Effective Working Capital Management: Strategic Key to Operational Performance

2017 Working capital management study for retailers in China
Acknowledgment

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In 2017, online retail sales as a percentage of total retail sales in China increased to 15%, while share of physical store retail sales, represented by China’s top 100 chain retailers, declined. The contrast between this rise and fall reflects the enormous pressures that brick and mortar retailers are currently under.

In the era of technology-driven industrial reforms, retailers seeking to unleash their operational potential must optimise their working capital management. This will help in resolving difficulties such as contracting margins and slow inventory turnover, thereby improving operational efficiency and return on assets.

China’s Ministry of Commerce has entrusted China Chain Store & Franchise Association to conduct surveys on a host of issues such as retail industry development trends, retailer-supplier relationships, and retail industry working capital. With years of research experience and exceptional resources on working capital in the retail industry, CCFA chose to partner with PwC on a joint survey report on working capital management of China’s retail enterprises.

This report is based on data collected from 96 listed retail companies in mainland China and Hong Kong, as well as questionnaires completed by 35 retailers, and interviews with retail senior executives in different subsectors. The report compares key financial indicators, such as revenue, profits, inventory turnover, etc., of firms with different business models, to identify the challenges retailers have in managing working capital as well as the underlying causes. Moreover, this report analyses the current inventory turnover and accounts payable turnover of firms in the fresh products, food, home decoration, clothing, electronics, and personal care & cosmetics sectors to provide insight on working capital management for individual product categories. Finally, the report offers solution for improvement in five areas: offline experience, resource integration, category adjustment, private brands & innovation, and rational development. This report aims to be used as a reference for retailers that are striving to master their transformation.

March 2018

China Chain Store & Franchise Association
Q: Can you please tell us a little about yourself and your interest in retail?

A: I will be brief in introducing myself because I had introduced myself in my responses to your questions last year (in the 2016 Working Capital Management Study for retailers in China). I am the UPS Foundation Professor of Business Logistics at Harvard Business School, where among other responsibilities, I chair the Owner/President Management executive program. I work extensively with retailers and retail supply chains in my research and in my consulting.

Q: You had alluded - in last year’s study - to the role and importance of inventory management and supply chain management in retailing. These remain a significant opportunity for many Chinese retailers. Can you elaborate on this matter?

A: From an inventory management perspective, the Holy Grail for retailers is to have the right product in the right place at the right time and right price. The supply chain seeks to enable that.

Numerous factors come together to make it hard for retailers to achieve this Holy Grail. Retailers have to manage numerous products (or SKUs) across numerous stores. A retailer with 1,000 stores and 10,000 SKUs per store has to plan inventory for 10 Million store-SKUs each replenishment period (a week or less at many retailers). Each of these is a “mini-store” with its own demand (e.g., seasonality) and supply (e.g., leadtime from the distribution center) pattern. The old cliché, Retail is Detail, truly applies to inventory management.

In addition, product lifecycles have become and are becoming shorter in many product categories. This makes it harder for retailers to forecast demand and also leaves them with harder-to-liquidate excess inventory when the stocking quantity is wrong.

The problems are compounded by some common fallacies that retailers commit. For example, it is generally a good idea for retailers to consider the optimal service levels for different product categories based on a number of factors, including the cost of carrying inventory and the margins that accrue from selling the product. Most retailers do not think at this micro-level; it is common for
retailers to set a blanket target service level for all product categories and all stores. Similarly, my colleague Marshall Fisher had argued many years ago that retailers need to set up different types of supply chains for their “functional” (steady demand, long lifecycle, low gross margin) products and their “innovative” (uncertain demand, short lifecycle, high gross margin) products. Fisher had argued that functional products need “physical efficient” supply chains – those that target high utilization and seek to lower manufacturing and transportation costs. However, innovative products need “responsive” supply chains –that would deliberately underutilize capacity and incur higher manufacturing and transportation costs to save on the costs associated with mismatched supply and demand. Most retailers hurt their financial performance by seeking to be physically efficient across all product categories.

Q Can you elaborate on the various supply chain levers available to retailers?

A Broadly, retailers have three levers – forecasting, inventory planning, and supply chain responsiveness – that coupled with a solid foundation for operational execution would enable them to better match supply with demand.

Let us start with the first lever, demand forecasting. While generating a perfect forecast in retailing is generally impossible, retailers can make systematic efforts to improve demand forecasting. Retailers today have access to vast and growing amounts of data and tremendous computer power that they can use to analyze these data to produce better demand forecasts. Moreover, retailers should recognize that forecasts can improve over a product’s lifecycle; this is especially valuable for short lifecycle products where demand forecasts are very inaccurate when a product is launched and improve dramatically based on early sales data. Finally, it is useful for retailers to invest in quantifying not only the forecast but also the uncertainty in their forecasts; demand uncertainty – as I argue briefly below - can be useful in planning.

Responsiveness is a second supply chain lever available to retailers. Most retailers recognize the value of reducing leadtimes and also that leadtimes can be reduced through holding raw material inventory and working more closely with suppliers. Apparel retailers, for example, can reduce leadtimes aggressively by holding fabric inventory and “reserving production capacity.” Supermarkets similarly can work with suppliers and invest in inventory of packaging materials to become more responsive. In some recent consulting projects that I have been involved with, we found tremendous value from being able to move inventory from one store to another. In other words, while the leadtime from the factory or even the distribution center to the stores did not change appreciably, the supply chain became more responsive through transferring inventory from one store to another. However, relatively few retailers have made progress in making their supply chains more responsive. The barriers to reducing response times are not primarily technological but managerial. For example, most retailers do not have a good
estimation of the benefits of greater responsiveness, which are usually measured in higher sales or lower obsolescence costs. Moreover, often the costs to reduce leadtime are borne by one function (e.g., logistics or manufacturing) while the benefits accrue to another function (e.g., sales). These features complicate leadtime reduction, and the fix usually lies in management. If managers – especially senior executives – understand the tradeoffs, they can take steps to ensure that appropriate choices are made in the supply chain.

Planning is the third supply chain lever that retailers can use to manage their supply chains better. To improve planning in their organizations, retailers should explicitly acknowledge that their demand forecasts are likely to be inaccurate, sometimes wildly so, and incorporate this uncertainty in their planning processes. In many organizations that I have studied over the years, forecasts are assumed to be accurate. By acknowledging the inaccuracy in their forecasts, retailers - like portfolio planners in finance - can make more intelligent choices on inventory and capacity levels at different points in the supply chain.

Supply chain performance is often driven by superior operational execution, a term I use to encompass “basic” functions like inventory accuracy and misplaced SKUs within a store. In most retail contexts, inventory data tend to be notoriously inaccurate. In other words, the “actual” inventory of a particular item often differs from what the computer system says is available in inventory. This is even true with electronic scanning of barcodes – all of us have seen the supermarket checkout clerk scanning the Diet Coke twice instead of scanning the Diet Coke and Coke individually. Similarly, “phantom” stockouts – items that are available at the store but cannot be found by a customer – are also common. This problem needs to be addressed through superior execution of “basic” tasks in the store and other parts of the supply chain.
Private-label brands are growing in popularity in China and elsewhere. How should retailers manage their supply chains for private-label brands?

Private-label brands are an integral and increasing part of the assortment for most retailers. By carrying private-label brands, retailers can often serve a segment of their customer base that might be underserved by major brands. Moreover, private-label brands allow retailers to differentiate their offerings and earn higher margins than on national brands.

Private-label products are a double-edged sword for the retail supply chain. On the one hand, retailers have to develop lots of capabilities that they have traditionally relied on manufacturers for. In many contexts, manufacturers help retailers plan inventory, alter assortment, determine prices, develop new products, manufacture, distribute, etc. A retailer will have to develop the capabilities to do these activities on its own.

However, a private-label product is also an opportunity to create a more integrated supply chain. Incentives are often misaligned among different firms in the supply chain, which makes it hard for these firms to coordinate effectively. These incentives are hard to align given that in addition to the firms having different shareholders, manufacturers typically serve competing retailers and retailers carry products from competing manufacturers. An integrated supply chain – where the brand is owned by the retailer – has the potential to align incentives across manufacturing and retailing.
Executive Summary


New Retail is driving a gradual rebound for the retail industry

The retail industry showed signs of progression, although slowly and steadily, witnessing moderate growth over the past year. Driven by the concept of “New Retail”, leading retailers began taking proactive actions to gradually resolve pain points cumulated over a long time. Meanwhile, a variety of business models under New Retail have sprung up and its innovative use of internet technologies is being widely used to enhance business integration between online and offline. The impact of the changes are beginning to reflect in results for second half of the year with many business performance of big retailers’ beginning to rebound significantly.

