Distribution Channels of Philips Domestic Appliances and Personal Care Products in Chinese Economic Transition -- A Case Study

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Abstract

There is general agreement that the distribution channel is the key to any company's success in Chinese market. Nonetheless, distribution is always cited as one of the most serious problems for foreign companies (including joint ventures) that operate in China. One of the reasons contributing to the difficulties in managing channels in China is that they are so different from western channels, thus difficult to understand. This teaching case provides detailed information about distribution channels in China to business students, managers and scholars who are interested in marketing in China.

The case illustrates distribution channels management of an international joint venture company in China's transitional economy, using Philips domestic appliances and personal care products as examples. The case devoted considerable coverage of key channel management issues, distributor selection, contract and incentive designs, monitoring and socialization between the boundary personnel of the up-stream and down-stream. In addition, the case also shows the general management problems in the state-run distribution companies, particularly, inequitable reward systems. In line of transaction cost theory, the case gives descriptions of Chinese distributors' opportunism (such as selling to other distribution territories); and exemplifies associations that distributors' opportunism may result from high uncertainty in market demand and legal enforcement of Chinese regulations, and from inadequate incentive design. Channel restructuring was the decision context. After six years' successful cooperation with a Chinese distribution company which was Philips' sole distributor for its domestic appliances and personal care products in the Shanghai territory, Philips found that the distributor' performance was constantly declining. Philips managers were therefore faced with decisions of whether or not to restructure the distribution system with consideration of the business environmental changes that had occurred in the past six years in China.

Distribution Channels of Philips Domestic Appliances and Personal Care Products in Chinese Economic Transition -- A Case Study

One evening in April 1998, Mr. Ricky Chan was still working in his office in the Philips Building in Shanghai, China. He had to make a decision whether to change the distribution structure of domestic appliance and personal care (DAP) product lines in Shanghai. The distribution system had been unchanged in almost eight years. Ricky is the Director of the DAP Division, one of the seven divisions of the Philips Electronics China Group. The Group's headquarters moved from Hong Kong to Shanghai in 1996. Ricky, a native of Hong Kong, joined Philips in 1991 after he obtaining an MBA degree from the University of Hawaii. He returned to Hong Kong and worked for Philips Hong Kong for five years, responsible for various operations in mainland China. In 1997, he was assigned to work as a director in the DAP division.

The DAP Division had seven regional offices (a region covered several provinces) and a total of 23 branch offices in various large cities in China. Shanghai is the most important city for consumer products, being the most populous city (with a population of over 13 million) and with one of the highest per capita disposable incomes in China. Ricky's predecessor, Mr. Yip, had established the DAP distribution in Shanghai in 1990 with heavy personal involvement. He had selected Sunjoy Company as the *de facto* sole distributor in Shanghai for DAP products. The distribution had gone well for over six years until early 1997 when sales growth rate dropped sharply.

Philips' Activities in China

Philips is a major firm in consumer electronics (audio/video products), personal care (hair-dryers, shavers and hair removers) and domestic appliances (irons and table-top appliances) and is known around the world. Royal Philips owns the Philips brand and is headquartered in Eindhoven in the Netherlands. It is one of the largest electronics companies in the world and the largest in Europe, with global sales of the Euro Unit of 30.5 billion (about US$ 31.9 billion) in 1998. Philips employed over 220,000 people in more than 60 countries around the world in 1998.

Philips Returning to China

Philips has a long history of doing business with China. Beginning in 1929, Philips exported its products to China to the cities of Shanghai and Beijing. Philips' radio sets and bulbs were particularly well known in pre-World War II China. Like all western companies, Philips retreated from the Chinese market in the early 1950s, because western companies were not allowed to do business in China. After an absence of 30 years, Philips returned to China in 1981 in collaboration with a Chinese enterprise to produce TV sets. Now, China is one of the most important markets for Philips. In 1998, this market generated 62% of the company's sales revenue for the entire Asia Pacific region (including Australia and New Zealand), and 13% of Philips' global sales (see Table 1).

[Table 1 about here]

Philips made its return to China in the early stages of economic reform in China, which started in late 1979. Philips collaborated with a state-run factory in Changchun, Jilin province (in the northeast of China) to produce 20-inch black and white TV sets. The collaboration was in the form of contractual cooperative investment. That is, Philips provided technology, machinery, technical equipment, and parts, while the Chinese partner provided factory space and labor. The output of the plant was exported outside of China. At the end of the contractual period Philips' investments were transferred to the Chinese partner, who had paid for it by production inputs. In 1985, Philips established Philips Beijing Audio/Video Corporation, its first equity joint venture (JV) with a Chinese partner in Beijing. Although the Beijing JV did not start manufacturing until 1988, the establishment of the JV proved to be a very important strategic move for Philips in exporting audio/video products into China.

