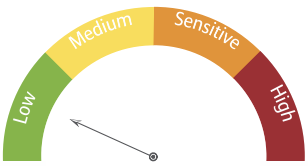
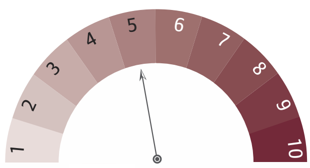
Retail in China

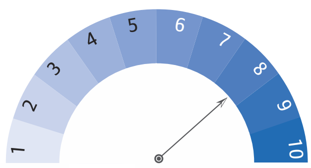
An O2O breath of life



Retail Non-Payment Risk (Q1 2017)



Digital Pressure



Digital Potential

- **In 2017 and further Chinese real retail sales should stabilize at around +9% growth, slightly below the double-digit long-term average. Retailers are betting on an online-to-offline (O2O) strategy to leverage opportunities offered by the rise of a new middle class.**
- **Publicly listed Chinese retailers saw a notable decrease in their debt ratios. Net gearing declined to 42% in 2015-16, down from 51% (2014). Profitability has remained high at 10.5%.**
- **Electronics and online retailers should keep the momentum going, while the luxury segment is set to restructure, due to the impact of the anti-ostentatious policy.**

Developing an online-to-offline (O2O) strategy to compensate slower but more qualitative demand

Nominal retail sales have displayed a strong +10.5% y/y growth in March 2017. Current performance may be lower than the ten-year average of +15% y/y because of China's economic readjustment. The rise in producer prices for the fifth consecutive month in January 2017 (+6.9% y/y up from +5.5% in December 2016) signals a budding reflation. This could boost retailers pricing power and provide an opportunity for wider margins.

Customers will drive the impetus for change. For now Chinese consumers are still torn between the search for the best deals – pushing retailers into aggressive pricing strategies – and the quest for quality and premium products. The latter is most related to the rise of the Chinese middle set to double by 2022. The digital savvy – half of the 30% internet users are in fact m-shoppers, they will be 72% by 2020 – and increasingly demanding customers force retailers to shift towards online-to-offline (O2O) retail models. This business strategy draws potential customers from online channels to physical stores. Consumers order and pay for products and services digitally. Orders are then fulfilled physically. Behemoths Alibaba and Bailian coming closer epitomizes how these two channels are being utilized as complements rather than competitors.

Improve connectedness to move to the next level

Despite the deceleration in sales in 2016, companies have enjoyed a strong financial standing. Double digit EBIT (10.5%) was accompanied by a sharp debt decrease - net gearing was down to 42% in 2016 (from 51% the year before). On the basis of these fundamentals, Euler Hermes assesses retail risk in China as Low (Q1 2017).

Chinese retailers have a clear awareness of the challenges they need to tackle over the next years to fulfil customers' expectations. Participants named in the Euler Hermes Digital Retail survey identified mobile customer journey as the top priority, with mastering omni-channeling at second place, followed by the cost of online presence. Expanding online activities in rural areas is a big challenge – and so is the potential for expansion.

The top-notch performance of international shipments (China is ranked 12th out of 160 countries in the Word Bank's LPI) exemplifies the solid foundations of the Chinese supply chain and cross-country delivery model.

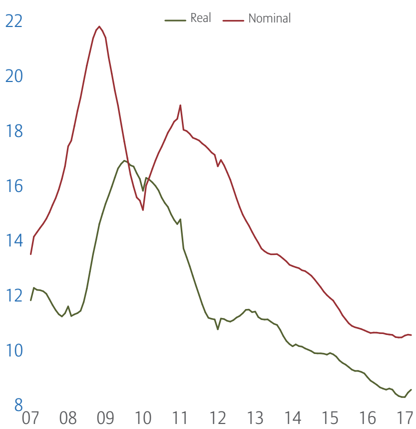
Looking forward: What does it all mean for businesses?

China has already laid the groundwork for an astute digitail and customers' display readiness to embrace the shift. Chinese retailers would be wise to better integrate supply journey upgrading further infrastructure while optimizing store footage, particularly in less populated areas.

✓ Promising sub-sectors: Online pure players have gained the critical mass. They now offer customers imported trendy goods.

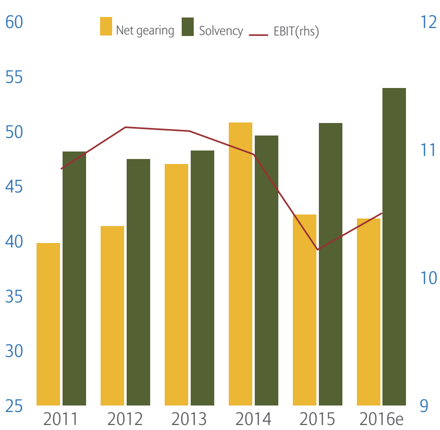
✓ Sensitive sub-sectors: Luxury brands are suffering from an austerity campaign launched in 2012. State workers are encouraged to neither offer nor receive luxury products. ■

Chart 1 Retail sales in China
in %, 12m/12m, as of March 2017



Sources: IHS, Euler Hermes calculations

Chart 2 Financial performances of Chinese listed retailers



Sources: Bloomberg, Euler Hermes calculations