Offline retail regains value while Online retail cools down

Offline retail is seeing signs of rebound as the principal focus of retail companies’ operations gradually shifted to merchandise management and profitability improvement in single stores. Recent operational actions in the past few years have had a positive impact on revenues and operating costs. There is also a stronger desire among retailers to identify the true value of in-store customer experiences and rebuild the offline retail channel. Although online e-Commerce remains a relatively higher growth channel, the key drivers of the growth are transforming from the number of customers to the purchasing power of single customers. The leading companies are optimising transaction flow resources, product supply chain, and customer service experiences in order to gain more competitive advantage. However, the overall online retail landscape has cooled slightly.

Retail industry still faces fierce challenges

About 36 of the top 100 China retail companies listed by China Chain Store & Franchise Association (CCFA) showed negative growth in terms of store expansion in 2016. This statistic tells us the number of existing stores closed exceeded the number of new stores opened. There are several common issues affecting retail industry growth: reduction of in-store customer traffic, the undifferentiated positioning of offline stores, the imbalance between driving revenue growth and profitability of online business, product similarity, low operating efficiency, and the increasing pressure from labour costs and rents. Converting operating pressure from these factors into the driver of business transformation will be key to retail companies’ success if they want to grow profitably in the future New Retail market.

There is a growing gap between successful and unsuccessful companies

Along with enhancing the customer experience and product quality, competition between retailers is intensifying. Enterprises with strong operating capabilities stand out for both online and offline as they continue to widen the gap between mediocre performance by enterprises in operations, management innovation, and capital efficiency. The polarising trend between those who are succeeding and those who are not is particularly obvious when we look at working capital management. Leading companies are taking the initiative to slow down expansion and optimise or reduce capital expenditure. These companies are
more focused on how to improve their operational capabilities and continuously increase gross margins. To accomplish this, leaders have developed private-label products in order to create a differentiated advantage for their brand and service, enhanced the integration between online and offline businesses to manage inventory efficiently, and implemented better working capital and cash flow management strategies to lift profit margins.

**Working Capital Management drives efficiency and enables differentiation**

Working capital efficiency reflects a company’s overall performance across: business vision, operating model, merchandise management, and financial management. Today, the retail industry contains more diverse business formats and models than ever before, making it a more complex to manage and to differentiate. However, there are a handful of key success factors which determine a company’s working capital management efficiency and future business growth. Key considerations include how to:

1. **Establish a consumer-driven operating model,**
2. **Develop synergies between internal and external resources,**
3. **Focus on the operating efficiency of products,**
4. **Promote sophisticated category management,**
5. **Meet different and personalised needs of customers.**

In order to invest in changes while meeting obligations of customers and suppliers, a company needs to be confident in its ability to manage working capital and improve inventory performance.

**Delayed supplier payment is still too often used to ease working capital pressure**

Over 90% of retail companies believe that inventory management is the biggest challenge for working capital management. Days of Inventory Outstanding (DIO) and Days of Payable Outstanding (DPO) for major retail companies increased at different rates as compared to last year. The main factors, noted by companies interviewed, for causing working capital challenges were new product launches and seasonal demands. In order to ease the pressure on working capital management, retail companies still chose to delay supplier payments.
Different retail categories experience distinct operational challenges

Supermarkets are no longer able to maintain sustainable growth they were accustomed to through extensive expansions. This is evident by the closing of stores with low profitability. Although changes to management practices and retail technology transformation increased productivity, the overall operating efficiency has not significantly improved.

Over the last few years, department stores gradually changed from the traditional expansion strategy of extensive new store openings to a more sophisticated, category-specific operating capabilities to improve overall operating efficiency.

Convenience stores entered a stage of rapid development. However due to this expansion, frequent delays in supply could result in product shortage and loss of sales revenues. As retail footprints expand, it becomes more urgent for retail companies to improve their supplier management programs.

Effective Category Management and Supply Chain Management is separating the winners and losers

Working capital management efficiency is reflected by cash flow cycles. If a retail company has a long cash flow cycle, it risks its future survival and growth. Retail companies must think about how to manage inventory effectively as well as maintain a healthy, sustainable and cooperative relationship with suppliers. Instead of diverting working capital pressure to their suppliers, retail companies need to systematically enhance their capabilities in category management, inventory management and supply chain management to use working capital efficiently.

Agile companies are exploring business transformation opportunities and building product advantages

Firstly, retail companies need to prioritise working capital management, shorten inventory turnover times and increase revenue per square meter. Moreover, they need to focus on increasing return on investment and replicating profitable operating models. In short, there is still a long journey ahead for retail companies looking to find their own path of transformation in order to remain competitive and be successful in retail.

To begin addressing your competitive position, PwC suggests retail companies improve in the following aspects:

1. Focus offline customer experiences, leverage dormant competitive advantages
2. Enhance integration of retailers and suppliers, leverage mutual resources
3. Focus on differentiated categories, optimise category structure and product mix
4. Promote private label business, encourage product management innovation
5. Pursue operational excellence, drive profitable growth

Research methodology

This report is based on research conducted jointly by CCFA and PricewaterhouseCoopers (PwC). It summarises our views on operational management for Chinese retailers and provides insights on improving operational efficiency. Our research included information from three major sources:

Interviews: We interviewed professors at Harvard Business School and senior executives of the Top 100 chain retailers in China.

Questionnaires: We conducted a survey of 35 Chinese retailers, most of them amongst the Top 100 chain retailers in China.

Financial data of listed companies: Our quantitative analysis, including financial indicators, was based on publicly available data of retailers listed in mainland China and Hong Kong. The sample consisted of 96 companies, including department stores, supermarkets, multi-format stores and specialty stores.
Financial analysis of listed retail companies in China
In this year's survey, the retailers place greater priority on raising profitability than increasing cash flow as compared to the last year. Generally speaking, is it possible for companies to maximise both profit and cash flow and if so, how?

Maximization of both profits and cash flows need not be incompatible long-run goals. But to answer this question clearly, it is important to be precise in how one defines “profits” and “cash flows.”

Cash flows from operations include cash inflows and cash outflows that are related to a company’s regular ongoing business activities that take place during the current accounting period, but exclude expenditures on capital equipment that generate longer-run benefits for the business (i.e., that extend beyond the current accounting period). Free cash flows are equal to current-period cash flows from operations minus current-period capital expenditures. Free cash flows are cash flows generated by the business, after deducting all business-related cash expenses and expenditures, that are left over for the company’s creditors and shareholders. Equity cash flows are the cash flows left over for shareholders after creditors have been paid interest and principal due on their loans.

Ultimately, investors in a business may care about how much profit it generates, but what they spend are the cash flows that it gives them. Finance tells us that cash is what makes or breaks a company. Dividends, loan interest, capital investments, employee wages, marketing expenditures, R&D – these are all paid for with cash, not profit.

The market value a company’s business (i.e., the price that a willing buyer should be prepared to pay to acquire the entire business) is equal to the present discounted value of all future free cash flows that the business is expected to generate; the market value of the company’s equity (i.e., the owners’ economic stake in the business) is equal to the present discounted value of all expected future equity cash flows. All else equal, companies that are able to generate more cash flows consistently over time will be more highly valued by the market. Companies that fail to generate sufficient cash flows from their operations to cover their cost of capital and pay investors a competitive rate of return will ultimately lose market value, be unable to obtain financing, and go out of business.

So should maximization of profits or cash flow be the primary concern for managers? Over the “long run” (which, in practical terms, may be many years), total cumulative profits generally converge to total cumulative cash flows, so the distinction may be less critical. But over shorter periods of time, such as
one year or a few years, profits and cash flows can differ significantly from one another. Importantly, for a growing business, reported short-run profits can sometimes be much higher than cash flows.

