target the towns and rural areas, and enterprises hope to solicitate demand from the towns and rural areas to further stimulate demand. At present, the offline channel still plays a dominant role in the household appliance sector, but ecommerce platforms like Jingdong and Tmall rapidly occupy the market relying on competitive edges including transparent prices, information symmetry, large efforts on promotions, convenient and complete logistics channels, which brought huge impact upon the traditional offline platforms.
(5) Cosmetics and personal care
According to Euromonitor, the retail transaction of cosmetics and personal care products in China amounted to RMB293.7 billion in 2014, and this figure is expected to reach RMB423 billion by 2019, with an annual growth of about 8%. In terms of specific categories, in 2014 the skin care products accounted for 48.3% in the Chinese cosmetics market, being the no.1 category and showing an upward trend, and its market share is expected to reach 50.8% by 2019. At the same time, the shares of make-up products, infant and children products, and men’s care products will be increasing in the next five years, and that of bath and oral care products, as well as hair products will see further decline.

Domestic brands occupy increasing market share, showing abundant development space
The domestic brands are rising and grasping the foreign brands’ market share. According to Euromonitor, among the top 30 domestic enterprises by market occupancy, local brands including Checedo, Herborist, Inoherb, and Proya have already taken a key position and most of them present a growing trend. In 2011, the market share by local brands was a mere 5%, and this figure rose to 9.3% in 2014. Although the local brands are taking increasingly large market share, compared with the foreign brands, the total volume is still small.

Combination of the personal care sector and ecommerce channels
At present, according different market orientations, the comestics and personal care brands in China adopt different ecommerce channels as the specific development strategy. For high-end and mid-end brands, the offline channel mainly uses department store counters and enjoys complete deployment in tier 1 and tier 2 cities. Under such conditions, the roles of ecommerce include: 1. to cover the regions which are beyond the coverage of the online channels 2. to satisfy the consumers who prefer online shopping experience 3. to provide itself with more complete market data. For domestic mass-market brands, generally speaking, they are active in ecommerce deployment and make the ecommerce channel become the major driving force for performance by leveraging marketing approaches and platform dataflow.
(6) Luxuries
According to Bain & Company, the 2015 global luxury market was over €1 trillion and personal luxuries market was over €250 billion, a yoy growth of 13%, but the actual growth adjusted for exchange rate was slowed down to 1%-2%. In 2015, the Chinese domestic luxury market felt decline: total luxury market size was approximately RMB113 billion, with a growth rate of -2%.

Luxury brands slow down expansion in China
Statistics show that, some of the luxury brands closed their stores one by one in 2015, and are more prudent in opening up new stores for expansion. And the single store sales performance was not satisfying, with most brands feeling negative growth by single store sales. Brands begin to “use diet” and put more efforts on how to improve single store sales and management quality, and are more careful when opening a new storefronts in terms of factors such as location and visitors flow.

Diversified marketing methods by luxury brand Owners
As a response to fiercer industrial competition and constantly changing consumer demand, in order to consolidate their market position, luxury brands begin to adjust the existing operating model and utilize various marketing initiatives. Customized Service and exclusive fashion attributes are elements more frequently shown in the luxury brands.

Overseas consumption and growing percentage of ecommerce
There are more and more overseas purchasing. The overseas purchase market for luxuries in China is much larger than any other countries and regions, and many professional overseas purchase agents have appeared. According to Bain&Company, the 2015 Chinese purchase agent market reaches RMB34-50 billion, and will be increasing in the future. The rapid growth of this market is promoted by the price differences at home and abroad as well as by the development of professional purchase agents and crossborder logistics companies. Overseas purchasing continues to grow, and tourism is the main driving force. In 2014, Chinese consumption of global luxuries hit USD106 billion, a yoy growth of 4%, yet local spending by Chinese consumers on luxuries was only USD25 billion in 2014, a yoy decline of 11%. The percentage of Chinese luxury market to the global market decreased from 13% in 2013 to 11% in 2014. Ecommerce consumption accounts for a small part of the total volume, but its position is in constant rise.
2. Competition between foreign and local brands in the consumer goods sector

In the apparel and accessories segment, international fast fashion brands represented by H&M, Uniqlo, and ZARA squeeze the market share of the local brands. These fast fashion brands experience rapid development after entering into the Chinese market. They first succeed in the tier 1 cities, and now have expanding to markets in tier 2 and tier 3 cities. Generally, they enjoy higher added value of brand, enforcing more scientific management, and producing fashionable designs. Instead, local brands usually adopt pricing competition to obtain certain market share, while their inventory percentage keeps rising and expand more into the towns and rural areas. To reduce inventory and go streamline, these domestic brands ceased to expand aimlessly during the past years, closed off storefronts with weak sales capability, and retain quality ones so as to enhance sales competence at each single store.

