



China's Retail and Consumer Industry Research Report

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Report Summary

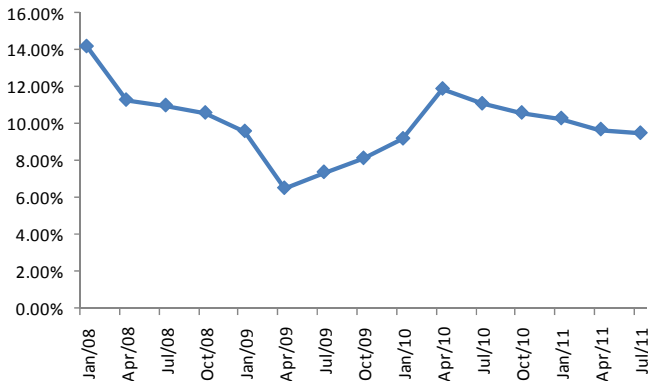
- In the 2nd quarter of 2011, China's GDP grew 9.5% which was slightly lower than the previous quarter. On a macro perspective, the trend that GDP growth is decreasing in the last few quarters has not changed. In June, CPI reached 6.4% which was highest level since July 2008.
- Vancl and Sun Art Holdings (RT Mart) became latest high profile IPO deals in U.S. and Hong Kong. While investors continue to be bullish on the retail industry, the market is also setting higher standards for companies that want to be publicly listed. Enterprises that simply relied on aggressive stores opening strategy in the past but overlooked the importance of profitability and efficiency will be tightly monitored by investors and regulators in the future.
- It is inevitable that in the future, retail enterprises have to operate in a high inflation environment. Mild inflation can directly increase sales. For the past few years, mild inflation and stable wages and rent are crucial factors that contributed to the prosperous development of the retail industry.
- However, as the macroeconomic environment changes, mild inflation and low cost operating environment may not exist anymore. Retail enterprises must get used to this new operating environment, especially on how to cope with the impact of the increase in different costs.
- Although the change in the macroeconomic environment will bring tremendous upward pressure on wages, the impact of higher wages on the profitability of retail enterprises should be relatively small. The key is to be able to raise prices and keep gross profit margins stable.
- Other ways for retail enterprises to fight inflation include increasing self owned properties, utilizing its own brand names to raise prices, having stronger negotiating power with suppliers, expanding its variety of businesses and raising operating efficiency.

1. Retail Industry Data Tracking

GDP Growth

In the 2nd quarter of 2011, the GDP year on year over was 9.5% which was lower than last quarter. The period on period growth for the 2nd quarter was 2.2%. On a macro perspective, the trend that GDP growth is decreasing in the last few quarters has not changed.

China Quarterly GDP Growth



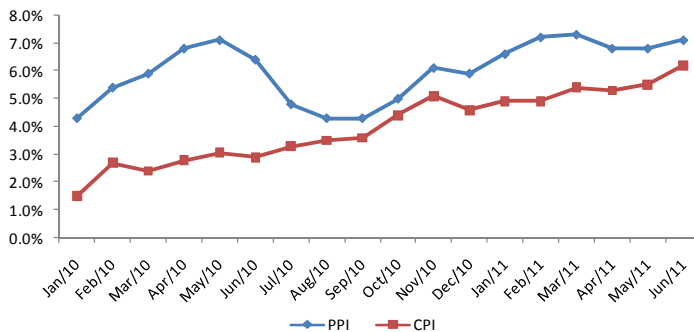
Source: National Bureau of Statistics

CPI and PPI

The CPI index grew 6.4% year-on-year in June 2011, which was the highest level since July 2008. The 14.4% year-on-year growth of food prices was the major cause of increase in CPI in June. The situation was similar to the one in May.

PPI in June was basically flat from the month before. PPI has a big influence on the non-food prices in CPI, which means the slowdown in PPI will lead lower growth in CPI as well.

