

CHANGES RESULTING FROM COVID-19

How China's retailers can respond

EXECUTIVE SUMMARY

China's retail sector has returned to 80% or more of its pre-COVID-19 volumes. There is a lot being written about how and why consumer behaviors are changing because of COVID-19 but much less about what these mean for retailers.

Advice for overseas retailers – which is plentiful – is not relevant to China; China is ahead in its recovery and is facing a different set of challenges.

Based on our client experience we have set out how we believe retailers in China should respond to the COVID-19 crisis to succeed and, potentially, grow in the medium term.

We believe that **the changes in consumer buying habits, accelerating digitalization and re-evaluation of the role of physical stores, and fundamental changes in global supply chains** are here to stay and will, if anything, accelerate, driven by worsening economic conditions and unpredictable disruption from the virus. To respond, we recommend retailers:

- Put into place analysis of consumer trends built on all available data; to reassess your assortment and re-focus marketing spend.
- Invest to strengthen your digital offering and re-examine the role of brick and mortar together with plan to integrate franchisees into digital solutions.
- Identify and manage risk in your supply base and supply chain.

More critically, there is an urgent need for retailers in China to put in place **business continuity plans** to ensure business survival through a second wave of COVID-19 should it eventuate.

In the short term retailers should assess how well they have these covered and shape realistic plans to implement and improve.

IMPACT OF COVID-19 IN CHINA: MAJOR STRUCTURAL CHANGES TO RETAIL SECTOR

The retail sector in China has returned to around 80% of pre-COVID volumes however there have been significant structural changes and there will be more to come.

CONSUMER PREFERENCES HAVE CHANGED

- Health and wellness is a continuing trend and increasing in importance. Higher spend in pure health and wellness categories – e.g. supplements, fitness and exercise.

Consumer spend favouring products with perceived health and wellness characteristics e.g. low sugar, low fat, high fibre; and in raw and pure form.

- More time is being spent at home. Spend is increasing in home furnishings, decorations and soft-home categories and consumers will be more value conscious.
- National pride to boost local brands and domestic consumption.

GREATER ACCELERATION OF DIGITAL

- Online sales and home delivery increased across all categories.
- Technology being introduced to reduce personal contact at stores and integrated cross-channel experience is emerging, including increased engagement and entertainment.
- Increasing social touchpoints are upping the game for brands in digital engagement with their customers.
- Increasing share of digital revenue is prompting a re-evaluation of the business model (i.e. how to work with partners/franchisees, low e-com margin) and how store value contribution is assessed as more sales flow to online.

A FRAGILE GLOBAL SUPPLY CHAIN

- Weak demand/cancelled orders will result in many distressed suppliers exacerbating unstable supply chain as production/capacity levels fall into doubt.
- Even with a full China supply base there is risk that your suppliers' other customers may default and cause your suppliers to fail.
- Supply assurance will be important but not at any price; difficult trade-off decisions will have to be made.
- Diversifying of supply base will gain traction with a particular attempt to localize/ regionalize supply networks for greater flexibility and sustainability.

THE POSSIBILITY OF A SECOND WAVE

- A second wave of virus infection (and lockdown) is a distinct possibility.
- In February this year, struggling through was acceptable; this was new territory. In a second wave that will seem negligent – companies must be fully prepared and must not be caught by surprise again.
- Continuity plans must cover realistic scenarios and model for impact to business, especially to cashflow.
- Plans need to have been validated in practice and staff trained in execution.
- Business must be managed with a risk-management mindset so as not to get caught if a next wave occurs.

POST COVID-19: CHANGING CONSUMER HABITS

Increased home-stay and media coverage has led to rapid and large changes in consumer spending patterns and spending continues to evolve.



THERE IS INCREASED SPEND ON HEALTH AND WELLNESS (H&W)

- Increased spend on direct H&W categories such as fitness & sportswear and supplements. Increased spend on H&W attributes in other categories:

Apparel: Outerwear and sportswear has and will continue to grow as consumers keep fit to keep virus at bay (e.g. continued e-commerce expansion of Nike and quick return to growth of Adidas).