The reason for this discrepancy has to do with accounting rules, which require companies to “match” related revenues and expenses, which affects when profits are reported. One area where profits and cash flows can diverge is accounting for customer receivables. When a company grants its customers credit, reported current period sales will exceed cash sales, with the difference recorded as an increase in accounts receivables on the balance sheet. Of course if customers eventually pay their bills, over time reported sales to a given customer will equal cash received from that customer. But if the company is growing, and adding new customers over time, aggregate reported sales (and profits) may permanently exceed cash sales and profits, making it appear that the business is performing better than it actually is on a cash basis. More problematic is the risk that the company may be tempted to grant too much easy credit in an effort to promote sales and gain market share from competitors. This may provide immediate gratification by inflating short-term sales, but it can also be very costly. As accounts receivables increase, more and more cash is “trapped” on the balance sheet. And growth in any asset, including accounts receivables, has to be financed somehow (i.e., accompanied by growth in debt or equity), which increases the company’s financing costs. A similar disparity between profits and cash flows can arise in connection with investment in inventories. It may be highly tempting to increase inventory stocks to attract customers and promote sales, resulting in higher short term profits, but excessive growth in inventories ties up cash that could be more productively used elsewhere in the business, or paid to shareholders.

The bottom line: there is nothing wrong with managing your business for profits. In general, firms that are more profitable also generate more cash flows for their owners over the long run. But it’s important to remember that the long run success of a business ultimately is determined by its ability to generate cash flows. Far better and safer to monitor profits and cash flows; each conveys valuable information about a company’s financial performance.
Based on your extensive experience in the field, what would be the key financial performance indicators and metrics that a CEO should review to monitor the financial health of a company and what should be the optimal frequency?

For most companies, the key financial metrics focus on the three “pillars” of financial performance: **profitability, financial structure,** and **liquidity.** Profitability can be assessed by reference to various profitability ratios: return on equity, return on assets, and return on sales (also known as the net profit margin); the gross profit margin; and the operating profit margin. In general, it is good practice to consider multiple measures of profitability, as no one measure of profits captures every possible scenario or contingency. For example, the net profit margin is calculated after deducting interest expense, but this measure of profitability will be affected by how much debt a company has – independently of how well the business is managed. A company’s financial health will also be affected by its **financial structure,** which represents how much debt (as opposed to equity) the company has issued to finance its operations. If debt is excessive, the company’s ability to operate as a going concern may be severely impaired, and it may be at risk of becoming insolvent. Many ratios are used to assess solvency, but in general these ratios measure two things: the amount of debt outstanding relative to the value of assets that support the debt; and the amount of profit that a company generates that it can use to pay interest and principal due on the debt. Commonly followed ratios include the ratio of total liabilities to total assets; the ratio of outstanding debt to EBITDA (earnings before deducting interest expense, taxes, and depreciation); and the interest coverage ratio (annual EBIT divided by annual interest expense). Finally, a company’s financial performance depends on its access to **liquidity,** i.e., access to cash to meet emergencies and unanticipated cash flow needs (such as a valuable acquisition opportunity that will only be available for a short time). Liquidity can be measured by the current ratio (short-term assets divided by short-term liabilities), and the ratio of cash and marketable securities to total assets or revenues. “Cash” used in these ratios can be supplemented by unused borrowing capacity under bank lines of credit, since these represent cash that can be accessed quickly, even though the cash may not be immediately “in hand.”
Our analysis of listed retailers shows a trend that the shorter the Net Working Capital (NWC) days, the higher is the Return on Equity (ROE). Is there an obvious linkage between ROE performance and the level of NWC (from other industries)?

This relationship is not surprising to me. In principle, one can envision scenarios in which a shorter cash conversion cycle (i.e., the average number of days that it takes a company to realize cash flows from selling merchandise, less the average number of days that it takes to collect cash from suppliers) is associated with higher profits and higher ROE. For example, if a firm is better at managing its net working capital (and can make due with less net working capital in support of sales), one might expect management to also be better at managing the business, controlling costs, and generating higher profits. Academic research suggests that the reward for achieving higher ROE is an increase in the firm’s market value.
Scope of the study and overview of the sample

For this study, we have analysed the 2016 annual report of 96 retailers listed in Mainland China and Hong Kong in the sample. We followed the criteria listed below to select the sample:

- Brick and mortar operation is the main source of its retailing business
- Retail revenue accounts for over 50% of total revenue
- Mainland China accounts for over 50% of revenues from the retailing business

For our quantitative analysis, there are four major categories based on the retail format:

- Department stores and shopping centres (“Department stores”);
- Supermarkets selling food and commodities (“Supermarkets”), including hypermarkets, comprehensive supermarkets, standard supermarkets and convenience stores;
- Specialised chain stores (“Specialty stores”), mainly in the apparel and footwear sector (“Apparel and footwear stores”) and the household electric appliances sector (“Household appliance stores”);
- Multi format stores (“Multi format stores”), mainly companies engaged in more than two retail formats, where the proportion of revenue of any one retail format is not more than 80% of the companies’ that provided income information from each format separately. In our samples, multi format stores mainly refer to retailers with both department stores and supermarkets.

To compare key indicators between retail companies which mainly deal with brick and mortar operations, and E-commerce companies which mainly sell online, we have selected 7 online retailers whose business is primarily based in Mainland China.
### Brick and mortar retailers

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<td>HKEx</td>
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<td>Department stores</td>
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<td>Supermarkets</td>
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<tr>
<td>Multi format stores</td>
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<tr>
<td>Apparel and footwear stores</td>
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<tr>
<td>Household appliance stores</td>
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### Online retailers

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<td>NYSE/NASDAQ</td>
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In 2016, China's GDP grew 6.7%, a decline of 0.2% compared with the previous year. The year-on-year GDP growth in each of the quarters in 2016 was 6.7%, 6.7%, 6.7% and 6.8% respectively. The national economy has been stable since the fourth quarter of 2016. The 2016 financial data of domestic retail companies shows transformation activities of some companies have been effective, indicated by the growth in their business capacity and the improvement in their operation and management ability. Overall, retail companies still face several challenges.

The total retail sales of social consumer goods increased by 10.4% in the first half of 2017, and GDP growth rate returned to 6.9%. From the 2017 interim report of retail companies, we see the distinct situation of domestic retail companies in the process of transformation. Among them, some department stores have reversed their declining situation or has even achieved substantial growth. For instance, Wangfujing witnessed a notable rise of 12.6% in retail revenue in the first half of 2017. Other department stores, even though still on a downward revenue growth trend, the drop has been narrowed down to a large extent. Standard supermarkets and convenience stores, which performed better among supermarket formats, maintained more than 10% year-on-year revenue growth, while most hypermarkets and comprehensive supermarkets still suffered a decline in retail revenue. Apparel and footwear stores witnessed growth in 2016 as some brands gained due to acquisitions. Household appliance stores witnessed differences in business performance. While Suning witnessed a year-on-year sales growth of 21.9%, other main competitors suffered a slow down or even declined slightly, primarily due to the transformation measures such as shutting down inefficient stores.

1 Revenue growth

In 2016, the overall transformation of brick and mortar retailers has not been fully implemented, and the growth rate of retail revenue declined.
**Department stores**

In 2016, department stores showed a negative revenue growth rate and was the weakest among all retail formats. 23 out of 29 sample companies witnessed negative revenue growth. Although most department stores have begun to adjust their strategies regarding store location, store position, business models and other aspects, the revenue increase resulting from the transformation was not able to cover for the revenue decline from massive shut-downs. This was primarily due to the large investments, long payback period of new stores and the slow pace of transformation.

Because of the difficulties with endogenous growth, some department stores seek rapid development by acquiring superior congeneric companies. For instance, Maoye Commercial (formerly known as “Chengshang Group”) enjoyed a 59% year-on-year revenue growth in 2016, the highest among all our sample companies. Maoye Commercial has accomplished three material assets reorganisation in one year, enlarging its scale of operation and maintaining its market competitive power in some regions through such merger and acquisition. Moreover, some listed companies began to explore mergers and acquisitions, or thoroughly transformed themselves into non-department stores or even non-retail listed companies through capital operation.

**Supermarkets**

In 2016, supermarkets witnessed a 3.8% year-on-year revenue growth, an increase of 0.2 percentage points from previous year. This was slightly better than performance of other retail formats. The year-on-year revenue growth rate of standard supermarkets was 14.3% and 16% in 2015 and 2016 respectively. However, the revenue growth rate of hypermarkets and comprehensive supermarkets in 2016 was a mere 0.5%, a decline of 0.6 percentage points from the previous year.

Yonghui Superstores and Hongqi Chain Store were among the best performing supermarkets in revenue growth in 2016 with growth rate of 16.2% and 15.4% respectively. Yonghui Superstores' annual growth rate for retail business has been above 14% since 2014. The company has achieved this remarkable feat through specific approaches in marketing transformation, store expansion, talent management, store innovation, digitalization/intelligent operation etc. Hongqi Chain Store optimised its operations and management structure by improving its commodity categories, delivery, and marketing. Meanwhile, it also put significant impetus in financing and investing projects. With 170 new openings in 2016, the supermarket is creating more space for development in second-tier and third-tier cities.