China CPI and PPI



Source: National Bureau of Statistics

Total Retail Sales of Consumer Goods

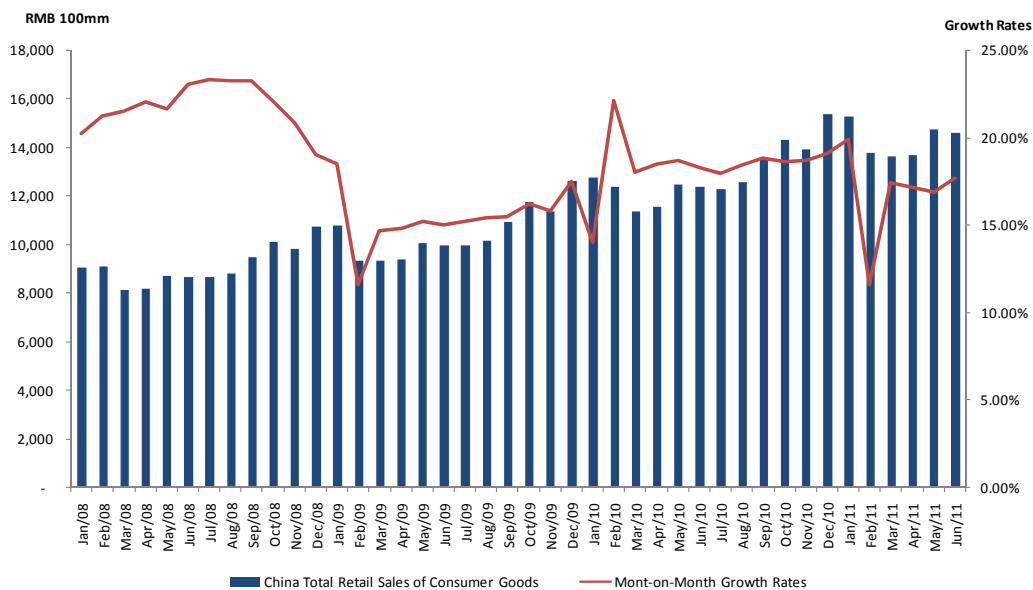
In the first half of 2011, total retail sales of consumer goods was RMB 8.58 trillion, up 16.8% year-on-year. The growth rate was faster than the 16.6% growth for the first 5 months in 2011. The total retail sales of consumer goods that are “above designated size” was RMB 3.90 trillion, up 23.7% year-on-year. In terms of different geographic areas, urban total retail sales of consumer goods was RMB 7.4 trillion, up 16.9%; rural total retail sales of consumer goods was RMB 1.13 trillion, up 16.2%. In terms of different consumption patterns, the catering services’ retail sales was RMB 957 billion , up 16.2%; the retail sales of goods was RMB 7.6 trillion, up 16.9%, of which the amount of enterprises above designated size was RMB 3.6 trillion, up 24.2%.

“Above Designated Size” companies represent companies that have more 60 employees at year end with sales over RMB 5 million.

As the impact of economic stimulus decreased, sales of products that are related to the consumption of automobiles and housing slowed down as a result. Automobiles related products grew 15.0%, which the growth rate was 22.1% lower than the same period last year; furniture related products grew 30%, down 8.5%; household electric and audio appliances grew 21.5%, down 7.3%.

In June, total retail sales of consumer goods grew 17.7% year-on-year and 1.38% month-on-month. The year-on-year growth rate in June was higher than the 16.9% in May. Both the year-on year and month-on-month growth rates were the highest since January this year. The trend of lower year-on-year growth rates in the last 2 months was therefore reversed in June.

China Total Retail Sales of Consumer Goods



Source: National Bureau of Statistics

2. Current Status of China's Retail Industry

Overview of China's Retail Industry Trends

IPO deals of retail and consumer products companies continued to be well received by the capital markets. Vancl and Sun Art Holdings were the two latest high profile IPO cases in U.S. and Hong Kong, respectively. However, while investors continue to be bullish on the retail industry, the market is also setting higher standards for companies that want to be publicly listed. Enterprises that simply relied on aggressive stores opening strategy in the past but overlooked the importance of profitability and efficiency will be tightly monitored by investors and regulators in the future. Moreover, under the threats of higher inflation and fiercer competition, many retail enterprises have begun to diversify their businesses hoping they would stand out from their competitors in the future.

IPO News

Chinese online retailer Vancl plans \$1 billion U.S. IPO

June 7: Chinese online clothing retailer Vancl could raise \$1 billion in the largest Internet initial public offering from the Asian country in the United States this year. The company aims to list in the fourth quarter, according to the people familiar with the situation, who said Vancl.com has hired Citigroup Inc., Goldman Sachs Group Inc., Credit Suisse Group, Morgan Stanley and China International Capital Corp. to handle the deal.

RT-Mart, Auchan Combined IPOs delayed

July, 14: Sun Art Retail Group's initial public offering was delayed for two weeks due to accounting mistakes. Despite the fluctuations in the markets, retail companies from the Chinese mainland remains attractive to investors. The great performance of Sun Art Retail is a good sign for other companies to be listed in Hong Kong.