Health and beauty: continued skincare and renewed cosmetic growth part of trend to look good and have fun/savor the short time out from the house while vitamins and supplements continue to grow.

Grocery: growth of fresh food, vegetables, fruits, milk and items that will boost immune systems and help to maintain a healthy lifestyle – studies have documented the rise and sustained demand in the past months.

- Consumers are more aware of supply chain transparency, product traceability and authenticity; and are prepared to pay for it.



THE HOME ECONOMY WILL RISE AND CONSUMERS WILL BE MORE VALUE CONSCIOUS

- As consumers spend more time at home, demand for home-related products in categories such as lifestyle products, home improvement/decoration, appliances, furniture, household necessities will grow.
- Home delivery of restaurant meals has surged but there has also been an increase in home cooking – and therefore grocery and produce sales; though brand loyalties have been changing because of availability.
- Unemployment, weak business outlook, and disrupted supply chains will likely drive consumers to be more value conscious and accepting of (cheaper) substitutes as they get used to shopping from home.



NATIONAL PRIDE TO BOOST LOCAL BRANDS AND DOMESTIC CONSUMPTION

- China is one of the first countries to resume business during this pandemic, prompting national pride among Chinese consumers which will spillover to boost the growth of local brands.
- Coupled with expected weak international travel, and stimulus measures, proud Chinese will boost domestic consumption.

ACTIONS TO ADDRESS IMPACT OF CHANGING CONSUMER HABITS

To respond to these changes retailers will need to use every available data source to understand changing trends and re-set the merchandising and assortment quickly.

CONSUMER INSIGHTS

- **Leverage POS and loyalty data:** establish baseline of changes in current customers' behaviors to obtain actionable insights; address individual customer's behavior changes and overall trends; deploy data science techniques to develop insights.
- **Acquire third-party data:** where it is available, don't hesitate to subscribe to third-party data sources to strengthen customer understanding and speed your response time.
- **Recalibrate marketing spend:** focus promotions on current winning categories. Suspend promotional spend on declining categories.
- **Develop cross-functional alignment on key decisions and expected outcomes:** ensure commitments on needed actions through clear use cases, priorities, and continued iteration.

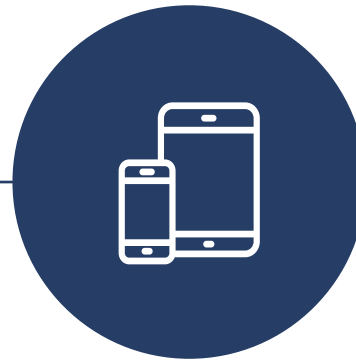
MERCHANDISING AND PRODUCT

- **Rebuild your merchandising plan from the ground up:** change assortment to reflect customer spending preferences; fill gaps in current assortment. Ensure risk of lower sales, if there's a second wave, is balanced against loss of sales if you under-purchase.
- **Review product positioning and pricing:** ensure competitiveness, especially compared to foreign brands; renegotiate supplier terms on declining products.
- **Clear seasonal and declining products quickly:** do this now and plan for longer fall/winter; promotional sell-out across the sector is likely to increase and margins will only decline. Go early and conserve cash.
- **Ensure smooth communication channel from the ground:** front-line information and assessment to be built into merchandising plan.
- **Develop multiple PD models and launch capsules:** test-and-learn.
- **Review product traceability and transparency in the entire supply chain:** from source/raw materials to finished products/shelf to remedy or highlight unique selling points, especially around product safety.

IMPACT OF ACCELERATED DIGITALIZATION AND IMPLICATIONS TO RETAILERS IN CHINA

Accelerated consumer shift to digital is forcing retailers to speed up digital engagement solutions both online and offline.

- Fragmentation of social channels (Bilibili, Tik Tok, Red, PDD etc.) and engagement options (Livestream/Live commerce, private traffic pool etc.) will require fast adoption and upgrading of organization capability.
- Social CRM will be key as retailers explore ways to better understand customers and identify customized solutions.
- Brand consistency is more critical than before with the plethora of channels and increased touchpoints.



