



**The Fresh Food Business:
Spurring the 'Local Community'
Trend Forward**



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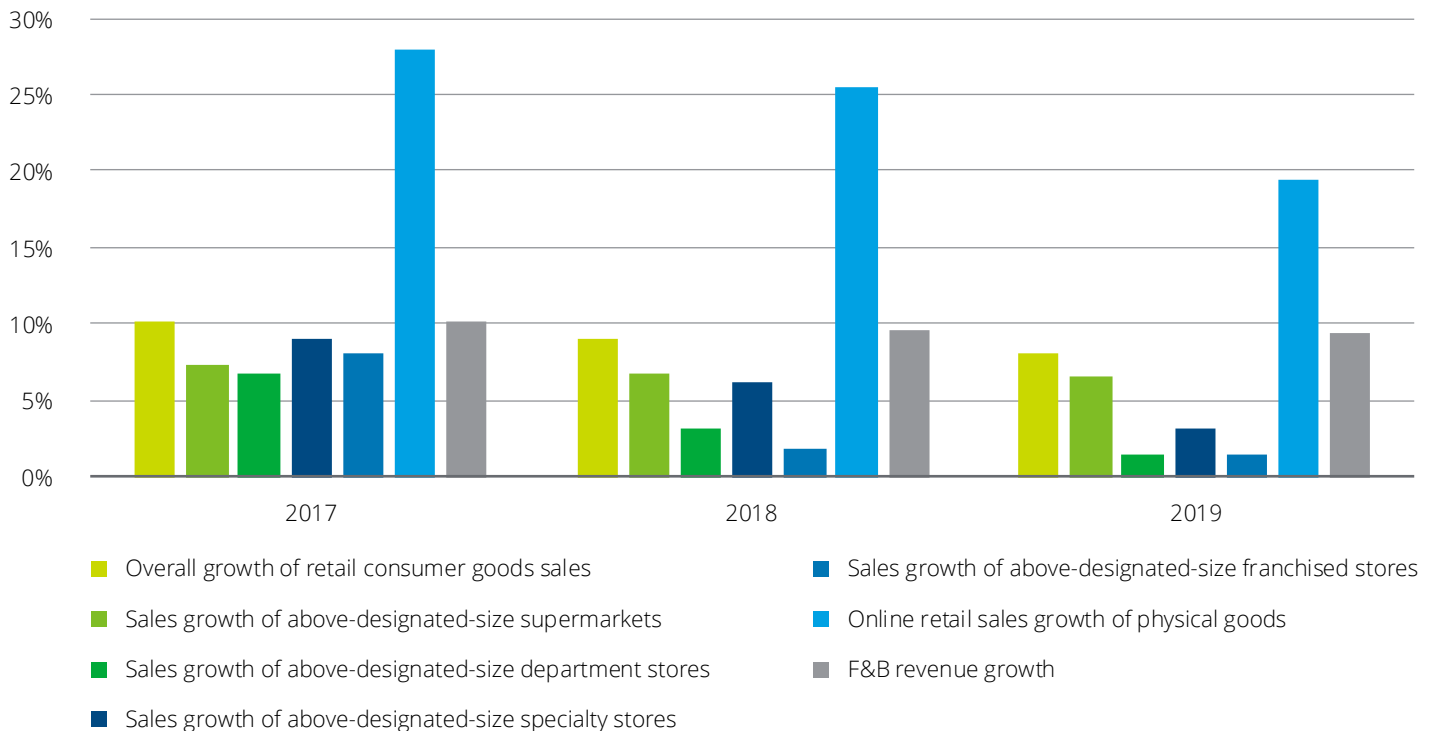
The COVID-19 (novel coronavirus) outbreak since Chinese New Year has been a particularly direct and damaging headwind for China's consumer sector, its largest contributor to growth, as shown in halved estimates for February 2020 consumer goods sales and dampened future growth predictions. On the basis of this new, challenging environment, a conservative downward revision of estimated consumer goods sales growth in 2020 has been adjusted to 6.5%.