**Apparel and footwear stores**

In 2016, apparel and footwear stores showed a 9.9% year-on-year revenue growth, a decline of 4.6 percentage points from the previous year. 22 out of 28 sample companies grew but at a slower rate than that of 2015 while the other 6 recorded a decline. There were some companies which witnessed outstanding revenue growth in retail business, such as JNBY (17.9%), Anta Sports (20%), Koradior (24.5%), and Ellassay (29.8%).

The following strategies have been adopted by these companies:

1. Multi-brand strategy, which is developed based on the group’s unified brand concept for specific subdivision of customer groups; 2. Promotion of the integration of international resources, outbound acquisition of superior brands, penetration of the affordable luxury market, and enhancement of the overall brand image; 3. Continuous investment in retail network, including new store expansion and structure optimisation of offline physical stores, and the development and operation of online sales platform (official website, WeChat, Tmall, etc.), to achieve full channel sales improvement and same store growth.

**Household appliance stores**

In 2016, household appliance stores witnessed a 12.7% year-on-year revenue growth rate, a decline of 2.7 percentage points 2015. This is the highest growth rate in all retail formats. 3 out of 5 sample firms experienced revenue growth, amongst which Gome and Hongtu High Technology increased the pace of their growing in 2016, with a growth rate of 18.7% and 12.2% respectively. Suning slowed down its growth after reaching a peak at 22% in 2015. The other two companies switched their business focus, resulting in a plunge in retail revenue.

Gome, Suning and Hongtu High Technology seek business development opportunities mainly through the following aspects:

1. The construction and operation of the full channel shopping platform from online to offline; 2. The structure transformation of stores, the close-down of inefficient stores, and the introduction of varying stores in scale, format and regions according to the pain points in market demands. For example, Suning introduced cloud stores and flagship stores in the core commercial sphere of the first and second tier cities, and set up mainly the convenience stores in urban community and in the third and fourth tier cities; 3. Innovative store renovation to enhance shopping experience and customer engagement; 4. Optimisation of the commodity structure; for example, Hongtu High Technology introduced Brookstone, IDT and many other novel popular commodity based on its original product lines. 5. Category extension; Suning also extended to mother care and supermarket categories in order to get more sales opportunities for high gross or high frequency and low value products.
2 Profitability

Under the new retail competition situation, the maintenance or increase of profit margin is a big problem for the companies in the period of transformation and investment. All the retail formats continued to witness a decline in net profit margins. Almost 10% of the sample companies were loss-making.

![Net profit margin of sample retail companies](image)

![Number of loss-making and profit-making companies in 2016](image)
Department stores

In 2016, net profit margin of department stores was 3.8%, a decline of 0.3 percentage points from last year; gross profit margin was 18.5%, staying stable; operating expense ratio (selling and administrative expenses as a percentage of sales) climbed by 0.7 percentage points to 17.1%, amongst which the rental expense ratio (rental expense as a percentage of sales) was 3.8% and labour expense ratio (labour expense as a percentage of sales) was 5.6%.

Department stores are most influenced by the new consumption pattern, however, most traditional department stores still adopt the concession model as the primary way to operate. Compared with other retail formats, department stores will experience more difficulties in the strategic transformation and implementation. On one hand there may be negative growth or stagnation in operating income, on the other hand there is no further cost-saving space for main operating costs such as labour and rent. Thus, most department stores struggle to maintain the minimum profit level.

Supermarkets

In 2016, net profit margin of supermarkets was at the same level as last year at 1.3%; gross profit margin rose by 0.2 percentage points to 18.4%; operating expense ratio climbed 0.4 percentage points to 20.5%, of which the rental expense ratio remained constant at 3.5% and labour expense ratio was 9.0%.

Three loss-making supermarkets were all hypermarkets or comprehensive supermarkets. The overall net profit margin of such these supermarkets slid further, from 1.2% in 2015 to 0.9% in 2016. Convenience stores, which showed a better picture in revenue growth, also recorded a decline in net profit margin from 3.3% in 2015 to 2.3% in 2016. However, the net profit margin of standard supermarkets defied the downward trend, increasing from 1.5% to 2.5%, primarily contributed by Yonghui Superstores whose net profit from 1.4% to 2.5% in 2016.

While maintaining rapid revenue growth, Yonghui Superstores also managed to integrate supply chain effectively, reducing the purchasing cost. Online system and offline physical stores such as member stores and selected stores were also highly integrated by data management and logistics system, which brought significant improvement in business efficiency.

Apparel and footwear stores

In 2016, net profit margin of apparel and footwear stores dropped by 1.3 percentage points to 9.9%; gross profit margin was 49.6%, staying stable; operating expense ratio climbed to 36% with a 1.3 percentage points increase, of which the rental expense ratio levelled out at 10.3% and labour expense ratio outnumbered all retail formats at 13.0%.

Apparel and footwear stores reported higher net and gross profit margin due to reaching upper stream of value chain (i.e. raw material purchasing, costume designing and manufacturing), which was different from other retail formats that only dealt with selling.
Household appliance stores

In 2016, net profit margin of household appliance stores dropped by 0.7 percentage points to 0.1%, just about breaking even and was the lowest amongst all the retail formats; gross profit margin was 12.4%, a decline of 0.8 percentage points from last year; the operating expense ratio fell by 0.3 percentage points to 13.7%, among which the rental expense ratio remained constant at 4% and labour expense ratio decreased by 0.3 percentage points to 4.1%.

Hongtu High Technology’s net profit margin in 2016 was 2.2%, the highest among all household appliance stores. Though its gross profit margin is lower (5%—6%) than Suning and Gome (12%—15%), its operating expense was 10% less, of which 3%—4% less in rental expense and 2%—3% less in labour expense. This may be due to the sale of 3C digital commodity which is Hongtu’s main business, leading to a higher revenue per square meter than Suning and Gome, who mainly dealt with white goods.

Under the strong competition in white goods market, Suning recorded a decline in net and gross profit margin while Guomei saw a net loss in 2016.
3 Working capital

The overall total asset turnover rate has declined slightly since 2014, but remained stable to a large extent.

Working capital turnover reflects the efficiency of a company’s cash cycle during operation. The faster the turnover is, the higher is the efficiency. Working capital consists of three parts: accounts receivable (and advance received), inventory and accounts payable (and prepayments).

3.1 Inventory turnover

Comparison of total asset turnover

![Comparison of total asset turnover chart]

**DIO-Department stores**

![DIO-Department stores chart]

**DIO-Supermarkets**

![DIO-Supermarkets chart]
Overall in 2016, inventory turnover further slowed down for all retail formats except household appliance stores. Department stores had the lowest inventory level with the average Days Inventory Outstanding (DIO) at 20 days as most of the goods sold were under concession sales model except for small portion of goods, i.e. cosmetics and gold jewellery under direct sales model. The portion of goods sold under the direct sales model in supermarkets and household appliance stores was higher than that in department stores, reflecting longer DIO at about 50–60 days. The average DIO of apparel and footwear stores was around 150–160 days, the longest amongst all retail formats. This was because they generally reached upper stream of value chain that covers procurement and production so that companies need to prepare raw material, design and manufacture new clothes in advance before the sale of season clothes. Climate was another big factor that affected apparel and footwear stores’ DIO. Warm winter in 2016 led to low sell-through of winter season goods and slow-down of DIO at year-end.

Suning, Gome and Hongtu High Technology all reported a speed up of DIO of about 10 days, with 38 days, 60 days and 65 days respectively in 2016. Effective actions regarding value chain management from these companies include:

- Optimisation of product structure to increase the proportion of best sellers;
- Strategic cooperation with or acquisition of external logistics suppliers to expand the logistic network (e.g. Suning acquired equity shares of TTKDEX);
- Continuous investment in the construction of intelligent and modernised logistics facilities and information systems in pursuit of the integration of logistic, information and cash
- Flattened supply chain mode with suppliers
3.2 Trade payable turnover

**DPO-Department stores**

![Diagram showing DPO-Department stores turnover for 2014, 2015, and 2016 with color-coded categories for (30)-0 days, 0-30 days, 30-60 days, 60-90 days, 90-180 days, and >180 days.]

**DPO-Supermarkets**

![Diagram showing DPO-Supermarkets turnover for 2014, 2015, and 2016 with color-coded categories for 30-60 days, 60-90 days, 90-180 days, and >180 days.]