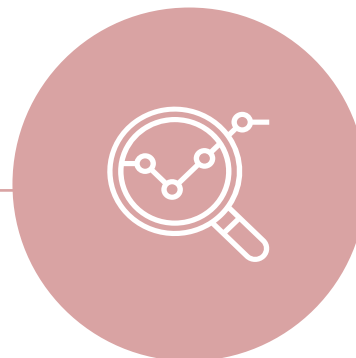
Social touchpoints and digital engagement

Integrated and immersive store experience



- Rapid rise in e-commerce and customers' comfort level with digital will push expectations of digitalized store (e.g. mobile checkout, unmanned stores etc.)
- A physical store experience that can enhance consumption is still desired (e.g. virtual shelves, interactive mirrors and comfy fitting rooms) – B&M will grow beyond showrooming into entertainment.
- Expect an exploration of formats and collaborations (e.g. innovation labs).

- Partnership models (i.e. franchise) will need to be re-shaped as digital revenues are shared.
- Accounting for individual store profitability will need a re-examination to make attribution for online sales.
- Rethink the role of the store and expand metrics beyond sales (i.e. customer lifetime value, contribution to memberships etc.)



Re-evaluation of business (store) model

ACTIONS TO ADDRESS IMPACT OF ACCELERATED SHIFT TO DIGITAL

As the move to digital accelerates ensure that you have a high-performing digital channel and that you have a strategy for what to do with stores as their sales decrease.

DIGITAL AND SOCIAL SOLUTIONS

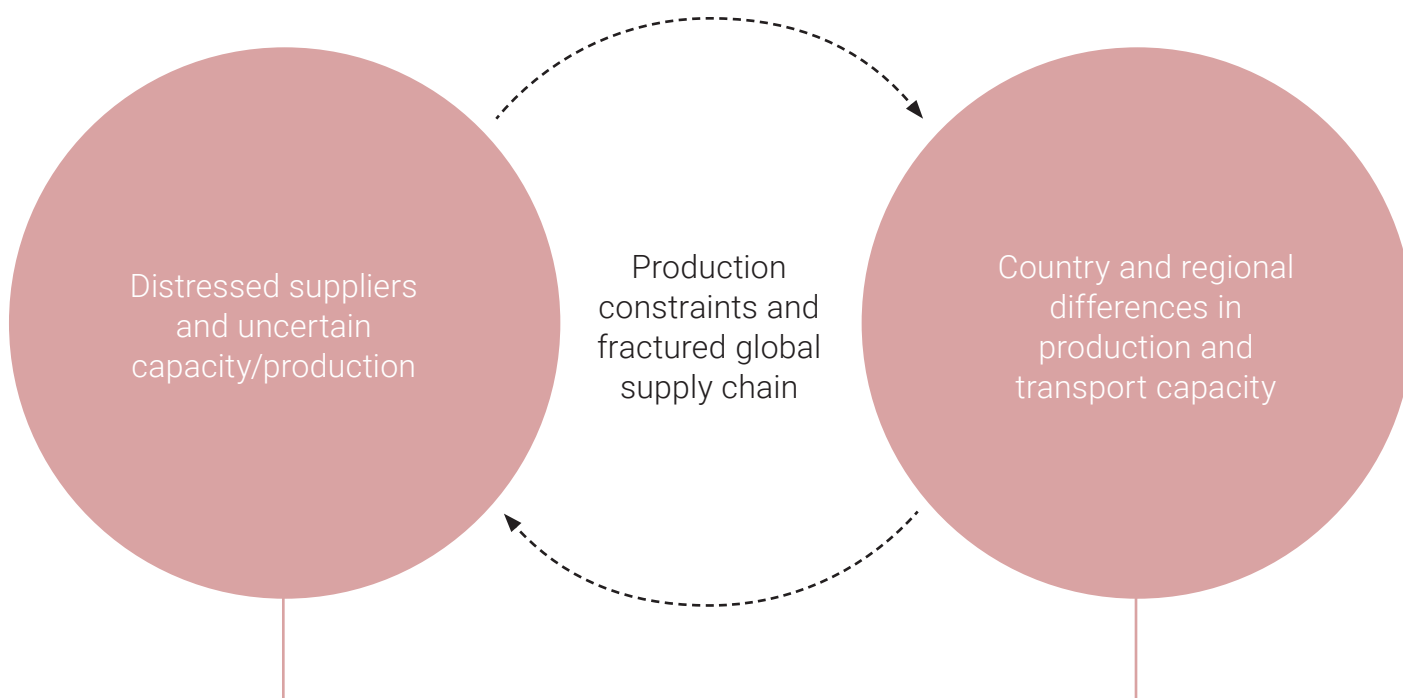
- **Set up online channels:** if you do not already have one, set up now and make sure its mobile-friendly – for speed and results adopt one of the major platforms to start (Tmall, JD, PDD). If you have an online channel, assess its ability to grow; can it handle peak sales and order management volumes, is the logistics system going to be able to grow.
- **Identify the most suitable social channels:** focus on your target audience - test and trial even the upcoming ones to know if they are suitable. Be aware that success in social-media based selling, e.g. livestreaming, can overwhelm order management and delivery capacity.
- **Develop a compelling O2O/multi-channel experience:** Stores can continue to be a valuable asset if integrated into an excellent multi-channel offering. Consider how technology can be used to maintain store sales in an online environment especially with low-touch models for social distancing – e.g. delivery from store; buy online pickup in store, or pickup at roadside.
- **Put in place a robust SCRM system:** collect and analyze customer data, and help to enhance customer value.