China raises bar for some IPOs

July, 5: China's securities regulator has tightened its approval requirements for initial public offerings by companies in some industries seen as having high risks of financial irregularities, including restaurants and chain stores. At least some of the steps appear to have happened in the wake of accounting scandals among some Chinese companies listed overseas, which have cast a spotlight on weaknesses in Chinese corporate governance. Many of the rejected plans were for IPOs on the Shenzhen Stock Exchange, in a range of sectors including biotech, materials, agriculture and pharmaceuticals. The lacklustre post-IPO share performance of many newly listed companies in Shanghai and Shenzhen after selling their shares at sometimes extreme valuations earlier this year has drawn criticism from local media and investors on the quality of new listings. Shenzhen hosts the ChiNext market -- a start-up board dubbed as China's answer to the Nasdaq -- as well as a small- and medium-sized enterprise (SME) board for smaller companies.

M&A News

Tencent Makes a 50 Million Yuan Investment on *mamacn.com*

June, 19: Reporter had learned yesterday that Tencent has made a 50 million yuan investment on *mamacn.com*, a parenting community website. This investment constitutes the first round of financing of *mamacn.com*, which will be mainly used in expanding its staff team, exploring lives in cities around china, as well as improving the technology so as to help with the website's successful transition into a comprehensive e-commerce site that covers a great range of urban living consumption aspects including real estate, home improvement and decoration, and automobile industry. This investment is Tencent's another move carried out in the E-commerce industry.

7 Days Inn 136 million acquisition of Huatian

July, 8: 7 Days Inn Group (NY SE: SVN) announced that it will buy all of the shares of Huatian Hotel Chain for RMB 136 million in cash. This is 7 Days Inn first acquisitions. Last year, 7 Days Inn's revenue was RMB 1.49 billion and was fourth in the industry. Huatian currently operates in Changsha, Wuhan, Zhengzhou and other 12 cities with 21 outlets and 2,682 rooms. Its revenue last year was RMB 118 million.

COFCO owns 99% of Tully Sugar

July, 19: COFCO increased its share holdings in Australia sugar producer Tully Sugar from 61.25 percent to 99 percent. Tully Sugar's second biggest shareholder, Mackay Sugar, which had a 31.5 percent stake in Tully Sugar, announced on Tuesday it had sold all its shares to COFCO. COFCO began the deal with Tully Sugar on April 16. The acquisition costs COFCO RMB 938 million (USD 145.15 million). Analysts said this deal will expand the planting area of sugar cane and the processing capacity of sugar and lower the cost of China's import of sugar.

Retail Industry News

WALMART sees another senior exec depart from China ops

May, 30: Walmart has said its Vice President of Operations for China, Shawn Gray, has left the company – marking the third senior departure in a month. According to the retailer, Gray left for “personal reasons”, and no replacement has been mentioned as of yet. In May, Chief Financial Officer for China, Roland Lawrence, and China COO, Rob Cissell, left the company to “explore other opportunities”. The two were replaced by Mario-Jose Medina and Del Sloneker respectively. Walmart currently runs some 330 stores in China amid what is fast becoming an increasingly crowded marketplace. European retailers Carrefour and Tesco also operate stores in China.

PC Mall Enters Chongqing

June,28: PC Mall, which operates over 200 IT chain stores in China, is starting its location in Chongqing later this July. Although the first store is less than 2,000 square meters, PC Mall showed great ambition in the IT market of the southwestern city. The company will open 8

stores in Chongqing this year and will have 20 in two years, according to Zhao Shichun, executive vice president in the southwest region. IT companies, such as Lenovo, HP, Dell and Canon, provide the latest models to PC Mall stores and prices of computers and other digital products are generally lower than traditional stores.

Ren Ren Le entered home appliance business

July, 14: Ren Ren Le, which started as a supermarket chain, plans to enter home appliance business after its opening of Chongshang Department Store.

Most of the new stores were comprehensive ones with department store, supermarket and appliance store together. Such moves reveal Ren Ren Le's transformation from its supermarket business to the combination of various formats.

"We have set up Melo Appliances in Xi'an and Shenzhen and we will create a new business model—a combination of supermarkets, department stores, appliance stores and home products in the future," said sources from market department of the company.

Suning Appliance Purchases 3 Bestbuy Stores

July, 19: Suning Appliance purchased three closed Bestbuy stores—two in Shanghai and one in Hangzhou, according to a source inside the Chinese home appliance retailer.