Establishment of Philips' Own Distribution Networks for Its Imports

Traditional Chinese Distribution System

Due to Chinese government regulations, Philips was required to import its products, which were mainly made in its subsidiaries in North Africa, into China through the Import and Export Corporations (IEC) of China (under the Ministry of Foreign Trade). The IEC, in turn, sold them primarily to distribution networks that had been established for over 30 years in the planned economy. As illustrated in Figure 1, until the mid-1980s, there were three tiers in traditional distribution networks, namely, the primary, secondary and tertiary levels. The primary distributors were at the central level, usually located in large industrial cities and ports, predominantly in three city-provinces: Shanghai, Tianjin and Beijing. The secondary distributors were at the provincial level, usually in the capital city of a province, and the tertiary ones were located in smaller cities and counties within provinces. According to the state economic plan, all the products manufactured by Chinese factories, as well as imported products, were required to be sold to the first or the second tier of distributors on a cost-plus (fixed margins) basis. They in turn sold to distributors at the next hierarchical level at a fixed margin. The Ministry of Commerce determined margins for various consumer products. The distributors were not allowed to buy merchandise bypassing their direct superior distributors. Therefore, distributors at the third tier had to buy from those at the second tier, and retailers (except very large retailers) had to buy from distributors at the third tier. Several large retailers (mainly department stores, food stores and pharmacies in Shanghai and Beijing) were authorized by the Ministry of Commerce to buy directly from first tier distributors; and one or two large retailers in each province were authorized to buy directly from second tier distributors.

There were some serious problems plaguing this traditional distribution system. Being a monopoly system and buying from factories whatever they produced, required neither party to make any marketing efforts. Things they could not sell were simply warehoused as inventory. In the mid-1980s, the Chinese government began to realize the drawbacks of the existing distribution system and started gradually reforming the system. The essence of the reform was to break the monopoly of distribution and permit factories to choose their own distribution channels. Factories were eventually allowed to sell to distributors, wholesalers or retailers, and even to consumers directly. Many Chinese enterprises gradually expanded their sales branches and their own distribution networks.

Philips' Own Distribution System for Its Imports

Philips saw a golden opportunity to establish its own distribution networks. It would have taken the IECs forever to sell Philips imports to distributors nationwide if Philips had relied on IECs to distribute them. They would still be simply waiting in the traditional style for orders to come to them. Philips aggressively deployed the Beijing JV partner's existing sales force to establish its own distribution networks nationwide. These networks "pushed" imported Philips audio/video products to many Chinese distributors all over China, including those in the traditional three-tier systems and in the newly emerging distribution networks. The Chinese IECs still played a role, though, because on the surface they were still the party who imported Philips products and issued invoices and receipts, although they never paid for or physically possessed those products. IECs would receive a fixed margin, like a commission or service fee, for processing the "documents" for Philips imports. In the process of building its distribution networks, Philips, working with its Chinese partner, learned about the new distribution practice and market situation in China.

More Philips JVs in China

Having realized the large market potential in China, and the constraints of the Chinese import regulations, Philips has now established over 20 JVs in China, covering almost all major Philips product lines.

Philips DAP Channels in China

Having gathered knowledge about and gained experience from building distribution networks for the audio/video products in China, Philips began to build its own distribution networks for all product lines. The distribution channels for domestic appliances and personal care (DAP) products in Shanghai were used to exemplify the development of Philips' distribution networks. However, these networks are similar to those for consumer electronics and networks in other cities as well.

Through experience in the importation of Philips consumer electronics, Philips began importing DAP products via its Hong Kong office, Philips Domestic Appliances and Personal Care Products Co. Ltd. of Hong Kong (or Hong Kong DAP) into the Chinese market at the end of 1989. Products included the Philips brand cord and cordless steam irons and electric cookers in the domestic appliance category, the Philishave brand electric shaver, the Ladyshave brand hair remover, and the Philips hairdryer in the personal care category. Although the DAP market was already competitive, brimful of Chinese manufactured products. Philips products instantly gained top preference by Chinese consumers because of their high quality, better design, additional functions and attractive warranty terms.

In order to achieve further penetration of the DAP market in China, Philips established a DAP JV in 1990, Philips Domestic Appliances and Personal Care Co. of Zhuhai SEZ Ltd. in Zhuhai Special Economic Zone (SEZ). The products manufactured by the JVs were even more competitive because they were exempt from import duties that included two parts: 1) import adjustment tax (i.e., customs duty), 35% (of FOB price) for DAP, and 20% to 35% for consumer electronics; 2) value added tax for all products, imported or domestically manufactured, fixed at 17% of FOB price or of wholesale prices from manufacturers. Thus, the price for DAP products could be much lower than that of imports. The distribution of both the imports and products manufactured by the Zhuhai DAP JV were managed by the Hong Kong DAP Co.

Selection of Chinese Distributors for Philips' JV DAP Products in Shanghai

Philips' JV DAP products were one of the first foreign brands made in China and available on the Chinese market. Compared with imported foreign products, they were much less expensive, only about half the price of the imports. The high quality, modern designs, and overall good image of this well-known brand impressed Chinese consumers. All of these made Philips a desired supplier for Chinese distributors, who competed with each other in order to be selected by Philips. A big problem, however, was the lack of qualified distributors in China. In 1990, the Hong Kong DAP managers selected four regions (east, southeast, north, and northeast) as target markets, where there was more potential for Philips' DAP products. Philips actively recruited distributors in the large cities in each region.