In the food and drink sector, competition between as well as integration of the local brands and foreign brands can be noted. According to Deloitte’s 2015 Gloabla Force – Report on Consumer Goods, the no.1 ranking player in the food and drink subsegment Nestle Limited, mainly achieves its localization strategy by M&A activities. Currently except for Nestle’s own brands, others in China include Haoji, Totole, Hsu Fu Chi, Yinlu, and Wyeth Nutrition. On the other hand, a group of local brands with Wahaha as the representative are trying hard to get of control from the international giants while actively engaging in competition with these international brands in terms of product development, brand design, and sales channels.

In terms of personal computer business, after Legend Group bought IBM and became an international brand, it has risen as the undisputed leader in the global pc market with years of development. In terms of mobile devices, although the domestic high-end market was under firm control of foreign brands like Apple and Samsung, but local brands like Huawei and MI have their place in the market relying on price advantages, and are narrowing the gap with the international brands in R&D design. In terms of white and small household appliances, the domestic brands dominate. Representatives including Haier, Midea, Hisense, and Gree are taking a leading position in their respectively segments. With over a decade of development, these domestic brands have forged certain scale, and added by implementation of the policy of “household appliances to the countryside”, they enjoy high market penetration in the towns and rural areas.

In terms of cosmetics and personal care products, market share of the domestic brands is gradually growing with large development space. They are rising and grasping the shares of the foreign brands. According to Euromonitor, among the top 30 enterprises by domestic market share, local brands including Checedo, Herborist, Inoherb, and Proya have already taken a key position and most of them present a upward growth trend. By comparison we found that, the local brands only occupied a 5% market share in 2011, yet this figure rose to 9.3% in 2014. Although market share of the domestic players are rising, their total volume is at a low level compared with foreign brands. They should be fully leveraging their local advantages to meet consumers’ needs, enhance their management skills, strengthen channel management and online integration, and further improve their brand awareness and trustworthiness.

The luxury sector is mainly dominated by the foreign brands, while exploration in apparel & accessories, perfumes, and leather by the domestic brands has not generated desired results.
Chapter III M&A Activities and Investment Opportunities in the Chinese Retail Industry

1. M&As

M&A activities in the retail industry increased significantly in 2014. Retail enterprises sought for proper chance and the right target to break the dilemma by merger. According to Mergermarket statistics, compared with 2013, the total size of retail enterprise merger in China grew by 3 times in 2014. In 2015 the market remains active and the transaction volume grew by 50.31% year on year, and the transaction amount reached the peak for the six years.

(1) M&A activities in the retail sector show high activeness

From the beginning of 2014, M&A activities in the retail industry experience rapid increase. Only in 2014, the M&A size among enterprises surpassed the total during 2011-2013 combined. In 2015 such trend keeps continue. Disclosed transaction size during the first nine months was over the total of 2014, and the whole year transaction amount reached a record high in the past six years. Under the background of slower macroeconomic growth, the troubles faced by physical retail stores and the rapid expansion of ecommerce both pace up the M&A deals in the retail industry. On one hand the physical retail sector tries to achieve diversified ordinary business development by active transformation via multiple channels, or enhances their industrial influence by enlarged company size after M&A activities; on the other hand, ecommerce players are engaged active construction of whole channels while consumer closed loop pushes these ecommerce companies to carry on multi-sector business expansion through M&A activities.