Policy

Chinese businesses urged to set up service posts to treat consumer complaints

June, 21: Shopping malls, supermarkets and other retail businesses are encouraged to set up service posts inside their business locations to facilitate the settlement of disputes with consumers, China's industry and commerce regulator said. The State Administration of Industry and Commerce (SAIC) said it hopes that consumers' rights can be better protected with the establishment of service stations.

And the administration has drawn up a guide for the establishment of service stations, specifying that each station should have one or two mediators on hand to deal with customer complaints and disputes. According to the SAIC, about 200,000 service posts were established across China by the end of last year, with 5.21 million consumer queries and 754,000 filed complaints.

China's Luxury Tax Reduction

June, 29: Ministry of Commerce spokesman Yao Jian indicated that Beijing is paying attention to its citizens by reducing its stiff luxury tax and it was a "general trend" for China to cut tariffs on mid- and high-end consumer products as part of the nation's efforts to boost domestic consumption. There has been "consensus" on the issue among various government departments, Yao said. Policymakers are trying to boost domestic spending and reduce their reliance on exports and investment to drive the world's second largest economy.

The finance ministry's revamped system will reduce or remove taxes for products such as watches, clothes, shoes, suitcases, cosmetics, perfumes and milk powder, the newspaper said, citing unnamed sources.

CSRC issues guidelines for changes to PE pilot

July, 9: The China Securities Regulatory Commission (CSRC) on Friday issued guidelines that will enable securities companies to incorporate the pilot program for private equity (PE) investments into their regular businesses. The move will allow more brokerages to launch PE funds, which will broaden their revenue streams and the fund-raising channels of the country's cash-strapped small and medium-sized enterprises, said Yang Zhihua, deputy director of the department of securities firms at the CSRC, at a news briefing. The regulator required that domestic brokerages can use no more than 15 percent of their own capital for PE investments, but it did not set limits on the funds they raise from the market. It also ruled that the number of investors in a PE fund set up by brokerages cannot exceed 50.

3. Gains and Losses of the Retail Industry under the Inflationary Environment

Inflation has become a problem that draws the most attention in China. In June 2011, CPI reached 6.4% which was the highest in the last 6 months. PPI also reached 7.1%. The impact of inflation on retail enterprises has begun to emerge after several months of continuous high CPI levels. High CPI can help retail enterprises increase revenue. However, after enjoying the rise in sales performance brought by inflation, retail enterprises will face the problems of decreasing consumers' spending power and unprecedented cost pressure in business operations. Consolidation in the industry will also accelerate as a result.

Moreover, the rise in workers' wages, which is one of the biggest cost components, will bring significant impact to the retail industry. In this issue, we will analysis the impact of these changes in China.

Benefits Brought by Inflation to the Retail Industry

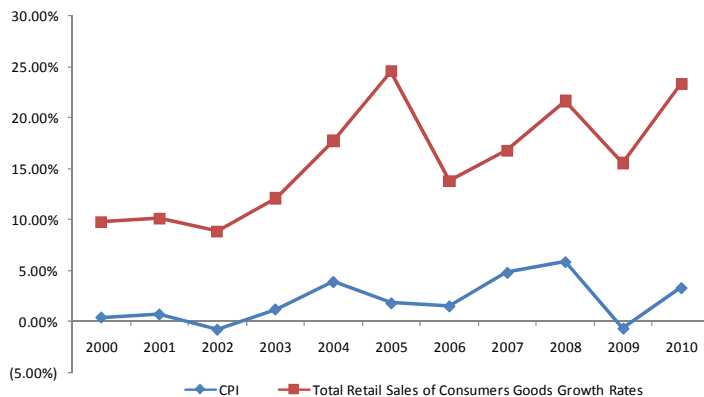
Being in the downstream of the industry chain, retailers interact with consumers directly. If there is only a moderate increase in goods prices, consumers can usually bear with the price increase, and thus retailers can pass on the cost to downstream customers. On the other hand, retailers also have strong negotiations power with upstream suppliers, so they are able squeeze additional profits from manufacturers and wholesalers during the process.

According to past international experiences, during the period of high inflation, for the sake of asset value preservation, consumers tended to pay more attention to high end luxurious products, such as jewelry, high end fashion, cosmetics, high end alcohol and tobacco and luxurious watches.

During the 60s and 70s when the U.S. experienced high inflation, Walmart was still able to develop quickly. We mentioned in our May report that in Japan during the 60s and 70s, although inflation was high and labor costs raised quickly, the rapid rise in wages led to higher tolerance of high CPI by consumers. Rapid rise in retail sales showed that high CPI had very limited adverse impact on consumption. Moreover, during this period of high inflation in Japan, high end luxurious products sales did very well, and many well-known international luxury brands came to Japan and opened stores at that time, making Japan the largest country in luxurious goods consumption.