It was common practice for almost all foreign-invested enterprises, particularly those in consumer products, to establish authorized distributors in each of the large cities. In the process of abandoning the planned economy and establishing a market economy, the central government consequently decentralized its power to local (provincial) governments. Local governments, in order to protect their territorial economic interests, usually set up trade barriers (such as administrative orders or guidelines) against distributors from other provinces. To use authorized distributors within the provinces was probably the only way to overcome the trade barriers. In Shanghai, from many state-run and private potential distributors available, three candidates were considered for the DAP distribution: Sunjoy Electrical and Electronic Appliance Company, Shanghai No.1 Department Store, and TopBrand Department Store. All of them were state-run wholesale/retailer enterprises. Philips was concerned about recruiting private distributors. In China, as there was no credit rating system, there was no way to check individuals, including the owners of private enterprises, for their credit history. This was a serious threat to suppliers if credit term was offered; those opportunistic private distributors could simply get merchandise and disappear. Once a distributor disappeared, there was virtually no way to trace him or her. Besides, even if the distributor was traced, the much less-than-perfect legal system and inefficient implementation of the law made it literally impossible to get any recourse. So, why bother? Another reason was that private wholesalers had very limited working capital: it was unlikely for them to achieve a sales target set by Philips, and at that time it was almost impossible for them to get loans from banks. The third reason for Philips being limited to state-run distributors was, of course, to obtain their existing distribution networks, which they had inherited from the central planning system and gradually expanded since then.

Sunjoy Electrical and Electronic Appliance Company was formerly a wholesale and retail subsidiary of the Farms Administrative Bureau (FAB) of the Shanghai Municipal Government, established in the late 1970s, at the end of the Cultural Revolution. The FAB's main function was to oversee educated youths who were native to urban areas (mainly Shanghai) and relocate them to the state farms in Congming County, the countryside of Shanghai, for resettlement and work. This part of government policy, called "go and work in the countryside or mountain areas", was applied during the Cultural Revolution. Over the years, these farms were in gradual expansion. They not only contained schools, kindergartens, and hospitals, but later on, as they grew, they also built and ran many factories, manufacturing automobile parts, air pumps for tires, stainless steel wares, and various locks, watches, and radio sets. The FAB had a sales office in Shanghai, which exhibited their products and engaged in wholesale and retail activities. The wholesale and retail subsidiary of the Shanghai FAB was transformed into a company (Agriculture-Industry-Commerce Allied Group Company, or AICAG Company) in observance of the central government policy, issued in early 90s, mandating that no government agencies be engaged in the running of enterprises. Sunjoy Electrical and Electronic Appliance Company established in 1992, was still under the control of the AICAG Company.

Sunjoy was mainly involved in wholesale involving consumer electronics and home and domestic appliances. In addition to products manufactured by their own factories in Congming, they also sold products made by other factories. There were about 200 employees in this company, the majority being former state farm workers in Congming County. These workers were happy to return Shanghai to work, as Shanghai is an internationally known cosmopolitan city vis-à-vis Congming, just a small town on an island. Sunjoy, in late 1993, merged with the Agriculture- Industry-Commerce Allied Trading Group, a state-owned stock company under the Shanghai FAB, engaging in a variety of businesses, from A(dvertising) agencies to Z(ucchini) production.

Shanghai No.1 Department Store was formerly the Da Shing Department Store before 1949, when the Communist Party came into power in China. It was the largest of the four largest department stores in China then, namely Da Shing, Wing On (now Hualian Department Store), Sincere, and Shing Shing (now the Shanghai No.1 Food Store). The owners of Da Shing fled China with most of the store's capital before the People's Liberation Army (PLA) took over Shanghai from the Kuomindang (the Nationalist Party). Da Shing was on the verge of bankruptcy following the withdrawal of its assets. Immediately after the founding of the new China, the central government took over Da Shing in November 1949 and it became the first state-run department store in China, known as the Shanghai No.1 Department Store. Until the beginning of the full bloom of the economic reform in 1992, there were ten large department stores in Shanghai, all under the jurisdiction of the municipal government agency, the Shanghai Municipal Commerce Committee. All the ten large department stores were involved in retailing and wholesaling an extended variety of merchandise. No. 1 Department Store's sales volume always topped the entire retail industry in China, and its distribution networks were extensive. It was also a sought-after partner for both domestic and foreign companies during the economic reform, due to its prestigious image, long history and prime location (Nanjing Road) where all the tourists, domestic or international, and many Shanghainese like to go shopping. Nanjing Road is therefore termed the "No. 1 Street in China".

The TopBrand Department Store was a new department store located in the Everbright Commercial Area, near the Shanghai New Railway Station, and was completed in 1992 with 20,000 square meters of floor space. It was a subsidiary of the Everbright Group Company of Shanghai Zhabei District, Limited. Everbright was established in 1990 by merging several department stores at the district level under the jurisdiction of the Shanghai Zhabei District government agency, the Commerce Commission of Zhabei District. The district government also made some investment in the Group Company.

The Everbright Commercial Area was one of four areas nominated by the Shanghai Municipal Government for concentrated commercial development. In the 1990s, domestic (state-run) and foreign companies invested over 10 billion RMB (or over US $ 1.2 billion) in the Everbright Area for many commercial buildings, with the TopBrand Department Store being one of them, funded by the Zhabei District Government. The store faces the New Railway Station, which generates a flow of hundreds of thousands of people per day. In 1990, the TopBrand Department Store Preparation Office set to work, located across the street from the Philips DAP Office in Shanghai.