Suspensions in food and beverage services related to the coronavirus have directly and negatively affected overall growth in the retail goods market, most profoundly in the F&B

and physical retail segments. F&B revenue grew 9.4% and accounted for 11.3% of total retail sales in 2019, but will be encumbered by heavy losses in physical retail as a result of the epidemic. Physical retail dominated consumer goods revenues in 2019 with 68% of total sales, but the severe impact of the virus on more than half of physical retail businesses will have significant effects, including on specialty and franchised stores across the grocery, apparel and homeware sectors. Furthermore, the seasonal characteristics of F&B, grocery, apparel and other specialty and franchised stores would seem to dissuade hopes of any post-epidemic "retaliatory rebound" in industry consumption that might make up for these setbacks.

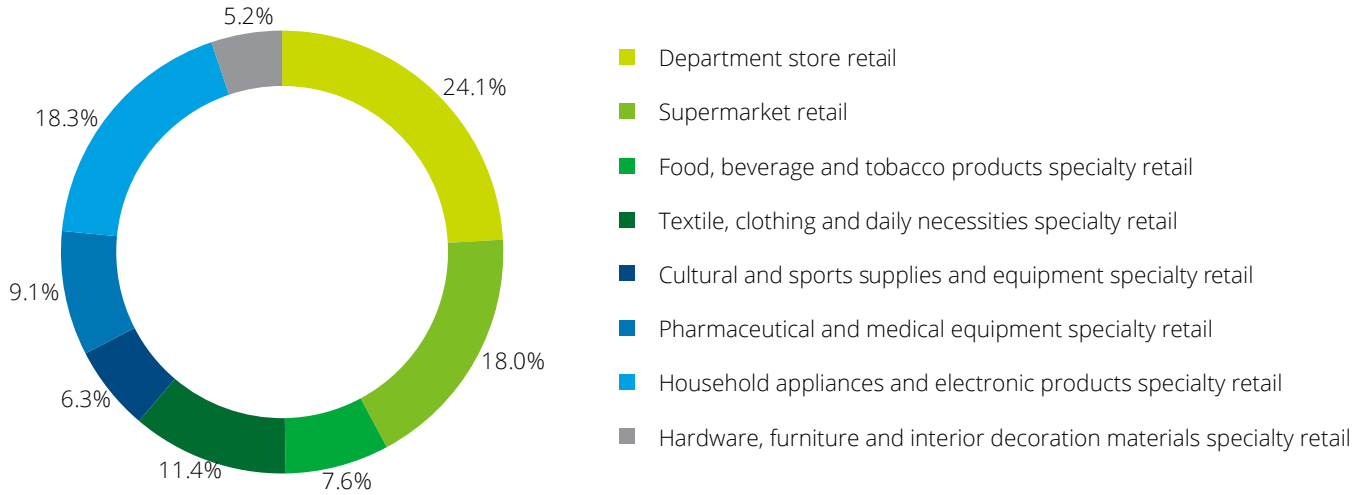
The outbreak continues to impact industries and businesses attempting to resume normal production, particularly F&B and physical retail, which appear to be experiencing a much slower recovery than that of online retail, which has already returned to a semblance of normality. This is most probably because physical retail tends to involve potentially crowded public spaces, i.e. a greater risk of infection. The physical retail industry is also making a significant shift online in search of new sales and services, which happens to coincide with a broader trend towards remote, "cloud-based" employment.