From China's past experiences, for the last 10 years, the growth rates of total retail sales of consumer goods have always been higher than CPI.

China's CPI and Total Retail Sales of Consumer Goods Growth Rates from 2000 - 2010



Source: National Bureau of Statistics

Past experiences showed that inflation did indeed bring a lot of benefits to retail enterprises. However, that was based on conditions like moderate CPI growth, the continued growth of consumers' wages, strong consumers' confidence and bullish expectations. The premise that rising goods prices will not adversely affect consumption is true only if consumers' willingness to spend can be released under the above conditions.

The Adverse Effect Brought by Inflation to Retail Enterprises

As CPI remains at high levels, people see their wealth shrink and purchasing power goes down. That will hinder the growth of consumption. Being in the downstream of the retail industry, retail enterprises will bear the brunt of continuous high inflation.

First, although the price of goods increases, income remains the same for most consumers. High end retail markets may not be affected too much but it is inevitable for low end consumers to decrease their consumption budget.

Second, although China has withstood the pressure of inflation in recent years, the pressure is far from over given the situations in both the global and domestic economies. In Europe and U.S., the implementation of quantitative easing policies is causing excess liquidity. In the next 3 to 5 years global excess liquidity will push up prices. Stores rent and labor cost will increase. These will all bring tremendous pressure to the operations of retail stores.

The impact on retail chain business brought by inflation has already emerged. Rent, labor cost, utilities and operating costs are all soaring. Management has no choice but to reduce costs. A large number of store leases will be due in the next 2 to 3 years. To continue the lease, some of the rent will increase by more than 100%. A survey conducted by the China Chain Store and Franchise Association shows that in 2010, the biggest problems facing retail enterprises are the increase in operating costs, rent and labor costs. Rent increased by 30% on average and labor cost increased by 15%. A lot of stores were closed because of

rent increases. In April this year, Jusco moved out from China Square in Guangzhou because it could not meet the rent increase. ParknShop Supermarket retreated from Zhong Lu Mall in Guangzhou because it failed to renew the lease. In Chengdu, although Pacific Chun Xi Department Store was willing to renew their lease and took a 50% hit on their profits, it was still forced to move out of the place where they have operated for 7 years. In general, stores need to be renovated every 3 to 4 years. As the lease period becomes shorter and shorter, stores will not be renovated unless leases can be renewed. Compared to RMB 50 /sqm/month 10 years ago, rent has now surged to RMB 200 - 350 /sqm/month, which is an increase of 4-7 times.

For labor costs, we pointed out in our May report that because of the change in China's population structure, the aging of population and the decrease of wage difference between western cities and eastern cities, the labor supply in the east coast line area is gradually decreasing. This change causes upward pressure on real wages. In 2010 some of China's provinces increased minimum wage by more than 20%. To address this situation, we did an analysis on the impact of the rise in labor cost on retail enterprises' profitability in a high inflation environment.

Wage Analysis

During our analysis of the impact of wage increases on retail enterprises' profitability, by looking at listed companies' data like sales, gross margin and wages as a % of sales, we tried to understand how the inflationary environment in the past few years has impacted the sales growth and profitability of these companies.

Retail industry is a labor intensive industry. It helps to solve social unemployment problem but at the same time this industry bears high labor cost. Within the retail industry, we picked supermarkets and department stores for our analysis. These two subsectors have different operating models but are both affected by inflation and rising wages.

Department Stores

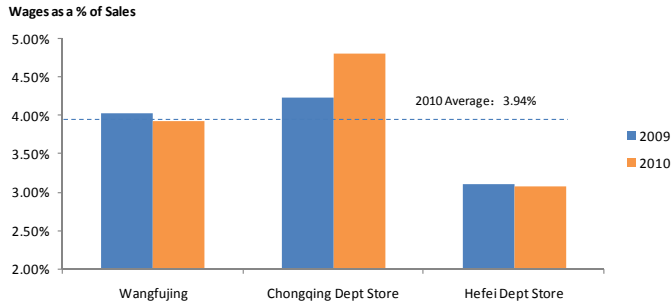
The majority of department stores revenue comes from sales commission, which ranges from 20% to 25%. Inflation has positive effect on its profitability. The price increase of high end products caused by inflation will increase department stores' profitability.

