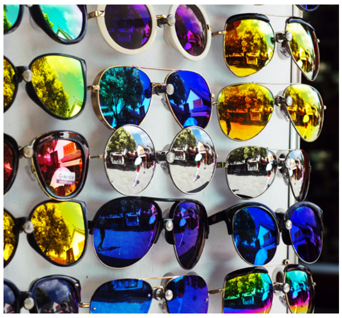
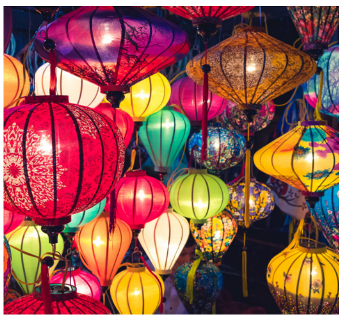
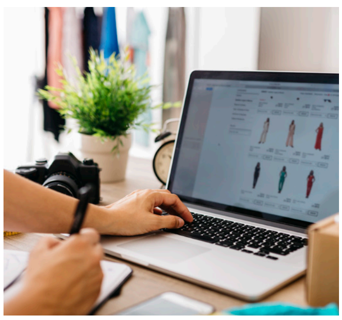
Navigating the distribution channel options for consumer products in China







With around 1.3 billion potential consumers, foreign investors have long considered China to be an important retail market. However, despite a relatively comprehensive set of national rules governing distribution activities, China is best thought of as a combination of many smaller markets. Consumer tastes and preferences vary from region to region, and logistics costs may make it hard to establish and maintain a nation-wide distribution network. Getting the right commercial operations in place is crucial for success. But without solid legal foundations, commercial success can be very short lived.

This article explores the different models for selling your products in China (including through cross-border e-commerce) and navigates you through the legal and regulatory regimes on product distribution in China.

Models for product distribution in China

Chinese law does not require a foreign manufacturer or reseller to have a presence in China in order to sell their products in China. Products, whether imported or manufactured locally, can be sold by third-party distributors or agents in China or cross-border. Having a presence in China, however, does increase control over the distribution network and allows for greater levels of aftersales service.

The distribution models available in China mainly include:

- Appointing a Chinese distributor – Entering into a distribution contract with an onshore distributor to distribute products through its sales network in China.
- Commercial agents – Appointing commercial agents to promote products and introduce buyers, with sale being made directly with the buyer. Commercial agents can be useful, whether products are manufactured in China or imported.
- Establishing a Chinese trading company – Establishing your own trading subsidiary in China for distribution of the products.
- Franchising – Entering into a franchise agreement, authorising Chinese franchisees to use the registered trademarks, logos, patents and know-how owned by the franchisor in exchange for royalties.
- Cross-border e-commerce (B2C) – Sale of products via online e-commerce platforms, with products delivered to Chinese customers through courier or postal services.

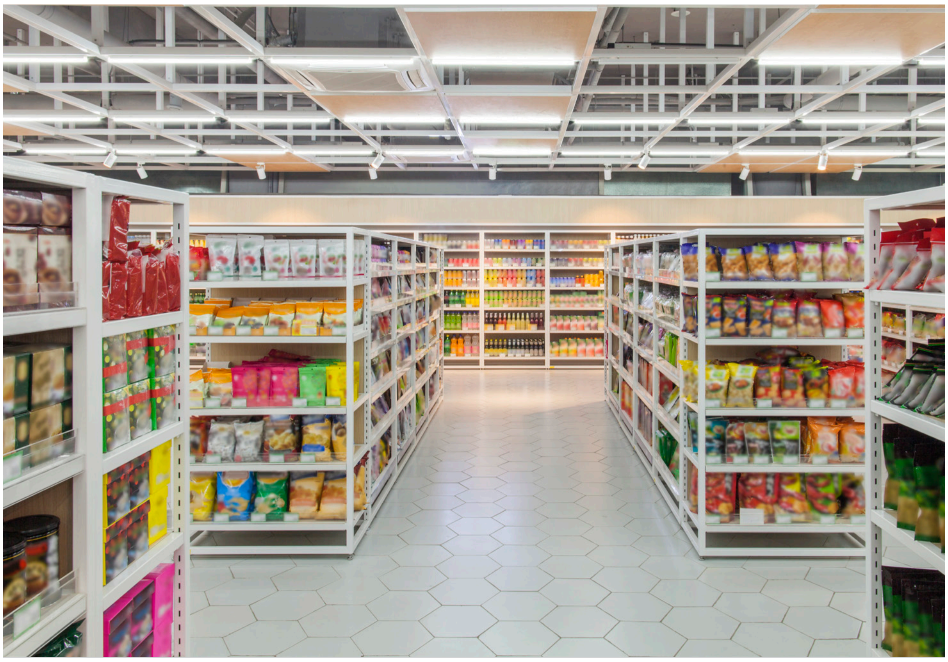
Both commercial and legal considerations must be taken into account in determining which model, or combination of models, is most attractive for any particular product.