[Table 2 about here]

Table 2 lists the advantages and disadvantages of the three distribution candidates. In 1990, the managers of the Hong Kong DAP made a decision to employ Sunjoy as the *de facto* sole authorized distributor in Shanghai to distribute Philips' DAP products, although "sole" was not mentioned in the contract. The decision to use a single authorized distributor, rather than multiple authorized distributors, was based on a number of considerations: First, Philips in Shanghai largely depended on Sunjoy to develop the new market and expand its retail networks. The single dealership ensured that the distributor received proper rewards from its effort. This incentive was particularly important for the new market development stages, which required tremendous effort. Second, due to the territorial restrictions imposed by local governments, a single authorized dealer was enough to cover the entire territory in the early stages of DAP distribution. Finally, a single authorized distributor could eliminate the competition between multiple authorized dealers for retailers.

Distribution of Philips JV DAP by Sunjoy

The negotiation teams of Philips and Sunjoy were headed by Mr. Yip (Ricky's predecessor) and Mr. Jimmy Wong, the deputy general manager of Sunjoy. Jimmy was a bright young man, then in his early 30s. He was transferred from a state farm in Conming County to the FAB sales office in Shanghai in 1981 to work as a salesperson. He loved the sales job and the interaction with his customers. In the 10 years he worked there he always performed exceedingly well, receiving numerous awards. In 1990, he became the deputy general manager of Sunjoy, in charge of cooperation with Philips.

The contract between Philips and Sunjoy was subject to an annual review process and was renewed only if Sunjoy could fulfill the sales quota assigned by Philips. In the first year (1990) the quota was very marginal, only 1 million yuan (about US $200,000). Sunjoy always exceeded the sales quota and the annual sales growth rate averaged 200% between 1990 and 1996. Sunjoy was allowed to distribute DAP products manufactured by Chinese companies but was not allowed to distribute competing products manufactured by foreign-invested JVs. The Philips products, at that time, mainly consisted of men's shavers and various irons. The contract also permitted Philips to scrutinize Sunjoy's operations if necessary.

Philips provided Sunjoy with a credit term of 60 to 90 days, depending on the volume purchased. Sunjoy always made payments promptly. For merchandise purchased by Sunjoy, even if it did not sell well and was high in inventory, Philips, as stated in the contract, was not obligated to swap these products for newer models or for products that were easier to sell. However, Philips did occasionally make some exchanges for newer models or easier-selling products, to show the company's flexibility and sincerity in maintaining a long-term business relationship with Sunjoy. As a result of negotiations with Philips, Sunjoy obtained a very favorable markup structure between Sunjoy and its retailers. For example, if Philips set a retail list price for a product at $135, Sunjoy could buy it from Philips at $100, and sell it to retailers for $120. Therefore, Sunjoy made a price-based markup of 16% to 17% or a cost-based margin of 20%, while retailers made a markup of 9% to 13% or a cost-based margin of

10% to 15%. Usually, however, for DAP products in Chinese market, wholesalers only received a markup or margin comparable with those of retailers at most. At the end of a year, if sales quota assigned by Philips had been met, Sunjoy would also get a 2% rebate as a financial incentive for the total purchase of the year. Philips granted favorable terms because Sunjoy performed some distribution functions, which included developing and managing the retailer networks, delivery to retailers, and serving as a warranty agent for Philips DAP products.

As required by Philips, Sunjoy had to develop an extensive retailer network for Philips DAP products, and the selection of specific retailers was subject to Philips' approval. Based on the personal connections accumulated by Jimmy and his colleagues, Sunjoy was able to develop, by 1997, an extensive network of over 200 retailers, including two DAP specialty stores established by Sunjoy. Out of similar concerns as the Philips recruiting distributors, all the retailers recruited for DAP products were state-run stores (state-run department stores or specialty stores), or subsidiaries of state-run enterprises, sometimes called stores with state-background. The state-background stores were usually run by individuals, who were employees of the state-run stores. The individual, by contract with his or her employing company, was required to hand in a certain fixed amount of profit per year, regardless of the business of the contracted store. State-run stores or stores with state background usually had fewer payment problems because they were backed by the state-run banks. In addition, for products like DAP, which were relatively expensive to Chinese customers, a store image is important; customers generally did not trust private stores, and had no confidence in the warranty terms provided by them.

Sunjoy monitored the retailers to see whether they priced Philips DAP products according to the list price (with ± $3 deviation on a base of $135). Sunjoy also provided transportation (trucks) and warehousing for the merchandise purchased from Philips and delivered the products to the retailers. Warehousing was needed because retailers would usually only keep inventory for one or two weeks and usually stored it underneath the counters. Although warranty was handled at the retailer level, retailers exchanged products with quality problems. However, Sunjoy had to collect faulty items from all the retailers in its network, transport them to Philips for exchanges and deliver them back to retailers.