Figure 1: Retail, Food & Beverage, 2017-2019



Source: National Statistics Bureau, Deloitte Research

Figure 2: Sales revenues, major offline retail sectors, 2018



Source: National Statistics Bureau, Deloitte Research

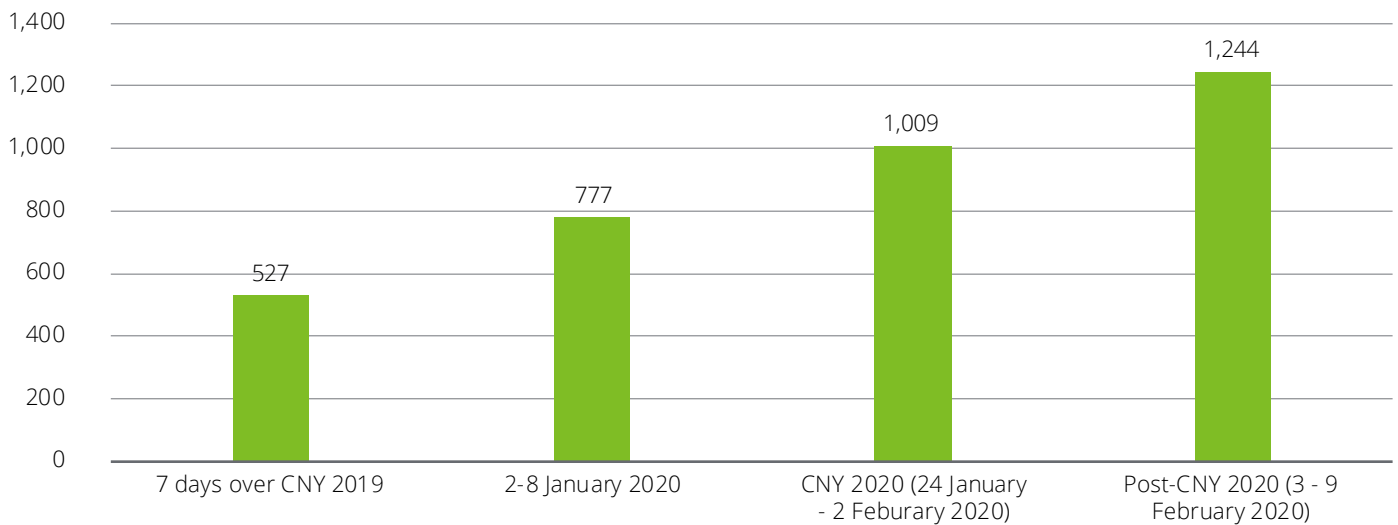
The epidemic has greatly boosted demand for contactless payment methods and, increasingly, new channels such as online-offline fresh food and food delivery. Online consumption actually grew amid the

overall downward, with a particular surge in online sales of fresh food, which has proved to be an enormous hit with consumers. Indeed, fresh food e-commerce statistics from Questmobile indicate the sector

enjoyed 10+ million daily active users (DAUs) over the past Chinese New Year versus 5 million in the equivalent period in the year before the outbreak.

Figure 3: DAU growth, fresh produce e-commerce

(unit: 10,000 people)



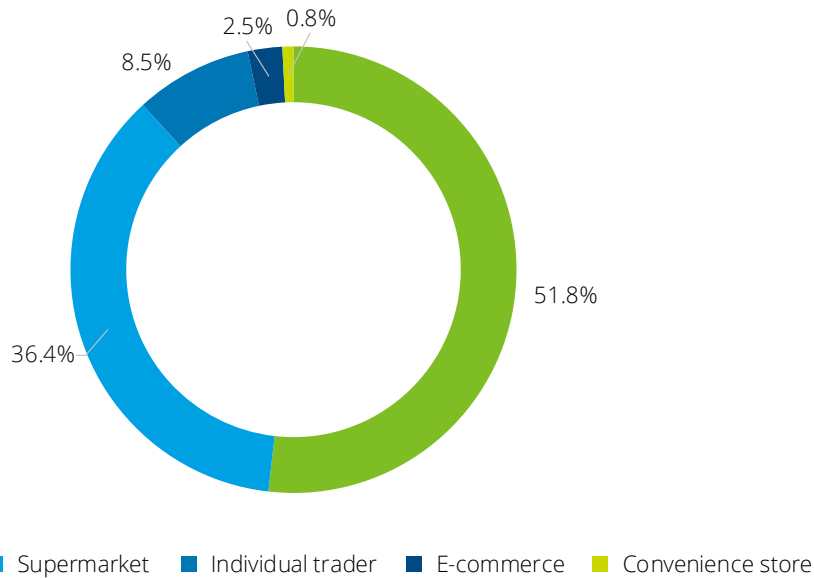
Source: Questmobile, Deloitte Research

Fresh products can be viewed not just as a daily necessity for consumers, but for the industry itself, given their inelastic demand and short shelf lives lend themselves to a high frequency, low price per transaction and low gross margin model. Chinese consumers are now buying fresh produce across two main channels:

The first is offline distribution by traditional farmers' markets and supermarkets, which are still the main venue in which Chinese consumers are buying fresh products. Statistics indicate farmers' markets account for more than half of the fresh agricultural produce on Chinese families' dining tables. Traditional supermarkets represent the second largest channel for purchasing fresh products, at

36.4% of the total, partially on account of recent, urbanization-related government policies such as the so-called "Vegetable Basket" initiative to phase out farmers' markets in favor of supermarkets. Analyses of fresh food consumption in China highlight the importance of several demographics, particularly often highly price-sensitive middle-aged and elderly groups.