Agents and distributors

Commercial agents in China typically promote products, introduce potential buyers and facilitate sales. They will not generally have the right to bind the principal. Rather, their role is typically just to find and introduce buyers. The resulting sales will occur directly between the principal and the buyer, with the commercial agent collecting a commission fee.

Where the products being sold are those of a foreign company or its affiliate, it may establish a representative office to facilitate sales. Alternatively, an independent third-party may be appointed as a commercial agent.

It can be difficult for a foreign company, and even for a foreign invested enterprise (**FIE**) in China, to ensure that a commercial agent markets its products appropriately and respects the seller's intellectual property and goodwill (which can end up attaching to the commercial agent rather than the seller's brand). The foreign seller may also have difficulty effectively prohibiting a commercial agent from engaging in unethical business practices. Where an affiliated representative office or an affiliated commercial FIE is appointed as the commercial agent, this would give greater protection to the foreign seller's intellectual property rights and goodwill.



The typical wholesale distributor in China buys and resells the products to retailers or other distributors. Many Chinese distributors cater to the distribution of foreign products.

Practical tips

China is a very big market, comprising multiple regional and local markets, each with significant variations. This means that it is very unlikely that any principal will find a commercial agent or a wholesale distributor with sufficient reach and competency to properly service the entire China market. While it is not uncommon for an agent or distributor to request rights covering the whole of China, overseas sellers generally achieve better results by appointing a commercial agent or distributor for particular provinces or regions of the country only.

Care should also be taken to properly vet an agent or distributor before it is engaged. We recommend that:

- Legal due diligence is conducted to ensure that the agent or distributor is duly established and in good regulatory standing. This must include Chinese-language due diligence. It is not unheard of for a foreign company to contract with a Chinese company that uses an English name only to find out when a dispute arises that the company doesn't actually exist.
- Commercial due diligence is carried out to establish whether the agent or distributor is a reputable business partner. This should also cover its key employees. You would want to know, for instance, if either the company or any of its key employees had a track record of misusing intellectual property rights.

Whichever commercial agent or distributor is chosen, the engagement agreement should provide maximum contractual protection in respect of the products and business of the seller. This includes contractual prohibitions against the agent or distributor engaging in bribery and other un-ethical practices. Having suitable governing law and enforcement provisions can be critical to a properly functioning agreement.

Setting up your own trading company in China

It is common for a foreign company to establish a trading company in the form of a foreign-invested commercial enterprise (**FICE**) when it has reached a certain level of success in selling to or trading with China, or simply where it prefers to have an on-the-ground presence in the country.

A FICE is permitted to import goods to China to sell directly, either in wholesale or retail. Establishing a FICE allows for a more direct relationship with Chinese suppliers and customers, stronger control over the distribution network, and also opens to the possibility of warehousing in China. A FICE is also permitted to engage in franchising and to take part in transactions on the basis of commissions.

Governmental filings and registration are required to establish a FICE, which generally take around two to three months.

Compared to an agency or distributorship model, setting up your own trading company in China will entail higher cost. You will need to bear the costs of, among others, incorporating and operating the trading company, developing and expanding the local distribution network and carrying out marketing and advertising.