Sunjoy's Segmentation Practice

As was required by Philips, Sunjoy established an extensive retail network (over 200 outlets) in Shanghai and divided the outlets into three segments in terms of sales potential and the floor space of the outlets. Segment 1 (about 30 stores) included mainly large department stores and appliance stores in the busiest commercial areas. Segment 2 (about 50 stores) contained the large or medium-sized department or appliance stores in the busy sections of a district. Segment 3 (about 120 stores) referred to smaller appliance stores in the remaining locations in Shanghai. Sunjoy made some innovations in store arrangement and organized Philips-brand counters in stores in Segments 1 and 2. In order to promote the Philips image in Chinese customers' minds, Sunjoy required these stores to arrange counters for Philips brand. This was the first attempt in Shanghai to have a counter specializing in a specific brand; the existing custom was to arrange counters by product, with mixed brands. In addition, Sunjoy set the retail price for Philips DAP and required retail outlets to label Philips DAP products with identical prices across areas in Shanghai, and to maintain a specific, unified image and promotion material throughout stores in all three segments.

Cooperation between Philips and Sunjoy

Philips provided free training to Sunjoy staff in modern, western marketing practices, including product knowledge, promotion and maintenance of the Philips brand image, store arrangement, counter design and arrangement, promotion techniques, etc. Philips also provided free literature about the Philips Company and DAP products. Sunjoy, in turn, would train the staff in the retailer outlets in the segments 1 and 2 (large DAP retailers), using techniques they had just learned from Philips. These training sessions were well received by staff in both Sunjoy and the retail outlets, because most people had not been exposed to marketing in the western world and were very keen to learn western methods. In addition to training, Philips also sent Hong Kong managers and mainland Chinese employees to Sunjoy's retailers to help them with point of purchase promotions, even hiring temporary staff to help with promotions. Of course, in addition to helping with the retailers' promotions, Philips staff also monitored these retailers to see if their selling activities (shelf display, attitudes toward customers, dealing with their inquiries, handling promotion material, etc.) were satisfactory, and at the same time obtained first-hand feedback from the customers.

Equally, Sunjoy was very cooperative with Philips. Sunjoy provided useful information about and helped Hong Kong managers with important aspects of marketing in Shanghai. These included how to deal with the Chinese government agencies and customs, with the practice of management and trade in China, with the distribution structure and practice, and with consumer preferences, etc. Sunjoy also gave valuable input to Philips' distribution plans. For example, they suggested selection scenarios for selecting retail outlets (sales potential and floor space), and made helpful suggestions regarding advertisements and promotional materials. In addition to the cooperative activities by Philips and Sunjoy as two organizations, the staff of the two companies also maintained good communications and social interaction. Some of them became personal friends and knew very well what their friends were doing in their respective company.

As Philips had a large number of JVs in China, manufacturing products in various product lines, it established a marketing company, Philips Sales Organizations, in 1995, at three levels: national (National Sales Organizations or NSO), regional (Regional Sales Organizations or RSO), and district (District Sales Organizations or DSO). To further penetrate the Chinese market, Philips expanded its distribution from four regions in the early 90s to seven regions in 1995. In the sales organizations at different levels, Philips hired new staff or promoted existing staff, most of whom were local Chinese. All these factors contributed to Philips' understanding of the DAP market in China, and the company rapidly adapted to the marketing environment and became increasingly more competitive in the Chinese market.

The Changing DAP Market and Increasing Competition

The distribution of retail stores and residential areas in Shanghai changed rapidly with each passing month. One third of the giant construction cranes in the world were concentrated in Shanghai, working day and night to build high-rises. New shopping malls suddenly appeared here and there even before the Shanghainese would notice their construction. Residential neighborhoods were in rapid flux. Many poor downtown neighborhoods with old buildings were rebuilt for upscale living areas. Old and deteriorated buildings were torn down, and their inhabitants reallocated to new apartments in newly developed areas far away from downtown. Only people with high incomes could afford to live in the new apartment buildings in the upgraded downtown areas as they were of a high standard, and very expensive. Shanghai was under continuous construction, for commercial and residential premises, resulting in the living conditions for Shanghai residents being significantly improved. The living space per person increased from 6 square meters in the early 1990s to 10 square meters in late 1990s. At the same time, the Shanghai people's disposable income increased steadily (see table 3). More income and better living conditions brought about increased demand for DAP products, home appliances and consumer electronics.

[Table 3 about here]

Despite the increased demand, the DAP market became increasingly competitive and competition started to turn fierce in late 1996 and early 1997. Several factors contributed to this increasing competition. In addition to the DAP JV manufacturer in Zhuhai, Philips established another DAP JV in 1995, Chun Fei Domestic Appliances Co. of Suzhou Ltd. in Suzhou, Jiangsu province, about 100 miles north of Shanghai. Similarly, many other foreign companies had also established JVs in China and started manufacturing DAP products, such as National (a Japanese brand) and Braun (a German brand). Other foreign brands entering the market then challenged Philips' powerful position in early 1990s when it was the only less expensive foreign brand made by a foreign JV. As the economic reform grew wider and deeper, many privately owned retailers sprung up like bamboo shoots in the spring and grew rapidly, competing fiercely with existing larger retailers in selling DAP products.