Figure 4: Agricultural products in China, channel distribution, 2019



Source: data.iimedia.cn, Deloitte Research

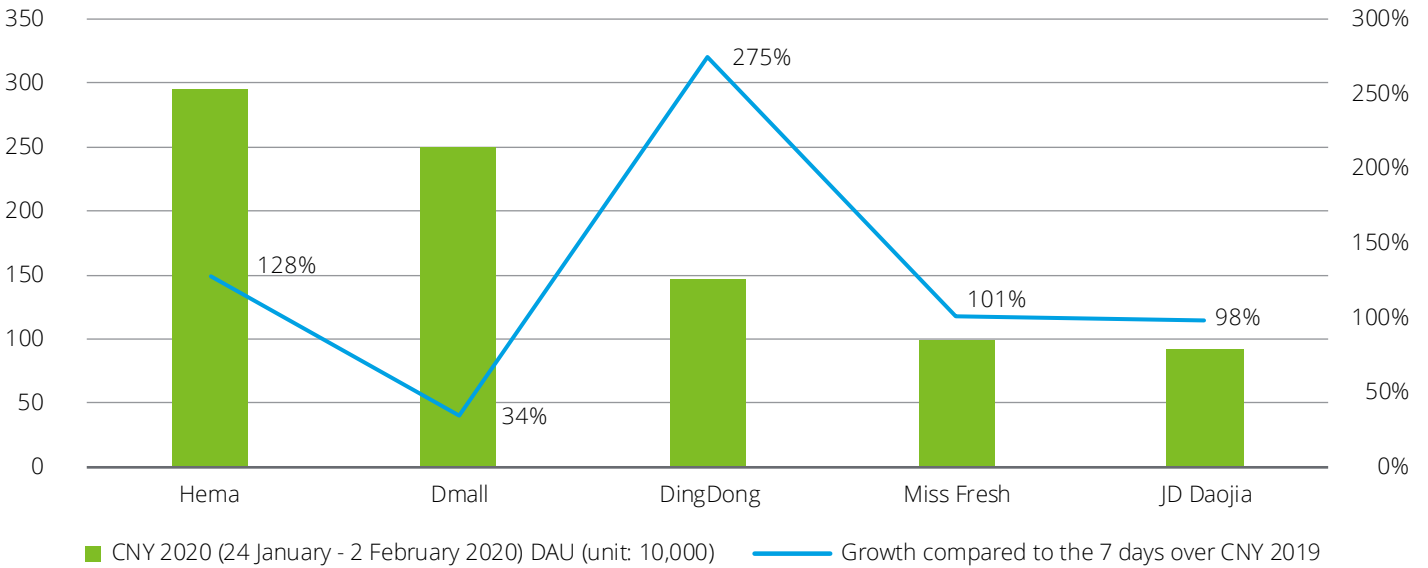
The other main channel is innovative fresh food sales powered by internet technology and capital investment. Five years of development has seen innovative fresh food business expand into new formats across a multiplicity of sales venues, such as "distributed warehousing", online-offline e-commerce + supermarket and

"neighborhood purchasing". These innovations in fresh food retail also happen to have seen the most rapid growth since the epidemic broke out, and their potential for further development is highlighted by the fact that fresh food e-commerce currently makes up just 2.5% of overall distribution in this segment. A common

thread uniting the new models has been their proposed means of overcoming the roadblocks—such as dispersed upstream production, lengthy distribution chains, high loss rates, quality issues and a lack of convenience and flexibility—faced by offline bricks and mortar channels.