STORE STRATEGY AND FRANCHISE MANAGEMENT

- **Review store footprint:** reduce footprint and/or store size as foot traffic will remain elusive, define and differentiate store types to determine the role each store should play based on GTM strategy and retail plan, and execute/change.
- **Re-examine the partnership/franchise model:** be flexible to ensure win-win for all system partners. Consider sharing on-line revenues with franchisees, either as margin share or deliver from store. Integrate franchisees into your digital plans and collaborate to fully leverage O2O potential.
- **Be clear on your offline stores value proposition:** if not, define it now. What value do stores bring in terms of branding, customer familiarity and projecting substance. Rethink P&L accounting for stores: ensure driving towards objective for each store type (e.g. flagship may focus on branding).

HOW COVID-19 IS IMPACTING GLOBAL SUPPLY CHAINS

COVID has fractured the already fragile global supply chain leading to more local/regional networks and distressed suppliers that will cause future production constraints.



- Cancelled and delayed orders are resulting in cashflow issues for many suppliers.
- Production/capacity crunch and raw material supply shortfall may occur as suppliers, including logistic providers face plant closures, restart issues, and cashflow issues (and may go bankrupt).
- Stranded stock is likely to be sold at high mark-downs, eroding pricing for everyone.
- When capacity and demand re-balances your supply base will be different.

- Logistics and delivery delays reinforce need for near/on shore solutions.
- Multi-country supply chains are only as strong as their weakest link. Single-country supply is stronger.
- Retailers will look to re-design chain that can support maximum flexibility and speed to react to unpredictable supply conditions, diversify networks to manage upstream and downstream risk.
- Political pressures locally and need to sustain domestic economy/needs will further disintermediate global supply chains.

ACTIONS TO ADDRESS IMPACT OF DISRUPTED SUPPLY BASE

Understand your inventory position (current and future) and evaluate supply base while utilizing opportunity to take costs out.

MERCHANDISE PLANNING AND FORECASTS

- **Re-assess MP&A:** ensure have merchandise and assortment plans have caught up with changes in customer spending; revise assortment as needed; understand if new categories are to be added and how we will source/develop product.
- **Define category sourcing strategies:** for newly added categories.
- **Change forecasting:** increase frequency of forecasts. Emphasize frequency and timeliness of forecasts; the future is uncertain and volatile and accuracy will be low – work with that.