The increased variety and volume of JV products made in China required more Chinese distributors. Nonetheless, wholesaling was an industry over which the central government still posed stringent controls. It was difficult for Chinese investors to get into wholesale business because of the high capital requirement set by the government, the lengthy approval process and other vague requirements. It was even worse for foreign investors. Foreign firms were prohibited from engaging in wholesaling except for products made by their own companies in China, including JVs. This made the expansion of distribution rather slow, resulting in many foreign JVs competing with each other to get qualified Chinese distributors.

However, the worst nightmare for manufacturers was a price war that occurred in this chaotic market. Although many JV principals required their Chinese distributors/retailers to maintain certain retail price levels for their products, most Chinese wholesalers and retailers participated in the price war due to a number of reasons: (1) Both distributors and retailers were eager to clear their inventory under the over-congested market conditions. (2) Philips pushed distributors to maintain even larger inventories. This caused some conflicts between Chinese distributors and Philips managers, particularly those from the Hong Kong DAP. Hong Kong managers changed jobs relatively more often than mainland Chinese managers. They wanted to prove themselves while they were working in Shanghai, thus were motivated to impose high pressure on Chinese distributors, for them to purchase more and keep high levels of inventory. (3) Almost all the manufacturers (domestic or foreign JVs) in electronics, home appliances in China adopted a sales quota system, distributors could get year-end or half-year-end rebates if they met sales quotas set by the manufacturers. Usually, the higher the sales volume was, the higher the rebate was as a percentage of the total sales (2% to 5%). In addition, the manufacturers also gave quantity discounts, the higher the purchase volume, the lower the price. Therefore, distributors were motivated to sell more products at a lower price, achieving or exceeding the sales quota in order to get the rebates. (4) Although the

Chinese people, particularly Shanghai consumers had significant increases in their disposable incomes (see table 3), the absolute income level was still low compared with those in developed countries, as a result, the price elasticity was high. High elasticity made price-cut very efficient for distributors who wanted to clear out their inventory and to achieve large volumes in order to receive rebates from manufacturers. (5) Some foreign JVs adopted a price differential policy, DAP prices were higher in Shanghai than other geographical areas, because Shanghai consumers' average income was higher. Plus, distributors in other areas were motivated to sell high volumes to get their rebates, they sold DAP products to areas such as Shanghai which was not assigned as their territories. (6) The distributors and retailers were unsophisticated in the transitional market economy, focusing on short-term sales, and did not realize the consequences of a price war. (7) Most importantly, to the Chinese consumers the DAP products made by foreign joint ventures were similar to each other, although they were believed to be better than DAP products made by Chinese manufacturers. Besides, DAP is of a relatively simple product category which does not require lot of services. These conditions made DAP products made by different foreign JVs difficult to be differentiated from each other.

Problems arose over the delay of payments by distributors to the foreign JVs. The oversupply of foreign brand products manufactured by JVs forced distributors to be very aggressive in pushing their products to retailers, often offering credit. Most retailers were state enterprises. They retained many redundant employees, but termination was impossible because the government did not want to have a high unemployment rate, which would have destabilized society. Additionally, state retailers had to shoulder the burden of retirees' pensions. As a result, their operating efficiency was low, and their overall financial situation was not good. Often, they could not make payments to the distributors or manufacturers from whom they bought the products on credit. The market was large with numerous distributors and retailers, foreign brands were in relentless competition, most JV manufacturers felt it a frustrating situation that called for a change in strategy.

Problems with Sunjoy Distributor and Channel Restructuring Decisions

It was this very chaotic time that Ricky assumed his new job as director of the DAP division. Since Shanghai was the most important market for DAP, he thoroughly examined the DAP distribution performance in Shanghai through talking to Philips sales managers, studying Sunjoy's quarterly reports, and visiting Sunjoy's office. To Ricky's surprise, despite the excellent performance by Sunjoy between 1990 and late 1996, he found that Sunjoy's efficiency had been consistently declining during this period. Sales growth was not up to expectations, logistics coordination frequently had problems, and more importantly, the communications between Sunjoy and Philips were getting worse. Ricky realized that the root of the problem lay in the rapid changes of Sunjoy personnel. Many of the sales people managed Philips DAP lines had left the company, including the deputy general manager, Jimmy Wong himself.

Sunjoy was a state-run wholesaler, part of the Agriculture-Industry-Commerce Allied Trading Group (AICATG) belonging to the Agriculture-Industry-Commerce Allied Group Company (AICAG). AICAG was ultimately under the control of a Shanghai government agency, the Shanghai FAB. AICAG was a well-diversifies group company, engaging in quite a few businesses across various industries, such as hotel, taxi fleet and others; and AICATG was the only one in the retail/wholesale industry. In the early 1990s, FAB did not pay attention to AICATG because fewer financial resources were involved. However, FAB later found that AICATG was the best performer and moneymaker, many other subsidiaries were operating on the red, therefore paid more attention to the trading group-company and Sunjoy in particular. More attention resulted in more intervention from FAB and more red tape. Communications up- and downward were slow and ineffective, inter-departmental communications within Sunjoy were few, co-ordination between managers of different associations was not very harmonious, and decisions were very conservative and took a long time to be finalized. The unfair reward system was an unequivocal shortcoming that plagued the state enterprises. Although Sunjoy made handsome profits for distributing Philips' DAP products, managers and sales people who made large contributions to developing the retailer networks and making sales were not rewarded. Their salaries were basically the same as others'. The compensation system made many people who had gained experience in distributing DAP products and had built up large distribution networks move to other companies: more flexible state companies or private companies. Or, they may start their own distribution business. Jimmy left Sunjoy at the end of 1996 and started his own private distribution company, distributing home electronics and DAP products for various JV companies and Chinese companies nationwide. He recruited some of the Sunjoy people to join his company. Mr. Cao was assigned to Jimmy's position in Sunjoy and placed in charge of Philips' DAP lines. Although Mr. Cao was an experienced manager, most of his experiences were from the central planning system in the old days, so he was not able to adapt himself to the new market economy. The DAP distribution performance kept sliding.