Figure 5: Top 5 fresh produce e-store apps by DAU, CNY 2020

(Unit: 10,000 people)



Source: Questmobile, Deloitte Research

Figure 6: Innovative sales models, fresh produce

	Pros	Cons
Distributed warehousing	<ul style="list-style-type: none"> • Direct connection between place of production and consumers; • Reduced loss rate • Quick and convenient, short distribution range 	<ul style="list-style-type: none"> • High upfront operating costs • Highly affected by logistics and supply chain
O2O E-commerce + Supermarket	<ul style="list-style-type: none"> • Flexible capital distribution • Extensive store network • Strong supply chain merchandising capabilities • Fast delivery - usually within 1 hour or within the day 	<ul style="list-style-type: none"> • High stock organization load in peak times; labor intensive • Often deficient in-house logistics systems; reliant on distribution platforms
Neighborhood fresh food buys	<ul style="list-style-type: none"> • Consolidated community resources, precise procurement, low loss rate • Neighborhood proximity 	<ul style="list-style-type: none"> • Simplistic supply channels, heavily dependent on farmers markets; • Greatly reliant on supply chain and logistics

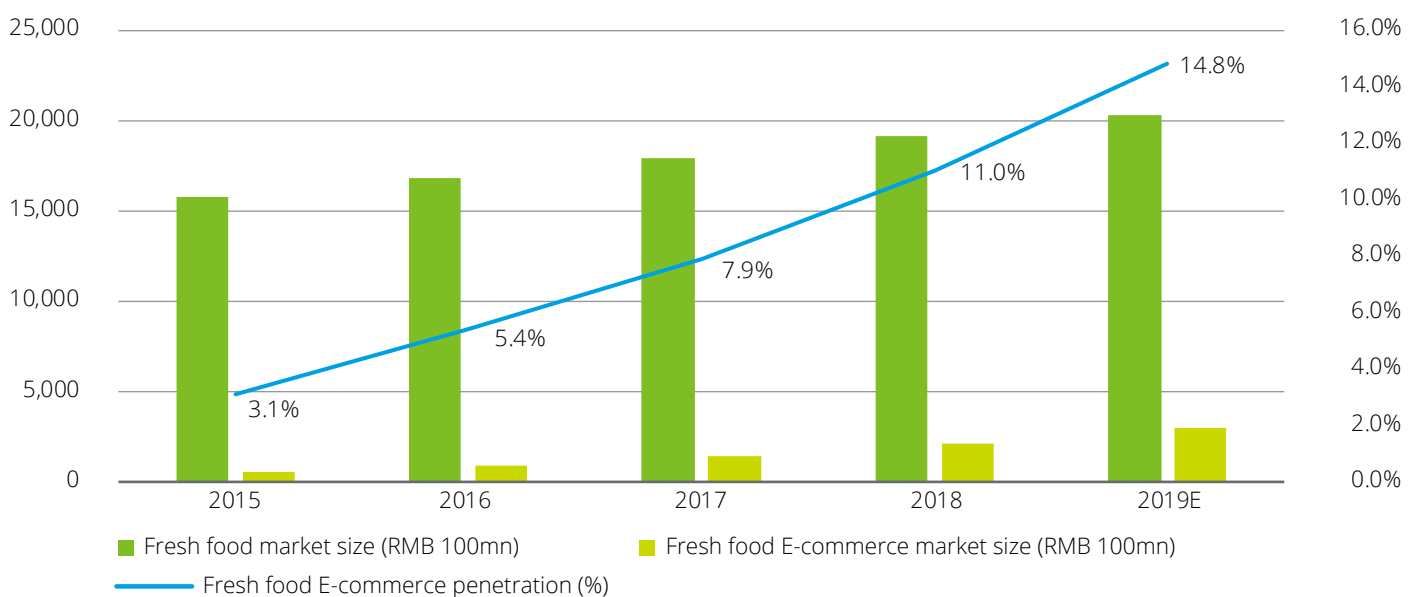
The challenge for these new models is to resolve logistics, supply chain and cost issues while mastering customer retention and order conversion

These innovative models tend to underperform in supply chain and logistics management. Indeed, reduced costs, which are supposedly achieved by building greater supply chain capabilities, are a core competitive argument in favor of fresh food e-commerce. E-commerce players cannot operate on a direct purchasing system without sufficient control of their lengthy supply chains. A surge in buyers was bound to have posed challenges for their supply chains, distribution, manpower, and payment days. Also, their appeal is likely to fade when the strain of logistics and traffic disruptions ease as the outbreak moderates. To continue their growth after the outbreak, fresh food e-commerce and neighborhood players are likely to need to familiarize themselves much more with direct procurement processes, as well as with running upstream procurement teams and proprietary logistics

networks. Distributed warehousing models, proprietary cold chain logistics networks and third-party cold chain partnerships would also be well-advised to utilize cold chain logistics technology throughout the distribution process to reduce loss rates and operating costs.