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3.2 Trade payable turnover
In 2016, department stores, supermarkets, and apparel and footwear stores further delayed payment turnover.

There were some small differences among segments of supermarkets. The average Days Payable Outstanding (DPO) of hypermarkets and comprehensive supermarkets was around 80 days, while for convenience stores it was 70 days and for standard stores 40 days. Except for one supermarket that reported a shorter DPO in 2016, all the supermarkets kept longer DPO in 2016 compared to last year.

Household appliance stores showed continuously declining DPO in 2015 and 2016, primarily attributable to Hongtu High Technology, Suning and Gome. Hongtu’s DPO was far below that of other market players (2015: 2 days, 2016: negative 5 days), mainly due to the nature of its main business of selling 3C digital products (Computer, Communication, Consumer Electronics), which accounted for more than 80% of Hongtu’s total revenue. Usually 3C product suppliers require large portion of prepayments since they are famous household appliance brands. In addition, household appliance companies make purchase more concentrated as the top 5 suppliers can account for more than 30% of total purchase. In order to ensure the on time delivery of core products and best sellers, household appliance companies must pay back on time to maintain good business relationships with brands, so their DPO could witness a downward trend.
Working capital management and ROE

Brick and mortar retailers

In order to cope with new market trends and consumption patterns, traditional retailers have to develop online e-commerce business. Under the new market trend, traditional retailers are facing a dilemma of sales and profits falling. Therefore, each level and even CEO of retailers pay more and more attention to cash retention and tighten up working capital management, instead of barely focusing on income and profit margins.

The correlation between working capital management and return on equity (ROE) has been quite obvious nowadays. Senior management deals with working capital more seriously and creatively in pursuit of higher ROE. In the past, retailers was covering accounts receivable level and the increasing inventory level by arrears of suppliers. However, relying on such arrears has led to a serious liquidity crisis that cannot be maintained for a long time.

In order to deal with the crisis, all participants in the supply chain have begun to strengthen cooperation and introduce supply chain financing projects, which can release cash, strengthen cooperation between suppliers and retailers, and drive for common goals at the same time.

Online retailers

Pure online retailers emerge as markets and consumers gradually turn to e-commerce consumption. However, the business model is also faced with the challenges of online operating capital and operating costs.

The correlation between working capital management and ROE still exists, and the cost structure of online retail has been reducing the overall return. Due to the lack of penetration of credit cards, the repayment of accounts receivable has always been a problem, which means that the payment takes place at the time of delivery instead of the time of order. Such kind of receivables collection is usually carried out by third parties, which can easily lead to potential fraud and reconciliation problems. In addition, a large number of returns are also constantly increasing the product and operation costs.

For inventory management, the challenge does not lie in the need for a whole set of products, but that the stock is usually located in different warehouses. The key challenge, therefore, is that the high downstream performing costs erode profits. A small number of orders are not enough to generate economies of scale, and the cost of purchasing, loading and delivery is quite high. The net profit is only 0% to 15% in some cases. The challenge of online retailing is to ensure enough stock, order and customer stickiness, so as to enjoy economies of scale, increase profitability and ROE.

3.3 Accounts receivable turnover and advance received

The accounts receivables of apparel and footwear stores are mainly in shopping malls, since the departments store settle accounts with tenants every month on the fixed day which gives rise to accounts receivables. Other retail formats generally enjoy less portion of accounts receivables.

Advance received represents mainly prepaid cards, which are often used in department stores and supermarkets to increase sales. Due to the government’s strict control on official’s spending in recent years, this sale of prepaid cards were somewhat influenced, leading to a decline in advance received as percentage of sales.
Analysis of Working Capital Management Survey in the retail industry
Scope of the study and overview of the sample

This survey uses two main categories to define the scope of Working Capital Management for each enterprise group: 1) company/group’s overall working capital management, and 2) company/group’s core business working capital management. To support data collection, our survey requests participants to provide data across three dimensions:

1. **Basic data collection**: scale of business, turnover ratios, inventories, receivable/payable ratios, etc.
2. **Challenges**: multiple choice to help companies define challenges of working capital management
3. **Root causes**: multiple choice to help companies summarize the reasons for challenges

The analysis will focus on the following three major categories:
- Supermarkets
- Department stores
- Convenience stores

### Overview of effective samples

<table>
<thead>
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<th>Core Business Revenue</th>
<th>Supermarkets</th>
<th>Department Stores</th>
<th>Convenience Stores</th>
</tr>
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<tbody>
<tr>
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<td>1</td>
<td>9</td>
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<td>1-5 billion</td>
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<td>7</td>
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<td>5-10 billion</td>
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<td><strong>11</strong></td>
<td><strong>11</strong></td>
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</tbody>
</table>

Noted: There are in total 35 samples. To ensure comparability across retail companies, this survey focuses on China’s top 100 retailers. Readers should note the results of this survey only show results of working capital management at relatively successful companies in China. The average working capital management performance in China would be expected to be lower.
Key Findings

1 Challenges and value of working capital

We categorized the retailers who participated in this survey based on their business operations and major sectors. The focus is on three major categories: supermarkets, department stores, and convenience stores. We designed the survey to gather information for our analysis on their overall working capital management situation. The types of working capital practices investigated in this survey are management of inventory turnover, Days of Payable Outstanding (DPO), Days of Sales Outstanding (DSO), capital assets (such as cash, bank deposits, other currency funds and financial assets held for trading) and treasuries (such as goods securities, commercial paper, bank draft and fund securities). The highlights focus on the effectiveness of the management of the cash conversion cycle (CCC) and related operations.

We noticed some commonalities among retail companies on the challenges of working capital management. Over 90% believe inventory management is the greatest challenge and is critical to effective working capital management. To a lesser extent, companies also pay attention to monetary capital management. The cash turnover cycle for most companies in our sampler is less than 3 months. The larger the scale of the business, the more effective its working capital management is. The working capital management of relatively smaller companies is not as efficient. Around 83% of companies claimed there was little change or even a decrease in cash turnover days compared with last year. Therefore, although the overall industry situation faces emerging new challenges, companies are making attempts to improve and optimize working capital management.
Retail companies from different categories have varying perceptions on the challenges of working capital management:

- **Supermarkets** have a concentrated and highly unified understanding on working capital management, mainly focusing on development factors from external forces. Since customer behaviours are changing and they demand greater personalization, the requirements on financial flexibility is increasing. Therefore, companies are increasingly paying attention to the challenges of working capital management. Moreover, lack of a capital management capability within the enterprise creates a challenge for large and small enterprises, but it disproportionately affects the relatively smaller and less mature organizations. Management capability has improved over the years, but the data implies it hasn't kept up with growth and development.

- Customer behaviour and demand for personalization became the second greatest challenges for **department stores** and further increases the requirement for financial flexibility. Also impacting challenges related to working capital management were regional development inequality and the rising purchasing power in tier 3 and 4 cities.

- Unlike traditional supermarkets, **convenience stores** have smaller single store sales volume and more dispersed store locations. Convenience stores require higher efficiency in upstream and downstream management to receive adequate benefit from synergies. Therefore, lacking synergy and effective communication along their retail value chain creates the greatest challenge to working capital management.

![Challenge in working capital management chart](chart.png)
Compared with last year, the companies changed their focus from revenue growth to increasing profit margins. Profitability pressure increased for retail companies, especially convenience stores and department stores. Meanwhile, department stores are more concerned about return on assets. Convenience stores became a greater focus of supermarket and department store giants. Since some supermarkets and department stores have limited scale in the convenience store ecosystem, they are more concerned with the expansion speed of convenience stores. We also found companies in different scales have different value proposition for working capital management. Smaller scale retail companies comparatively assign more value to increases in capital flow as a result of working capital management. While those operating at a larger scale pay more attention on how working capital management drives revenue growth.
1.1 Challenges in managing inventory turnover

Retailers across categories noted similar challenges in inventory turnover management. The primary complicating factor was the launch of new products and seasonal market demand. This was shown across supermarkets, department stores, and convenience stores.

However, retailers across categories had different views on challenges in Inventory Management based on type of operations. Compared with supermarkets and department stores, lack of on-time supply posed greater challenges to convenience stores. This is due to a convenience stores’ smaller storage area and limited inventory capacity. Therefore, out-of-stock translates to lost sales for convenience stores. Supermarkets and convenience stores of smaller scales are more passive about product launch, which brings greater challenges for inventory management.