Ricky called a senior management meeting the following week for the East Regional Sales Organization and the Shanghai District Sales Organization. He planned to discuss with his managers the possible restructure of Shanghai's DAP distribution. He wanted to review three decisions: 1) Should Philips terminate the Sunjoy distributorship? 2) Should Philips use a single distributor or multiple distributors in Shanghai? 3) Should Philips use state-run distributors or switch to private ones, or use a combination of distributors of both types?

In the past two weeks Ricky had talked with managers in the RSO and Shanghai DSO, and his colleagues in the DAP division as well, asking their opinions about channel restructuring. He had also reviewed a report published by a well-known American consulting company in Hong Kong that compared management practices in state and private enterprises in Shanghai, including those in the distribution sector. The report, based on a large scale research study conducted in Shanghai, contrasted five issues: 1) growth rate, 2) quick ratio (the ratio of current assets less inventory to current liabilities), 3) ability to finance from banks, 4) image of enterprises as perceived by Shanghai people, and 5) take-home pay. Since the rigorous implementation nationwide of economic reforms in early 1992, the private retailer/distribution companies in Shanghai had increased at an average of over 40% per year resulting in a growth of market share from a 12% in 1992 to a 29% share in 1997. The market share of state-run retailers/distributors kept decreasing from 53% in 1992 to 39% in 1997 (see Table 4).

[Table 4 about here]

In general, the quick ratio, a crucial indicator of cash flow for a retailer/ distribution company, is much lower (or more unfavorable) for state-run distributors than for private distributors. As a result, some Chinese banks (although still very few) started to be willing to make loans to some well-established private distributors, because their financial performances were good, and Chinese banks (state-run only) started to look to profits and get rid of bad loans. Because of this, banks tightened loans to state distributors and retailers. In addition, Chinese people's perception about entrepreneurs also changed. They used to think entrepreneurs were those who were laid off by their "units". They could not find good jobs, therefore "went to sea" as an entrepreneur because they had no other choice. They were adventurous, because they had nothing to lose. And, they were money oriented, willing to do anything for a buck, including cheating and other bad things. Simply put, they were low class people. But now, Chinese people had gradually changed their perceptions, and had started to show some respect to entrepreneurs and their business. Many young people even chose to be entrepreneurs instead of working in a state-run company. As the report indicated, the most important reason for this contrast, of course, was the government policy of promoting the market economy. On the firm side, however, the two most important factors contributing to the growth of the private sector and the decline in the state sector in the distribution industry were the differences in the reward system and management decision process. The pay for the manager in the private sector was much higher than that in the state enterprises, and the pay system in the private sector was much more flexible. Private companies paid “market rate”, which in some cases could make a manager’s salary 10 or even 50 times more than that of a similar manager in a state enterprise. But in the state sector a manager’s salary was primarily determined by his/her seniority and position according to rules set by the government, which had very little to do with performance. State enterprises in various industries had close associations with various government agencies, which often gave “instructions” to their subordinate state companies. This association made the decision process complicated and lengthy and frequently unable to adapt to the changing market. Companies in the private sector did not have these influences from government agencies. However, the report indicated that as the economic reform went further and deeper, these unfavorable factors associated with the state sector might be mitigating rapidly in the near future. Further, there were already some state companies that had used more flexible reward systems and significantly reduced bureaucracy in decision-making: mainly newly established state companies and those which had been converted to companies listed on the stock market.

Ricky seemed inclined towards the option of terminating Sunjoy, getting multiple distributors, and including some private distributors in the DAP distribution system in Shanghai. He also realized that his colleague, Nancy Leung, the Deputy Director of DAP opposed his opinions. Nancy, a native of Hong Kong, had worked for DAP product lines for seven years, since 1991 when she joined Philips DAP Division in Hong Kong. Nancy had witnessed the ups in the first six years and the recent downs of Sunjoy’s distribution. However, despite the poor performance of over a year, Philips still maintained a good working relationship with Sunjoy and she hated to see this good relationship terminated. Besides, she also noticed that although Sunjoy’s recent performance could not be compared with its earlier one, it was still improving, slowly but surely. Her view of the state distributors was that, even though at this point in time there was a lot of room for improvement, they would be improving in the course of economic reform; compared with private distributors, they had a better reputation, were more honest and more trustworthy. She believed that state distributors were to be more preferred to private ones.