Department Stores 2009 and 2010 Sales Growth and Gross Margin

	Wangfujing		Chongqing Dept Store		Hefei Dept Store	
	2009	2010	2009	2010	2009	2010
Sales Growth	25.7%	9.1%	190.1%	13.9%	20.0%	16.7%
Gross Profit Margin	18.2%	18.7%	14.9%	15.9%	16.7%	16.5%

Source: Company's annual report

Department Stores 2009 and 2010 Wages as a % of Sales



Source: Company's annual report

The analysis of gross margins and wages as a % of sales of the 3 listed department stores above shows that department stores' average gross margin is between 16%-18%. Wage cost is about 4% of sales. In the past two years, department stores enjoyed double digit growth. Same store growth came from the increase in sales price and sales volume. The increase in price would benefit from inflation. While sales grew at double digits during these periods, wage as a % of sales stayed flat.

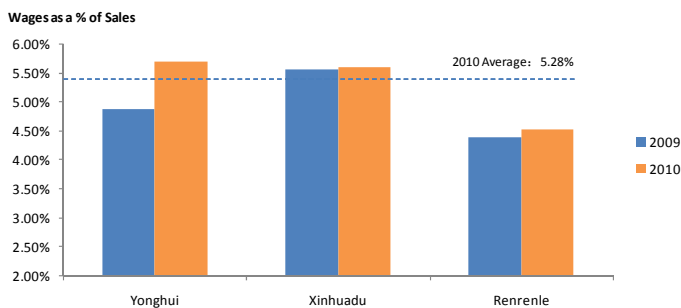
Supermarkets

Supermarkets and household electric appliance stores profit from the inventory costs and sales price differences, as well as distribution charges from suppliers. Although distribution charges only account for a small proportion of sales, its gross margin is very high. In an inflation environment, the retail business will be very profitable if they can reduce inventory cost and increase the sales price at the same time.

Supermarkets 2009 and 2010 Sales Growth and Gross Margin

	Yonghui		Xinhuadu		Renrenle	
	2009	2010	2009	2010	2009	2010
Sales Growth	49.3%	45.3%	36.4%	40.9%	14.1%	14.5%
Gross Profit Margin	17.9%	19.1%	18.8%	20.1%	20.8%	20.8%

Supermarkets 2009 and 2010 Wages as a % of Sales



Source: Company's annual report

The analysis of gross margin and wage as a % of sales of the 3 supermarkets above shows that wages as a % of sales is about 5%. Compared to department stores, supermarkets are more labor intensive. In recent years, the supermarkets industry has enjoyed high growth from opening new stores. In the future, under the high CPI environment, supermarkets will face more challenges than department stores. It will become harder to maintain their gross margins. When supermarkets increase prices, they will face pressure from consumers and competition within the same industry. It will also become more difficult to reduce inventory cost by squeezing suppliers' profits. The recent conflicts between Carrefour and Master Kong reflect that the tension between retailers and suppliers are growing.

Sensitivity Analysis of the Impact of Wages Increase on Profit Margins

When wages are soaring, investors worry that retailers will face profit decline. In the following model, we analyzed the impact of wage increase on the retailers' profit. In fact, because retailers are distribution channels, their gross profits can usually remain steady. Wage increase has a significant impact on their total costs. As long as the same store sales growth remains steady, retailers should be able to cover the growth of wage cost.

We focus on the impact of wage changes on retailers' profit. Another major cost is rent. Because retailers can choose to buy or to lease, the impact will depend on how retailers manage their capital.

The following is a simple financial model with the assumptions below.

- 1) The calculation of sales growth is based on the required sales to maintain the same profit or profit margins after costs increase. Assume base sales to be 100.
- 2) Assume gross margin remains the same.
- 3) Based on the above analysis, assume wage as a % of sales is 5% and will increase by 20%. (It is an aggressive assumption. In 2010, a lot of provinces in China did increase minimum wages by 20%)
- 4) Assume other costs will grow at 10%.

Model 1 – Required Sales Growth to Maintain Flat Profit Margins as Costs Increase

	Year 1		Year 2		Notes
Sales	100.0	<u>Growth %</u> 13.3%	113.3		Required sales growth to maintain profit margins.
Gross Profit	20.0	13.3%	22.7		
GP Margin %	20.0%		20.0%		Assume gross margin % stays flat.
Wages	5.0	<u>20.0%</u>	6.0		
% of Sales	5.0%		5.3%		
Other Costs	10.0	10.0%	11.0		
% of Sales	10.0%		3.0%		
Operating Profit	5.0	13.2%	5.7		
OP Margin %	5.0%		5.0%		Sales growth keeps profit margins the same.