Compared with last year’s analysis, changing customer behaviours, shorter product life cycle and seasonal demand change are still the key challenges for supermarkets and department stores. Product upgrades have larger impact to inventory management for both segments.
Challenge in inventory turnover management

- Changing consumer behaviour: 85% (64% Supermarkets, 40% Department stores, 64% Convenience stores)
- Fast product updates and short product lifecycle: 77% (64% Supermarkets, 40% Department stores, 64% Convenience stores)
- Demand seasonality: 70% (69% Supermarkets, 60% Department stores, 60% Convenience stores)
- Lack of timely supply: 70% (69% Supermarkets, 60% Department stores, 60% Convenience stores)
- Challenges for inventory information communication and report: 23% (20% Supermarkets, 20% Department stores, 20% Convenience stores)
- Lack of inventory management capabilities: 15% (12% Supermarkets, 9% Department stores, 9% Convenience stores)
- Inadequate storage area: 15% (10% Supermarkets, 10% Department stores, 10% Convenience stores)

Retail companies in different segments share similar understanding about the causes of challenges for inventory turnover management. Demand fluctuation, lack of inventory visibility, lack of inventory plan and warning mechanism are three of the major challenges shared across the industry. However, larger companies have already started to pay attention to more advanced inventory replenishment tools and enhancing their distribution network. Smaller companies are more concerned about their visibility into inventory management. It’s worth noting convenience stores emphasize more on supply fluctuation than supermarkets and department stores.

Compared with last year’s study, different categories focus on different aspects regarding the causes of challenges in inventory turnover management.
1.2 Challenges in managing DPO

The results of this survey demonstrated different retail companies have different perspectives on the challenges they are facing with DPO. These include cost orientation, financial burden on suppliers, market competition, account period transparency, and lack of excellent supplier management capability.

Compared to department stores, supermarkets and convenience stores believe if they are more cost-driven, it will have a greater impact to payable account management. The limited bargaining power between companies and suppliers becomes a prominent contradiction which will undermine payable account management for department stores.

Compared with last year’s study, there are discrepancies between some answers. For instance, many companies claimed being cost-driven is the greatest challenge this year.

![Chart showing challenges in management of DPO](image)
Retail companies take different approaches to managing DPO. Department stores emphasize large number of suppliers, but appear to lack an effective supplier management system.

Supermarkets and convenience stores believe untimely reporting of financial status by suppliers and procurement strategies for different product categories has the greatest contribution to payable management challenges. Whereas convenience stores claim decentralized procurement creates the greatest challenge to payable account management.

In last year's study, more than half of the interviewed companies believed the heavy financial burden on suppliers was an important factor. This year, with increasing scale and maturity of the interviewed companies, the emphasis is much less on a suppliers' financial burden.
1.3 Challenges in managing DSO

Results of this survey show retail companies don’t share the same DSO management challenges or, at minimum, prioritize them differently. It is widely accepted there’s a lack of comprehensive customer credit rating systems and an imbalance in collection capacity between regions. Supermarkets are highly concerned about the traditional collection style and the wide range of accounts receivable. Compared with supermarkets and convenience stores, department stores believe the wide range of accounts receivable are not the main concern regarding accounts receivable management.

Compared with last year’s study, the interviewed companies have fewer concerns about regional collection capability differences.
Retail companies disagree on the greatest challenges of managing DSO, while they are in general agreement regarding lack of credit and financial evaluation mechanisms. Compared with department stores and convenience stores, supermarkets are highly concerned about the lack of hierarchical customer management mechanisms. However, convenience stores believe the completion of account receivable management and supervision mechanism is the major cause of challenges.

Compared with last year’s study, the interviewed companies placed less emphasis on insufficient investments for modernization of information system this year. This was most notable for department stores.
2 Category based working capital analysis

The interviewed companies show common interest in category management. Effective category management has the ability to significantly boost sales revenue and profit margin. Therefore, it has become one of the most effective profit growth points for retail companies. However, it is increasingly difficult for retail companies to differentiate from their competition and increase profit margins.

In our survey, we have 7 product categories which fall under the three main retail categories in this survey:

- Fresh products
- Food
- Personal care and makeup
- Electronic devices
- Home appliances
- Houseware
- Apparel

Each category performs differently depending on the working capital management area:

- **In terms of inventory cycle management**, food has the highest inventory level for supermarkets, department stores and convenience stores, and its turnover days is second only to the fresh products (mainly within 0-45 days). Convenience stores perform the best in managing food inventory turnover and about 90% of the companies surveyed managed to keep inventory turnover within 30 days. Supermarkets and convenience stores claim they have managed the inventory turnover of the category pretty well. At the same time, food is still the supermarkets’ and convenience stores’ focus based on the ratio of products stored in distribution centres. The department stores mainly focus on houseware and personal care/makeup.

- **As for accounts payable management**, fresh products and food are the 2 categories with shortest DPO for supermarkets, department stores and convenience stores. Fresh products are within 0-30 days, while food is within 0-45 days. Supermarkets and convenience stores are more closely connected to their suppliers than department stores, and as a result have shorter DPO. Apparel is the category with the longest DPO for supermarkets, department stores and convenience stores, at around 45 to 60 days. Electronics and home appliances also have long DPO for supermarkets and convenience stores, at 30-60 days. Houseware has the longest DPO for department stores, at around 30-90 days. Supermarkets and convenience stores generally believe that DPO varies the most for fresh products and food year by year, while department stores are affected more often by personal care/makeup and clothing.

We found 60% of the respondents from supermarkets and convenience stores began to build private-label brands and include them in category management. Most department stores just realized the importance of private-label brands recently and introduced them without making any working capital investment. The major challenge for supermarkets and convenience stores with private-label brands is their lack of operating capacity for private-label products. Private-label fresh products and food contribute the highest revenue in their respective sales categories, and their DIO are also the shortest. They also have the lowest barriers for companies looking to enter the field of private-label brands. As consumers become increasingly willing to buy high-quality fresh products and food, retail companies become more optimistic about the profits in this category. As a result, retail companies have focused more on high-quality fresh products and food in recent years.

In this study, 50% of the companies interviewed conduct O2O business. Since O2O business has a large influence on inventory management in working capital management, it was included in scope for this survey.

Similar to the overall category inventory splitting, fresh products and food are still the two categories with the highest online inventory proportion for supermarkets and convenience stores, while home appliance is the focus for department stores. However, the two categories of products still have high DIO ratios. When compared with the traditional offline business, the DIO of online categories are shorter, at 0 to 15 days for fresh products.

In recent years, retailers’ attention to category management has gradually increased with their growing understanding of its importance. The investment and development in this area is expected to increase.
2.1 Working capital management analysis by category

This study conducts in-depth analysis on category working capital management of interviewed retailers. As mentioned in the previous section, there are 7 categories: fresh products, food, personal care and make-up, electronic devices, home appliances, household and apparel. We analysed the working capital indexes such as DIO, DPO, and DSO under each category.

In recent years, as a result of a growing focus on profit margin, many retail companies began to change their development strategy from rapid expansion to the boutique single-store model. Thorough category management became a strong driver of this strategy and nowadays, most retail companies’ category management is still in the shelf management stage. Though some companies have already implemented category differentiation management, due to discrepancy within execution capability and solutions, there’s no obvious short-term effect. Therefore, we will spend some time on how to achieve differentiated category management and complete end-to-end life cycle management.
• **Inventory amount for each category as percentage of total inventory**: The food category accounts for 40% of total inventory for 63% of supermarkets surveyed. Since department stores have a different operating focus, the proportions are different. Personal care and makeup are 30% of the department stores’ inventory and apparel accounts for more than 40% of total inventory at 25% of the department stores. As for convenience stores, food is the most important component of inventory, accounting for more than 50% of inventory for over 78% of the convenience stores.

• **DIO for each category**: due to different category management levels, different business models, and corresponding operating efficiency, huge differences exist for DIO for companies in the same category. For example, in the food category some retail companies already launched online businesses and 62% of the companies’ online food DIO are below 30 days. The integration of online and offline business drives down the overall DIO.

• **Changes in DIO for each category**: last year, 50% of the interviewed companies thought there were minor changes in DIO. DIO for 30% of the supermarkets increased by 0-30 days compared with last year. Comparably, overall DIO for 36% of the department stores and 36% of the convenience stores was reduced by 0-30 days. Among all categories, food and apparel categories change the most for supermarkets, convenience stores, and department stores.

• **Account payable days for each category**: it is common to find categories with longer DIO will have longer account payable days. However, leading companies have reduced the DPO and eased suppliers’ cash flow pressure through further category cooperation with suppliers. For example, home appliances for 34% of the interviewed companies keep their account payable days within 30 days. This is in distinct contrast to the industry average of 50 days.