(2) International capital flows accelerate and crossborder M&A deals become more frequent

With increasing competition in the domestic retail sector, many retail giants reach for the overseas retail enterprises. In April 2014, Nanjing Xinjiekou Department Store announced to buy the established English department store House of Fraser, which became the no.1 direct purchase among the Chinese A-share stocks and was the largest overseas investment by a Chinese enterprise in the retail industry at that time. According to the company disclosure, this deal aimed to improve the management capability, promote its overall business transformation, and this investment was expected to realize appreciation by virtue of the British economic recovery. In May 2014, China’s largest retailer China Resources Vanguard successfully acquired the foreign brand TESCO, and the two business partners would form a diversified retail joint-venture into which TESCO injected its Chinese business and cash. Based on this, China Resources held 80% equity stock of the joint-venture and TESCO 20%.
(3) Scale expansion represents the mainstream
Among all deals, no matter by the transaction amount or by the transaction number, the proportion of horizontal mergers and acquisitions surpasses 30%, implying that scale expansion still remains to be the main purpose of the retail industry in the recent years. On one hand, the traditional retail tries to achieve expansion in business scope and in operating mode through m&a activities. On the other hand, whole-channel expansion transactions are also becoming increasingly popular, and its transaction number accounts for 10% of all horizontal transactions and transaction amount for nearly 30% of all horizontal transactions. A trend of accelerated growth began to reveal starting from 2014. A series of landmark events include Alibaba’s strategic investment in Yintai chain, Warmart’s full acquisition of Yihaodian, Jingdong’s strategic investment in Yonghui Supermarket, and cross stock ownership between Alibaba and Suning.com. At the current stage, most of whole-channel expansion transactions take the ecommerce player as the leading party, and several landmark events involve Alibaba and Jingdong, which are two ecommerce giants, showing the ecommerce player’s enthusiasm to realize multi-channel integration.

(4) Vertical and Mixed crossborder transactions experience rapid growth and M&A transactions are becoming diversified
With regard to amount, vertical transactions also account for a relatively larger share, which are mainly embodied by M&A transaction between the manufacturers and the retailers, the retail enterprises’ acquisition of the commercial real estate players, and the retail enterprises’ acquisition of those from the logistics sector. These express the retail enterprises’ attempts on whole-channel construction and cost optimization. The mixed type mergers and acquisitions also have some highlights. Retail enterprises significantly increased the numbers of mixed type M&A deals in 2014 and 2015, and while engaging in horizontal expansion, the retail enterprises are also playing an active role in trying diversified deployment so as to mitigate the impact brought by the decline of physical retail sector. Among the mixed type M&As, finance, software and special service sectors account the largest number, all of which take up over 60% of the mixed mergers and acquisitions. Deals of these three types could help enterprises to enhance their back-stage management competence and capital operation ability, and to some extent improve the consumer experience.

(5) Buyers
Analysis on the buyers of these M&As found that, although the acquirers are relatively dispersed, the transaction amount is concentrated. The top 10 buyers contribute 45% transaction amount of the whole retail industry, but the deal number only accounts for about 20% of the total deals. In terms of transactions of the top 10 buyers, the ecommerce enterprises and the traditional retail enterprises have different focuses. The former group emphasizes whole-channel construction and consumer closed-loop, while the later group put their focal point on multiple operating model and scale expansion.

(6) Whole-channel integration becomes a hot issue in the M&A segment
In the later half of 2015, a series of M&A events, represented by cross stock ownership between Alibaba and Suning as well as Jingdong’s strategic investment in Yonghui supermarket, whole-channel integration has become a hot issue in the 2015 M&A market. These deals on one hand embody ecommerce players’ exploration in the new model faced with development bottleneck, and also show that some of the retail enterprises hope to realize new growth by whole-channel integration in times of physical store retailing downturn. As abovementioned, the ecommerce and physical store retailing show their
respectively advantages and bottlenecks, and in exploration of the future business model, the whole-channel integration is expected to be the last-kilometer solution for the ecommerce players, and it is also possible for the physical retail stores to regain growth and gradually achieve counterbalance with the ecommerce companies.

2. Investment in the retail sector by PE funds

(1) Investment of the retail market by PE funds rebounds to the peak
After the short quiet period in 2013 on the market, PE/VC shows heating enthusiasm to the retail market, and the 2015 investment surpassed that in 2011 peak, with a growth of 25% in transaction amount compared with 2011 yet the deal number remaining flat. As the main force for emerging company investment on the primary market, PE/VC show high sensitivity towards the national policy, industrial changes and the mid- and long-term development. Therefore, PE/VC’s attention again on the retail sector reflects to some extent the new potential growth points on the market.