SUPPLIER RISK MANAGEMENT

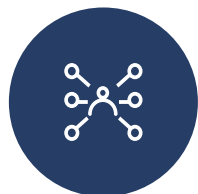
- **Review country-of-origin mix:** switch thinking from lowest landed cost to have a supply-assurance mindset. Resilience through diversity comes at a cost – align with merchandising where the right balance between cost and supply assurance lies. Where raw materials and manufacturing are in different countries understand the impact of any of those countries suffering a lock-down.
- **Evaluate supplier risk and rebalance supply base:** some vendors will not survive and your volumes alone might not be enough to sustain them. Assess the viability of all your key vendors; which customers do they serve, how secure are those other customers, what is the cash position of the supplier, how much was cancelled on them, before or after manufacture? Open up a dialogue to ensure best possible understanding and transparency.
- **Diversify production capacity:** for key items; no single-source at vendor or factory level. Include raw materials in the no-single-source policy.
- **Enhance risk management processes:** Strengthen financial risk management processes especially need to have a strong financial commitment control process.

WORK WITH SUPPLIERS TO REDUCE COSTS

- **Use positive cash position – if you have one:** confidence of the supplier in receiving payment and short payment terms are valuable to suppliers and can gain price reductions. But use carefully as the more value these are to a supplier the more chance that they'll fail.
- **Supplier transformation:** identify suppliers capable and willing to leverage digital solutions (i.e. B2B commerce, product sampling etc.) to streamline and build stronger future processes.

KEY CONSIDERATIONS IN DEVELOPING EMERGENCY BUSINESS CONTINUITY PLAN

Proactively developing a business continuity plan now in anticipation of a second wave of COVID-19 will ensure stability for your business, staff, and community.



1. Central command and communication



2. Stores, staff, and safety



3. Information needs



4. Supply chain



5. Social responsibility



6. Business operations

1 CENTRAL COMMAND AND COMMUNICATION

- Develop command center/war room structure to make key decisions/ensure consistent approach across all regions and locations and be the focal point in emergency situations.
- Test and conduct dry runs to ensure plans are robust and everyone knows their role. Rehearse with key people missing.

2 STORES, STAFF, AND SAFETY

- Prioritize safety of employees and customers by developing clear operating guidelines – clean & sterilize, mandatory health authentication, limit traffic per government regulations, social distancing guidelines, floor markers/discovery path, contactless solutions, masks and hand sanitizers provision etc.
- Train employees on safety procedures and set up social workgroups, hotline, intranet, employee handbook etc. for Q&A and 2-way communication.

3 INFORMATION NEEDS

- Identify information needed to run the business and where that information resides.
- Deploy technology so information can be used in temporary work-places, e.g. at home.
- Develop IT DRP in the event of lock-out of your datacenter/offices.

4 SUPPLY CHAIN

- Plan for store shipment capability to leverage store network as backup in case warehouses shut down.
- Establish vendor communication protocols and keep in touch if a risk eventuates.

5 SOCIAL RESPONSIBILITY

- Plan for how your business can support the community now and in the event of another lockdown emergency situation.

6 BUSINESS OPERATIONS

- Review business procedures to simplify and account for need to work and make decisions remotely.
- Determine impact to margins and cashflow in event of another lockdown; check for sensitivity using scenario testing.
- Have specific response to specific risks. Make then clear and simple.

We recommend that retailers in China take stock of how well they have responded to these four continuing challenges and revise their plans accordingly

1 Understand what has been done

- Place emphasis on what has changed since the beginning of the year.

2 Assess completeness and practicality

- Are the changes sufficient.

- Are they practical and will they work in a real-world situation.

3 Define what needs to be improved

- A few initiatives done well are likely to outperform a broad programme of change that doesn't get traction with your staff.

- Prioritize risk management and a business continuity plan: essential that they are in place will work. If they have not been tested – test them.

4 Plan and mobilise for implementation

- Other initiatives can be rolled-out progressively

- Bring forwards benefit delivery. Aim to have tangibly different ways of working in weeks not months.



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These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.

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