• **Changes in DPO** for each category: most supermarkets and department stores believe there is little change in account payable days compared with last year. However, as more convenience stores enhanced cooperation with suppliers and improve procurement strategies, 36% of the convenience stores reduced their DPO by 0-30 days.
2.2 Analysis of private-label products

Through surveys and early-stage interviews, we found boosting overall profit margin by developing private-label products is a growing trend in the industry. More than 60% of the companies interviewed have launched private-label businesses; all of them sell private-label food. 74% of the companies conducting private-label business sell private-label houseware and 63% are sell private-label fresh products.

Due to a lack of coordinated management of upstream suppliers and insightful predictions on consumer behavior, the operating cost of private-label products stays high, and the management levels of different categories inconsistent. The sales volume of private-label products was lower than expected. Survey results showed different challenges across companies and emphasis on merchandise category management.
• By analysing the growth rate of private-label products, we found the supermarket industry has been experimenting with how they run a private-label business. 2/3 of the interviewed companies achieved double-digit growth. In comparison, the private-label products at department stores have undergone a slowing trend. The private-label product business at convenience stores didn’t change significantly over the same period.

• By analysing the sales ratio, we found except for the food category, all the other categories of private-label products contribute only 0-10% to total sales. The private-label products of supermarkets and department stores are still at an early stage of development and contribute less than 5% to total sales. The sales of private-label products at convenience stores account for a significantly higher proportion of total sales, where some categories of leading companies contribute more than 20%.

• Taking a deeper look at inventory turnover rates across categories, we found the management level of category operations is relatively uneven among the companies with private-label business. For example, private-labels in the food category are not being managed well by supermarkets and department stores. 63% of the supermarkets and department stores selling private-label food have an inventory turnover rate higher than 30 days. In comparison, 87% of the convenience stores manage to control the inventory turnover rate of their private-label food categories within 30 days.

Interviewed companies identified different challenges of conducting private-label business according to the characteristics of their category:

• Supermarkets and convenience stores with self-private-label business are paying close attention to their lack of management experience of upstream suppliers and lack of capability to operate private labels. Some retail companies are making significant profits from collecting rental fees while they are extremely inexperienced in cooperating with upstream suppliers. Under the scope of developing multiple categories of private-label products, it is difficult to achieve efficient collaboration among production, supply chain, and sales. This is resulting in unstable product quality and long inventory turnover ratios. The lack of operational capability of private labels is also reflected in a lower customer demand forecast and competitiveness of private-label products.

• Department stores are more prudent in investing in private labels, considering the risk of operation. Furthermore, recently the scale and development trend of the department store industry is declining. Department stores are transforming their development strategy from consistent expansion to making a breakthrough and increasing profit margin.
## 2.3 Integration of Online and Offline businesses

Online business has become one of the major expansion points of retail companies. However, the rapid change of demand in the online category and the increasing difficulty managing inventory logistics are bringing new problems to retail companies when they integrate online and offline business. Online business is significantly different from traditional retail, resulting in a relatively small revenue and low ROI when retail companies enter the online business channel. The online business unit of most retail companies is still unprofitable.

- 50% of companies interviewed have begun to conduct online business. Except for two retail companies that have conducted online business for a long time, most retail companies have an online sales volume of lower than RMB300 million. Our analysis revealed the online business of retail companies consists of more than 5 categories and the inventory amount of each category contributes less than 10% to total inventory amount. There is no emphasis for online categories and there is little difference between online and offline categories.

- We also found 58% of the companies use offline distribution centres for online warehousing and order fulfilment. However, the maturity level of online businesses fluctuates across companies and the inventory turnover rate of each online category varies significantly. Take the food category as example: 62% of the companies conducting online business manage to keep the inventory turnover rate under 30 days. However, 24% of the retail companies have an inventory turnover rate of their online food categories higher than 45 days.

Comparing the categories, we found reports on the challenges of conducting online business followed the characteristics of their approach to business growth:

- Department stores and supermarkets pay close attention to the impact of challenges such as: changing consumer habits, lack of inventory management capability, seasonal changes, and fast product iteration on inventory management of online business. During the process of integrating online and offline business, inaccurate category demand forecasting makes it challenging to apply real time updates to changing category demands online.

- Convenience stores are more cautious when dealing with their suppliers for online business. Similar to the challenges companies are facing for offline inventory management, the unstable supply has become the bottleneck of convenience stores’ online business.

- Currently, the overall online business strategy of retail companies has been to take advantage of offline to boost their online business. 62% of the interviewed companies are taking advantage of offline stores to share and integrate distribution, product information, and shopping experience with online. Further integration of online and offline inventory was reported by the companies interviewed as a future trend of shared service and inventory.
Finding and recommendations of working capital for retail industry
Over the past few years we’ve seen online and e-Commerce businesses disrupt the traditional retail industry. At the same time, new trends in the retail industry drew attention from capital markets and new entrants driving innovative operating models. Hence, challenges and pressure to traditional models are coming from multiple directions for incumbent retail companies. In this section, we will address differences across regions and industries and share examples of where leading companies are focusing their future development. The value and importance of working capital management has again been demonstrated as it’s closely tied to a company’s growth and development. ‘Innovation’ and ‘change’ have become the new buzzwords motivating action in retail.

Last year’s report addressed changes in consumers’ shopping habits, increasing demands on personalization, and improvement of product quality and consumer experience as the major challenges for retail companies. When we drafted this year’s report, we found leading retail companies have stepped into the New Retail operating mode and achieved surprisingly promising growth. We are also seeing industry leaders actively make moves to improve product quality and upgrade category structure. The key focuses of the improvements include the following:

1. **Focus on offline customer experiences, leverage dormant competitive advantages**

New forms of business, such as cashier-less retail, Fresh Hema, JD.com offline convenience stores, and TMall offline convenience stores became the hottest topics in the market last year. When facing new challenges, leading retail companies developed and tried new operating models in order to keep up with new trends and identify growth opportunities. The competition for retail companies in the future is not only about the traditional retail concepts, but also how to break industry barriers and compete against other industries. It is extremely important for retail companies to innovate their operating models and provide high quality products and services. According to the new industry trend, companies will experience new requirements on supply chain and operations management. For instance, high-end, fresh supermarkets will require stronger cold chain capability and faster inventory turnover; franchise businesses will rely heavily on suppliers’ planning and replenishment abilities; cashier-less supermarkets will pay more attention to supply chain...
stabilization and risks. In this survey, we found companies are paying significantly less attention to the growth of online e-Commerce business. Over the last decade, traditional offline retailers rarely succeeded using the online business model. However, since there are still lots of offline growth opportunities, most of the retail companies have re-focused on the more familiar, offline battlefield. Unlike previous years when companies simply pursued the growth of their online business, companies are now focusing on how to efficiently integrate online and offline business in order to effectively share resources such as inventory and data.

Yonghui, one of the leading supermarkets in China, has unique perspectives on its future development. Yonghui plans to be an enterprise that specializes in supply chain as a core competitive advantage. In turn they will use the advantage to support its business development and enhance its supplier management capability. To designate full authorization to its shareholders and drive the incentive mechanism, Yonghui has adjusted its traditional KPI system and introduced the mechanism of “Partnership” in business operations which serves as significant motivation to business personnel. Yonghui focuses on global procurement, merchandise planning, and customer experience.

By acquiring Daymon Worldwide, Yonghui gained experience in planning its private-label brands, designing stores, and optimizing customer interaction. What’s more, Yonghui uses direct procurement from oversea to increase control over suppliers and accounts payable. Yonghui's five future business units are: (1) customer flow at stores, (2) global product flow with high quality, (3) information flow of integrated supply chain, and cash flow of (4) upstream and (5) downstream suppliers. The five business units complement each other, combine different operation models, and build up a unique Yonghui value chain. It is noteworthy that the online business is not among the key development focuses for the five business units. Yonghui's online business is regarded more as an information transformer or supplementary form of offline business to improve customer experience. Yonghui's approach concentrates more on how to integrate online and offline business.