(2) PE funds investment highly concentrated on the internet retail sector
The choice of the underlying asset by PE/VC becomes quite different in the past decade. Prior to 2011, enterprises obtaining fundings were mainly traditional retailers, but from 2011 financing obtained by the traditional players showed steady decline, and during the past three years, 80% of the fund-winning players belonged with internet retail companies. In the coming years the trend marked by rapid ecommerce development will be continued, and online transaction will be accounting for a greater slice in the total social retail. Added by the constantly emerging business models from the subdivided ecommerce sectors, the internet retail enterprises will still remain a focal point for PE/VC investment.
Chapter IV Summary and Outlook

The consumer retail market presents a good trend in general and will retain steady growth in the future
As the 2015 national GDP slowed down to 6.9%, the Chinese economy gradually entered into a stage marked by steady and relatively rapid growth from the previous rapid growth period. According to the development goals in the “Thirteenth Five-Year Plan”, GDP growth in the coming five years will be no less than 6.5%, showing an overall steady trend. Under the new normal of the Chinese economy, the clear trend of downward traditional manufacturing industry forebodes the inevitable reform of the economic structure, and growth driven by consumption has become one of the decision-makers’ directions to deal with economic slowdown. Simulated by multiple elements including consumer upgrade, urbanization reform, and disposable income growth, the overall consumer retail market shows a positive trend and will retain relatively stable growth in the future years, showing an even more obvious effect to drive economic growth.

After transformation pains, the physical retailers show diverged operating performances
Under the double shock of the internet retail and economic slowdown, the physical retail industry comes across real problems and there is an obvious trend with diverged operating performances. According to operational data of the publicly traded companies as well as Deloitte research, retail business mode, areas covered, business structure and company scale have all become the key factors influencing the retailers’ operational performances, and these inherit features to some extent intensify the divergences of their operating performances. With further transformation and reform, the divergence will become more significant. Whole-channel construction, business model improvement, and scale expansion have all become the directions of the retail enterprises to complete their transformation. With rich online resources and the supply-chain advantage, the physical retail players can be expected to obtain new growth momentum.

Crossborder ecommerce value chain integration will become the trend, and the industrial pattern is likely to be established
Crossborder ecommerce experiences rapid growth in 2014 and 2015. With rising consumer recognition and gradually improved business model, the growth trend will be ratified in the following years. From the sector’s new emergence to its maturity, complexity in crossborder transaction and the long business chain make value chain integration even more important. Even more direct control over the brands, effective logistics system and complete customer services all constitute the key segments of the crossborder ecommerce business chain, and will become an important direction for resources integration. During integration of the value chains, the industry will also face shuffle and the industrial pattern will be gradually established: the giants will go larger scale and more standardization, focusing on meeting the general requirements of most consumers; the vertical ecommerce will go further in the sub-sectors, satisfy the consumers’ specific demand to realize long-tail effect, therefore leading to the establishment of markets in different levels.
**Foreign brands dominating the consumer market will face greater competition from the growing local brands**

Foreign brands mainly take dominant in the consumer goods field, but the rise of local brands in the recent years brings constant pressure to the foreign brands, and such trend will become more obvious in the future. As the no.1 representative in the main categories of consumer goods, electronical products by local brands including pc, cell phones, and household appliances all occupy a larger market share; as for apparels and accessories and personal care products, the local brands are taking up an increasing market share year by year, and some excellent brands are established. In the next years, the local brands will be more mature in terms of technology, management and brand operation, which will also exert greater pressure on the foreign brands.

**The capital market will retain active, with M&As growth driven by transformation of the retail industry**

The recent two years witness the capital market being extremely active, with M&A activities and PE/VC transactions both realized a record high in 2015. Decline of the physical retailing causes many retail enterprises to try transformation, and to achieve scale effect, value chain integration, and business diversification via merger and acquisition become the no.1 momentum for the retail enterprises; at the same time, some internet retail companies kick off the exploration of the whole-channel integration after certain accumulation, and to merger with the physical retail stores so as to obtain the offline resources has become a major direction for the ecommerce enterprises. With the physical retail stores’ transformation and further integration, retail-related M&A transaction size will still retain relatively large in the coming years.
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