The model shows that even under the aggressive assumptions of a 20% wage increase and a 10% increase in other costs, since wage cost as a % of sales is quite small, as long as retailers can maintain their gross margins and same store sales can grow at steady rate, profit margin can remain flat or even keep growing.

Model 2 – Required Sales Growth to Maintain Flat Profits as Costs Increase

	Year 1		Year 2	Notes
	<u>Growth Rates</u>			
Sales	100.0	10.0%	110.0	Required sales growth to maintain profit level.
Gross Profit	20.0	10.0%	22.0	
GP Margin %	20.0%		20.0%	Assume gross margin % stays flat.
Wages	5.0	20.0%	6.0	
% of Sales	5.0%		5.5%	
Other Costs	10.0	10.0%	11.0	
% of Sales	10.0%		3.0%	
Operating Profit	5.0	0.0%	5.0	
OP Margin %	5.0%		4.5%	Sales growth keeps profit the same.

The second model shows that when costs increase, retailers only need a small sales growth to maintain profits at the same level. A 10% sales increase will cover a 20% wage increase and a 10% other cost increase.

Solutions for Retail Enterprises during Inflation

Of course, the above analysis makes an important assumption that retailers are able to maintain the same gross margin. Whether retailers can maintain the gross margins depends on the ability of retailers to pass on the higher costs to consumers.

Utilizing the Advantages of the Retail industry

Department stores usually perform well and their business model advantages emerge during times of inflation. Department stores are distribution channels for cosmetics and brand clothes. They can always choose to sell the bestselling and most popular brands. In this round of inflation, the supply of industry products is greater than the demand for it. Also, the sales commission based business model will benefit greatly as sales increase during inflation. Rising inventory costs have limited impact on department stores.

Self-Owned Properties

Facing sky high rent these days, some retailers choose to buy their own properties and change to a “retail + real estate” expansion model. According to public information, if an enterprise owns the property, its operating cost will be 30% to 40% lower than its competitors renting the property.

“Rent + Build” operating model is recognized by many retailers these days. The trend of building self-owned properties can be traced backed to 2009. After the financial crisis, retailers began to build their own properties and got into the commercial real estate business. By doing that, they expected to get more stable revenue. As the economy recovers, the soaring rent costs further encouraged retailers to buy real estate. Tesco established its own real estate company in China and cooperated with a real estate fund. Tesco designed, developed, and operated Le Du Hui shopping center which opened in Fujian province. It is the first shopping center Tesco owns in China. Wal-Mart also began to buy real estate in China. In March this year, Wal-Mart began to recruit real estate managers and planned to open new stores in China. In addition, China Resources Suguo planned to spend RMB 1 billion to purchase properties. As the value of stores and other real estate increased, it encouraged retailers to buy and build more properties and rent part of the properties out.

Negotiating Power with Suppliers

Large-scaled supermarket chains can utilize their distribution networks to negotiate with suppliers and lower the cost of goods. Supermarkets that target high end customers have stronger capabilities to raise prices as wealthy consumers are less price sensitive. Supermarkets can also attract consumers through sales discounts and sales promotions. Smaller competitors that lack these kinds of negotiating power will eventually withdraw from the market.

Utilizing Brand Names

For retail businesses other than supermarkets and department stores, having established brand names in the subsector will put retail enterprises in advantageous position to protect their profit margins. Consumers are less price sensitive to products with established brand names. During our research and due diligence process in the retail industry, even in industry where the barrier of entry is low and products can be copied easily by other OEMs, it is difficult for imitation products to compete with brand names products when it comes to pricing. When their gross margins are much lower than that of brand names products, imitation products manufacturers find it difficult to use the same materials and thus provide the same product quality as brand name ones. At the end, the difference in product quality leads to product differentiation between brand name products and imitation ones.

Expanding the Lines of Business

Under the current competitive environment, some retail enterprises have already begun to expand their lines of business. “Cross-industry” operations are becoming more popular. Other than getting into the real estate business as mentioned above, many retail enterprises tried to add additional profit growth drivers by increasing the number of self-owned brands, expanding their logistics capabilities, developing e-commerce business and increasing the number of products they can offer. This year, supermarket operator Renrenle established the “Meile Household Electric Appliance” brand in Shenzhen and Xi’an as a low profile way to get into the household electric appliance chain stores market. By getting into a new line of business, Renrenle intended to achieve breakthrough as it became more difficult for the traditional supermarkets model to expand. On the other hand, China Resources Enterprise bundled its different 6-7 brands and businesses it owned, such as drugstores, Pacific Coffee, OLE supermarkets, “HuaRunTang” (a healthcare store chain), and wine stores, and put them together in a shopping mall owned by the Swire Group in Guangzhou. Multi-lines of business can create synergies and increase the retailers’ advantage when negotiating with landlords.