2. Enhance integration of retailers and suppliers, leverage mutual resources

With the adjustment of retail companies’ business strategy, the emphasis on managing working capital has changed as well. Different forms of business have different demands for supply chains. Retail companies need to focus on their core business units, to work with value chain partners, to create unique operating management advantages, and make clear pathways to improve capability and support the sustainable development. During the process of developing new products, the retail companies interviewed originally thought new products should be released to market by brand owners.
However, the results turned out to be poor. Recently, brand owners have not been developing products that are highly accepted in the market. Retailers are the front end, are closer to customers, and have and inherent advantage in collecting customer behaviour data. Brand owners are becoming more aware of a retailer’s value and their important role in introducing new products to the market. The hope is deeper, strategic collaboration with retailers will lead to more successful product launches and increased customer demand.

The survey found some regional and medium/small retailers are more active and exploring deeper cooperation with suppliers. In contrast, large international and domestic supermarkets still persist in the zero-sum game of budget control when managing supplier relationships. This mind-set prevents upstream and downstream suppliers from cooperating effectively based on information parity and equal status. COFCO, as a leading enterprise in food production, has kept innovating and built up strategic cooperation with leading supermarkets. Compared with traditional retailers which are restricted by management terms such as price and credit period, the deeper cooperation between COFCO and supermarkets has motivated the retailers to conduct analysis on future trends and peak-season promotions of specific products and categories. Based on shared product information and customer experience, COFCO and retailers have more effective discussions and make the relationship more valuable through their strategic cooperation. Strategic cooperation is not about blindly signing contracts, but about aligning the development goals and strategies of both parties to achieve a win-win situation.

3. Focus on differentiated categories, optimize category structure and product mix

Compared to last year, it was a positive finding to see some leading companies are beginning to realize the importance of structuring product categories. Retail companies have transformed from thinking like a “retail property agent” to thinking like a real retailer and paying attention to the full lifecycle management of merchandise categories. They are analysing different target customer groups which is leading to new merchandise categories serving different functions at different stages. Category management is mainly embodied in the following aspects: merchandise planning and selection – researching customer behaviours and preferences by analysing big data and providing better products in-line with customer demand; adjusting unreasonable category structure and increasing the turnover rate of merchandise; abandoning the ‘many SKU mind-set’ to provide products to satisfy all demand – reducing and eliminating SKUs significantly to increase operating profit, and decrease complexity of supply chains. The operating units of retail companies, such as planning, procurement, and inventory management, deeply understand the negative effects of too many SKUs. In the past, to boost sales, the final decisions were extremely sales-driven – increasing the number of SKUs and expected sales growth. However, retail
companies have recently realized the continuous growth of SKUs couldn’t necessarily lead to sales growth at the same proportion. Instead, it might have a negative impact on operating efficiency and cost associated with working capital. Originally only the focus of the supplier team or the mid-level management staffs, operational efficiency has become one of the major consideration factors for the high-level management team.

As a leading player in convenience stores, 7-11 is unique in its practice in merchandise operation. The core advantage of 7-11 is how it manages its merchandise categories. Each 7-11 store has different SKUs, adjusted for seasonal demand and commercial districts and communities. The merchandise operating team monitors the data continuously and manages to increase revenues of merchandise categories by focusing on each category one by one. 7-11 doesn’t passively wait for its suppliers to recommend new merchandise; instead, it actively chooses merchandises and develops private labels by analysing data and customer behaviours. Regarding accounts payable, 7-11 takes full consideration of maintaining long-term relationship with suppliers: it sets the target of payment period at 30 days and makes payments on time to avoid supply delay or supplier closing due to insufficient cash flow. Regarding inventory management, 7-11 adopts a VMI mode and employs professional warehouse distribution service providers to help keep the inventory turnover rate under 12 days. Regarding supplier management, 7-11 chooses leading suppliers and achieves local procurement to support the stable growth of local suppliers. Regarding private label, 7-11 is more prudent in choosing suppliers. It has a specialized R&D team and the development process is conducted together with the suppliers. To ensure a rational category structure and optimized management ability of private-label products, 7-11 sends staff to supervise suppliers in-house or even buys out the production line.

4. Promote private label business, encourage product management innovation

Although private-label products contribute to only a small amount to a retail company’s revenue, it is undeniable that the high profit margin of private-label products remains enormously attractive to retailers. From the perspective of suppliers, brand owners under-performed in introducing new merchandise. However, international competitors such as Carrefour, Walmart, and TESCO are inspiring domestic retailers by their success in operating private-label products. Under the model of food+retail, new demands were created for cooked and semi-finished food products. Products of this category don’t have strong brand loyalty with customers. In the past few years, we found the supermarket industry has been testing the way they conduct private-label business. 2/3 of the interviewed companies have achieved double-digit growth. In the past year, department stores repositioned themselves and the sales of private-label products increased significantly. The sales of private-label products at convenience stores grew significantly, benefiting from the industry new joiners and their own focus on private-label products. The previous indications demonstrated the development of private-label products will still be one of the major projects for many retail
The competitive strategy of a brand should leverage the knowledge of its strengths and weaknesses and develop a private label selectively. A private-label product should focus on “brand” for differentiation. The younger generations desire a better shopping experience and product quality. Instead of only relying on the traditional low-price competition strategy the development focus of private-label products should adjust accordingly. Yonghui developed private-label brands for 4-5 years and it realized revenue growth of private-label products is limited by the enterprise developed private-label products in the traditional supermarket. Yonghui learned the importance of customer experience to post-80s and post-90s generations, and even the millennials. It decided to abandon traditional retail companies or e-commerce as its benchmark; instead, Yonghui switched its benchmark targets to companies such as Muji and IKEA which are more experienced in capturing the market by optimizing customer experience and product quality. After identifying the development plan of private-label products, Yonghui will conduct a deep analysis on merchandise categories and select parts of the categories scientifically to be developed and sold as private-label products.

Retailers can learn from best practices and take advantage of external resources. Vanguard, by China Resource, has inreased consumers’ demand recently and identified two main directions of how its competitors developed private-label products. First, the brand owner develops the private labels itself and advertises them for low price. RT-mart is one of the best-practice companies in the industry. Second, international supermarkets such as Carrefour introduce private labels from France, categories mainly being chocolate and snacks. Historically, Vanguard introduced TESCO’s private-label brands by transforming TESCO’s original resources. Nowadays, the products of TESCO’s private labels have entered the Vanguard stores. Furthermore, Vanguard develops private-label brands by itself. Through marketing, Vanguard hopes to strengthen the brand image of its private-label brands and increase the sales ratio of private-label products.

5. Pursue operational excellence, drive profitable growth

Compared with e-commerce giants like JD and Alibaba which easily spend millions on opening new stores, most offline retail companies are more prudent in expanding geographically due to stagnant or decreasing revenue growth. On one hand, traditional retail stores have expanded, increasing the burden of heavy assets. On the other hand, compared with expanding geographically, retail companies are more active in entering new forms of business. Faced with challenges from the complexity of the new businesses, companies should focus more on how to optimize the
operating mechanism to guarantee the replicability of their new business. For traditional retail companies operating regionally, a solution to expand rationally is to make full use of local advantages, increase management capabilities, and increase capital turnover rate.

As a regional retail enterprise in Beijing, Chaoshifa was motivated by recent industry developments to begin exploring new operating models and development trends. Chaoshifa has more than 160 stores and some of them are private-label. With the changes in the retail industry, Chaoshifa categorized its business into five types of operations: comprehensive, food, life, fresh, and convenience stores. For different types of operation, Chaoshifa segmented their positioning, gross margin levels, category structure, and inventory turnover. Efficiency is also spotlighted, other than sales volume. Chaoshifa conducted deep market research and planned categories accordingly. All new products need to go through a period of probation and after the probation period products with slow inventory turnover or that fail an assessment will be eliminated. However, the elimination mechanism brought new challenges to the suppliers’ procurement, cooked food processing, and warehouse distribution processes. This is especially noticeable when the traditional retail companies are limited by their warehouse locations, thus making it almost impossible to upgrade itself to a centralized kitchen to process cooked food. After addressing challenges, Chaoshifa’s focus on operating efficiency increased to an unprecedented level. To support the development of new forms of business, Chaoshifa actively explored allocating resources accordingly, making use of current warehouse facilities, and building distribution centres and centralized kitchens to achieve competitive advantages.

**Conclusion**

In summary, although the challenges the retail industry is facing will continue in the near term and new entrants will increasingly disrupt the market, we find retail companies are actively exploring different ways to increase revenue and achieve profitable growth. Additionally, operational efficiency was raised to an unprecedented level by many retailers and they are more focused on inventory management, supplier relationship management and customer experience. This is a positive change over our findings from last year and will help continuously support their business growth. We suggest retail companies manage working capital in a more sophisticated way and develop competitive advantages from the operational and supply chain management as they adapt to different business models.
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