Second, demand for online fresh could decline after the outbreak. Fresh food e-commerce merchants stumbled upon a large number of new users in a short time during the initial outbreak and containment of the virus. Nevertheless, although the fresh food market in China is quite mature, its e-commerce segment still has a relatively low penetration rate (14.8%). The outbreak could end soon without lasting changes in daily consumption habits, and if it does, then this will likely involve the return of many price-sensitive consumers to their more typical purchasing venues.

Figure 7: Size of the fresh food market



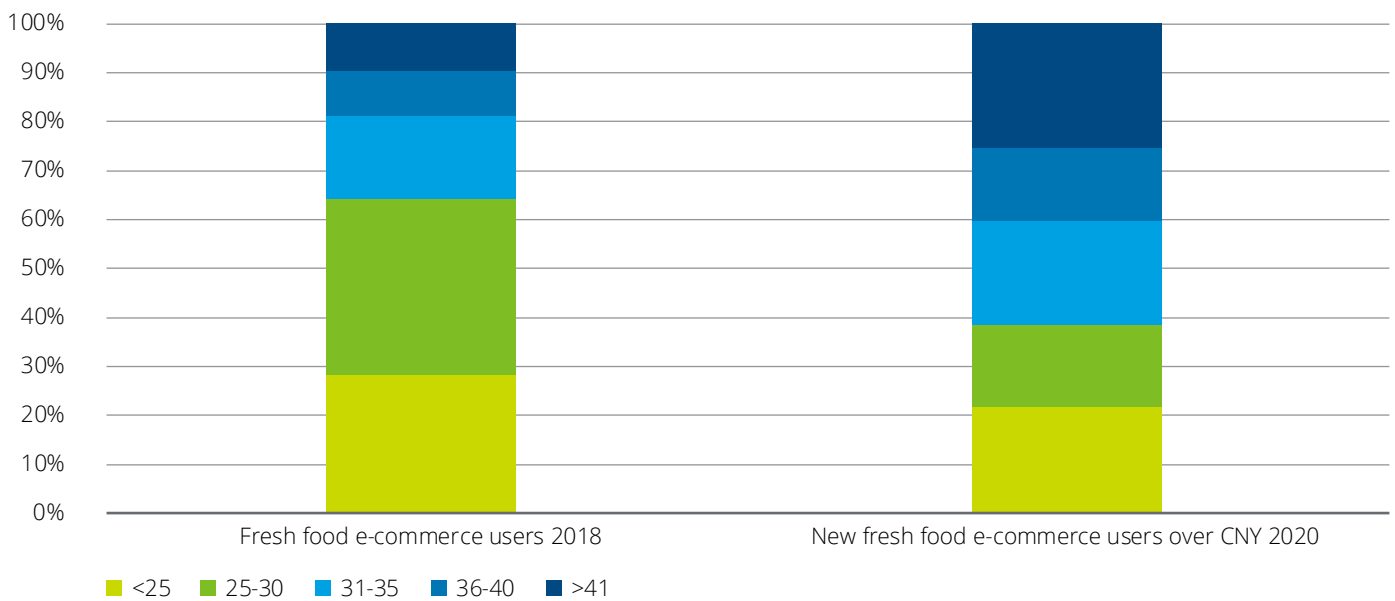
Source: Sootoo Research

Fresh food e-commerce has seen rapid uptake by the middle-aged and elderly during the outbreak. They now constitute a much larger share of this segment, although it is still dominated by Gen Y consumers (those born in the

1980s and 1990s). Over 41s accounted for 25.4% of new users during the 2020 Chinese New Year, more than Gen Y, according to Questmobile data. Elderly residents appear more price-sensitive when purchasing fresh produce, a

'lifelong habit' that is reflected in many areas. Therefore, it is reasonable to suppose that a portion of new elderly users will return to traditional purchasing avenues after the outbreak.