Ricky organized and put all his thoughts into a new file for the meeting the following week, and was eager to have an enthusiastic debate in the meeting. Hopefully they could come up with a decision about the DAP distribution structure in Shanghai.

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Table 1
Philips' Worldwide Sales by Region (1998)*

Region	Sales (million Dutch guilders)	Percentage (%)
Asia Pacific (excluding mainland China but including the Taiwan region)	7,797	7.1
Australia & New Zealand	923	0.8
China (including Hong Kong)	14,275	13.0
Europe (excluding Netherlands)	36,206	33.0
Latin America	4,436	4.0
Middle East and Africa	278	0.3
Netherlands	27,015	24.6
US & Canada	18,891	17.2
Total	109,814	100.0

* Table based on Royal Philips Electronics (1999), "Philips in China: 2000 and Beyond" and Royal Philips Electronics (1999), "1998 Annual Report".

Table 2
A Comparison of Three Possible Chinese Distributors For Philips DAP Products in 1990

	Sunjoy Electrical Appliances Company or Its Predecessor	**Shanghai No.1 Department Store**	**TopBrand Department Store or Its Predecessor**
Advantages	1. Top management personnel were relatively young and more willing to learn western marketing methods 2. Most of the salespersons were young (in their early 30s) and worked very hard because they had just come back from state farms in the countryside 3. Relatively less bureaucracy 4. Less intervention from government agencies 5. More flexible in decision-making 6. Did marketing research in order to know the potential of Philips DAP products in Shanghai	1. Had a long standing, with a history of over 60 years 2. Historically a strong retailer, was the largest and best known department store in China before 1949 3. Much experience in DAP products 4. More financial resources 5. More governmental connections 6. Started wholesale in 1950s, had a large network of lower level wholesalers and large retailers nationwide	1. More willing to learn from Philips 2. New company and did not have to pay pensions for retirees 3. Had little intervention from various levels of government agencies 4. Well known for its beauty store chain 5. New and large-scale department store
Dis-advantages	1. A relatively small company with only 200 employees 2. Although the company has a history of 20 years, it did not have experience distributing DAP products	1. At the beginning of economic reform, it was not clear about the direction the company would go 2. Had relatively stringent rules of doing business, which may fit the planned economy, but were not adequate for the transactional economy. 3. More controlled by the government agencies and subject to more interventions from various levels of local and central government agencies 4. A long hierarchy of bureaucracy, it was not flexible in decision-making 5. Because of its long history, they had to shoulder heavier burden of retirees' pensions 6. DAP products were only one of many areas of the company's product lines; not enough attention would be paid to Philips' products	1. A newly established retailer that combined many small state-run stores 2. Weak financial strength 3. Not much experience in retail or wholesale on a large scale 4. Little experience with DAP products

Table 3. Per Capita Disposable Income in Shanghai (1990-1999)

Year	Annual Disposable Income Per Capita (unit: yuan*)	Growth over previous year
1990	2181	/
1991	2486	13.98%
1992	3009	21.04%
1993	4277	42.14%
1994	5868	37.20%
1995	7172	22.22%
1996	8159	13.76%
1997	8439	3.43%
1998	8773	3.96%
1999	10932	24.61%

* Inflation unadjusted, 1 US $ 8.3 yuan in 1998. The annual CPI inflation since 1996 was low, between -1% and less than 2%.

Table 4. Sales by Different Types of Domestic Retailers in Shanghai (1990-1999)

Unit: 100 million yuan

Year	Retail Sales of Consumer Goods by All Types of Ownership	By Type of Ownership									
		State-owned Retailer		Collectively-owned Retailer		Jointly-owned Retailer		Privately-owned Retailer		Other Retailer*	
		Sales	%	Sales	%	Sales	%	Sales	%	Sales	%
1990	333.86	179.37	54%	115.59	35%	2.05	1%	16.17	5%	20.68	6%
1991	382.06	200.25	52%	135.30	35%	2.75	1%	18.70	5%	25.09	7%
1992	464.82	247.68	53%	157.56	34%	5.75	1%	22.88	5%	30.95	7%
1993	624.3	295.96	47%	205.30	33%	0.51	0%	30.00	5%	92.53	15%
1994	770.74	326.94	42%	256.16	33%	0.64	0%	47.04	6%	139.96	18%
1995	970.04	409.90	42%	302.79	31%	0.86	0%	55.32	6%	201.17	21%
1996	1161.3	454.28	39%	350.15	30%	30.10	3%	67.04	6%	259.73	22%
1997	1325.21	534.94	40%	385.03	29%	21.83	2%	83.14	6%	300.27	23%
1998	1471.03	590.92	40%	417.01	28%	36.79	3%	91.88	6%	334.43	23%
1999	1590.38	626.33	39%	441.83	28%	nil	/	102.16	6%	420.06	26%

* Other retailers refer to the ownership type that is different from all the four types listed in the table. A predominant example is where a state retailer subcontracts a part of the retail entity to an individual (including its employees), who is subcontracted to pay a defined amount of profit to the state retailer. The individual operates the subcontracted part of the retailer just like a privately owned retailer.

Figure 1. Conventional Distribution System in China up to the mid-1980s