The above strategy may only be suitable for enterprises that have strong balance sheets. For smaller retail enterprises, expanding the lines of business could mean accelerating the pace of development of new products and increasing the frequency of product upgrades. The more product items an enterprise can offer, the stronger negotiating power an enterprise has when negotiating for shelf space with supermarkets. Product upgrades also represent higher gross margins, and that gives more room in profit margins for manufacturers to cope with higher costs. Under this environment, some enterprises, which focused on “niche markets” and expanded through aggressive store expansion in the past, may run into trouble in the future. The narrow product line these enterprises offer could become a problem as these enterprises try to diversify its business. Also, it will be difficult

for these low margin businesses and single-line products to operate in specialized and independent stores as rent increases tremendously going forward.

Increasing Operating Efficiency

Finally, under the low cost operating environment in the past, the importance of operating efficiency has usually been ignored by retail enterprises. For a long period of time in the past, the three most common metrics to access a retail business are sales, gross profit and costs as a % of sales. However, as the pressure of higher operating costs increases, retail enterprises should put higher emphasis on the other two metrics - “labor efficiency” and “store area efficiency”. As a matter of fact, whether a retail enterprise is competitive, or whether its management is competent cannot be simply be decided by the sales figures. Sales can only reflect an enterprise’s market share but not its competitiveness in the market. How to effectively raise the workers’ efficiency and how to maximize the amount of revenue in a given store area are what retail enterprises should strive towards these days. “Labor efficiency” refers to the amount of sales each labor can generate in a year for the enterprise. “Store area efficiency” refers to the amount of sales the enterprise can generate in a given store area. The rise in labor costs should be coped with higher labor efficiency, and higher rent costs should go with higher “store area efficiency”. Otherwise, the competitiveness of the retail enterprise will decrease during the inflationary times.

Summary

Going forward, it is inevitable for retail enterprises to operate under the high inflation environment. Mild inflation can directly increase sales for retail enterprises. In the past few years, mild inflation and relatively stable rent and wages have contributed to the prosperous development of the retail industry in China.

However, mild inflation and the low cost operating environment could be gone forever in the future as the macroeconomic environment changes. Retail enterprises must get used to the new operating environment, especially on how to cope with the impact brought by the increase in different costs.

Our wage analysis showed that the increase in wages has relatively small impact on the profitability of retail enterprises. The key factors for retail enterprises to operate under the high inflation environment are having the ability to raise prices, having strong negotiating power with suppliers and keeping gross profit margin stable.

In the general analysis of the secondary markets, analysts and investors tend to be more optimistic on department stores stocks during times of high inflation. The major reasons are the ones we described above: consumers are less price sensitive to luxury products; the concessionaire business model and asset heavy balance sheet (through self-owned stores) will benefit during inflationary times. For other subsectors in the retail industry, the negotiating power with manufacturers and the ability to squeeze additional profits from suppliers become critical for retail enterprises to maintain stable profit margins. Enterprises can also expand their lines of business or products variety to increase their negotiating power with landlords. Moreover, enterprises that have established their brand names in the industry will be more able to raise prices as consumers are less price sensitive to their products. Finally, during inflationary times, fiercer competition and tougher operating environment will eliminate competitors that did not pay attention to operating efficiency and profitability in the past, and thus it will create more expansion opportunities for well-run enterprises.

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My Decker Capital is a China focused investment banking and asset management company. The company was established in 2007 and moved its headquarter from New York to Beijing in July 2008. The company's businesses include: Advisory, Asset Management, Research and Capital Markets. My Decker Capital's main shareholders are from the United States and Russia and its professional team members are bilingual with extensive investment or corporate finance experience. My Decker Capital's clients include mid to large Chinese and International companies and professional investors. Its focused sectors are Real Estate, Consumer Products and Retail.

My Decker Capital manages its own private equity funds focusing on investing in the retail and consumer products industries and real estate projects. It successfully completed US\$40 million investments into a leading Chinese retail chain: Beijing New Cooperation Supermarket Chain. Tianjin My Decker Capital Fund I, an RMB Fund, is focused on investing in the retail and consumer products industries and real estate projects which will benefit from the China urbanization process. My Decker Capital's professional team would like to work with Chinese entrepreneurs with advanced management skills and clear vision together and deliver superior returns for investors.

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