Figure 8: Fresh food e-commerce users by age group



Source: data.iimedia.cn, Questmobile

In addition to price-sensitive shoppers, fresh food e-commerce also seems to hold significant appeal for middle-aged, elderly, and Gen Y consumers who can afford premium services. These consumers place particular importance on safety, hygiene, convenience and the e-shopping experience, and are expected to remain fresh food e-commerce users after the outbreak is over. Fresh food e-commerce players would do well to manage this user group with finesse and aim for their long-term retention.

Cost control is another important area of concern. High loss rates, expensive logistics and low gross profit margins have been an ongoing challenge for the fresh food e-commerce segment since its inception. Indeed, fresh food enterprises (including online-offline, e-commerce and community players) have fought very hard to maintain stable procurement, logistics, personnel and other costs despite benefiting from an enormous inflow of orders during the outbreak. Fresh food enterprises will need to plan better and

increase products' added value, e.g. by cleaning or otherwise processing vegetables, to boost gross margins.

The fresh food e-commerce segment has the distinction of being the most important, sophisticated exemplar of the "trend toward community". As a mainstay thereof, it is working to further steer the retail industry towards a tighter community focus through innovative sales models.

Fresh food business: driving community-based retail development



The ranks of community-based retail services include many categories in addition to fresh produce, such as deli foods, cosmetics products and maternity products, as well as local lifestyle services. The underlying logic of the community-based business model is founded on the convenience of online ordering and offline home or store delivery services. This is quite a new business format that takes care of “the last mile” in catering to consumers’ increasing need for convenience. The retail industry more widely is evolving to offer new community-based business formats through innovative models that are similar to those in fresh food e-commerce:

- Innovative community-based home or store delivery: utilizes the community presence of traditional supermarkets. The main players include Yonghui Mini and Suning Xiaodian. Orders have surged during the outbreak, supported by strong supply chain and logistics capacities. Apart from a focus on fresh products, the standard SKUs are similar to those of traditional convenience stores.
- Community group purchases: an emerging community shopping model on top of the “WeChat ecosystem” that leverages the combined resources of multiple communities and groups to provide daily necessities and services. Major players include Shixianghui, Nicetuan and FRXS.
- Unmanned retailing: a “smart vending machine” model based on artificial intelligence (AI). AI is used to automate many simple retail tasks, including stock replenishment, and damage to goods is reduced by 95 percent. Unmanned delivery has also entered the public eye since the epidemic broke out, particularly “last mile” deliveries to targeted communities. Retail giants including Meituan and Suning have started to experiment with “contactless delivery” using unmanned delivery robots.
- Community mall: Hema launched “Hemali”, a community-based shopping mall, which aims to digitally recreate the goods and services of a traditional shopping mall and offers F&B, marketplace and offline lifestyle services.



The distance from communities and doorsteps to the modern retail industry's manifold offerings will continue to shorten as consumers prioritize convenience, instantaneity and the shopping experience. Indeed, the value of online-offline fresh food and other community-based consumption venues has been amply demonstrated during the outbreak as the industry continues to develop rapidly towards community-based retail.

Digital transformation has allowed traditional supermarkets to move closer to their communities.

Traditional supermarkets, already challenged by softening growth, have learned a valuable lesson about the great potential of online consumption during the outbreak. They are more motivated to expand their ranges of online, standardized services. Many players in have been putting substantial emphasis on the home delivery side of their businesses,

particularly chain-style, community-based fresh food and convenience services. Yonghui, an operator of traditional supermarkets, has entered partnerships with community property managers; Wumart and DMall have teamed up to launch community service stations. Community-based consumption plus online technology could become a major new area of market expansion for traditional supermarkets.

Local lifestyle services and delivery businesses will need to adjust.

The evolution of traditional supermarkets will flatten and bring local delivery services closer to local communities. Local lifestyle delivery players, such as Meituan and Ele.me, will need to amend their systems to focus more on efficient, short-distance community delivery and technology. These technological improvements, such as the optimization of unmanned vehicles, will increasingly deliver the "last mile".

E-commerce giants will compete for access by building a greater presence in communities. The outbreak is highlighting the importance of community-based group purchasing as a consumer nexus. Most of these group purchases now occur on community services within the WeChat ecosystem, which aggregates vast user traffic. In a bid for access, e-commerce giants are investing more in community-based group purchase services and related businesses. For example, Hema has already launched community-based group purchase trials, and is looking to establish its own community ordering system, to close traffic loops in its ecosystem.

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