Franchising

The franchising model, which allows franchisees with limited capital to be part of an established business, is well suited to a developing economy like China. However, foreign franchise brands have been facing fierce competition in China in recent years. In early 2017, McDonald's sold the 20-year franchise of more than 1,750 restaurants in mainland China and Hong Kong to a Chinese consortium, highlighting the challenges faced by foreign franchise brands in China. That being said, the huge consumer market in China is too great to ignore. Foreign franchises in sectors such as food services, business services, hotels, education and real estate are necessary to fill the needs of China's fast-growing middle class.

To establish a franchise in China, a franchisor must have an operating history of at least one year in China, operating at least two directly-owned shops in China and be the owner of a PRC registered trademark or other operational resource.

The franchise agreement provides the control over the franchisee by setting out the rights and obligations of both the franchisor and franchisee. The cost for the franchisor of launching and maintaining sales and distribution operations (save for the investment in marketing, training and advertising) are far less as compared to those for establishing a proprietary distribution network. However, the franchisor will have weaker control over the distribution network and will also lack any direct customer relationships which are developed and maintained by the franchisee.

Cross-border e-commerce

China's e-commerce sector is a major driver for retail growth, with China already the world's largest e-commerce market. Domestic e-commerce platforms such as taobao.com, tmall.com and JD.com have flourished. Cross border e-commerce is also booming, with overseas sellers increasingly using online platforms to export and distribute their products into China.

A number of options are available to access China's e-commerce market:

- Direct sales to consumers from foreign-based e-commerce platforms. Under this model, overseas sellers target individual consumers in China without setting up a website or operations in China. Individual consumers in China access foreign e-commerce platforms and buy goods via those platforms. The goods are then shipped into China directly to the customers. In practice, PRC customs only conducts random inspections on such shipments. The effect is that goods are often (but not always) imported without customs duties being charged. This model, however, is facing increasing regulatory challenges with the Chinese government strengthening the regulation of such sales.
- Setting up a shop on a Chinese e-commerce platform. This involves registering a shop on an existing e-commerce platform in China. Sales are conducted over that platform, with the goods being physically distributed in accordance with the overseas seller's usual practices.
- Setting up a shop on a Chinese e-commerce platform with bonded goods in China. This model works similar to the previous option, except that under this model, goods are held in stock in China in certain bonded zones (including China's FTZs) by third-party logistics service providers. The goods are stocked in bonded zones in China before any order is made and are shipped from the bonded zones to the consumers directly when they make their orders via the e-commerce platform. This results in shorter waiting times for consumers, and lower international logistics costs.

In March 2016, the Chinese government issued a series of new rules to regulate for the first time cross-border e-commerce. These include, among others, the issuance of "Positive Lists" which set out the scope of products that can be imported through e-commerce platforms and the introduction of new tax rules applicable to products imported via these platforms. The new rules also tighten the inspection and quarantine requirements for bonded goods and clarify certain registration procedures (in particular with respect to food and medical products) that must be completed before products can clear customs. Whilst regulation has been tightened, China has enacted the E-Commerce Law (which came into effect on 1 January 2019) to encourage cross-border e-commerce in general. This includes, among others, improving the administrative process such as customs, tax, quarantine and payment procedures.

As China shifts its economic focus from export to consumption, there are ample opportunities for foreign companies to enter this booming retail market. However, there are also many challenges given China's unique business and regulatory environment. Businesses are recommended to seek professional advice when analysing their distribution options in China to ensure the most suitable option is selected for the size and nature of their business.

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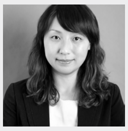

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This briefing is part of our Future of Consumer series on upcoming issues affecting the Consumer Sector. For other briefings in this series see the Future of Consumer pages of our website or contact Rachel Montagnon.

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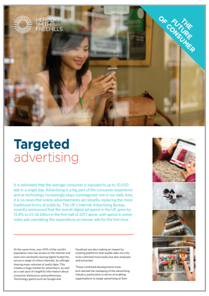

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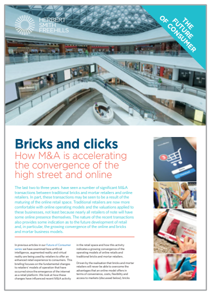

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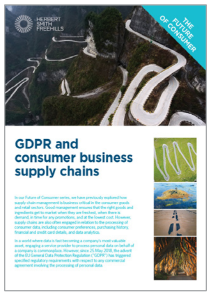

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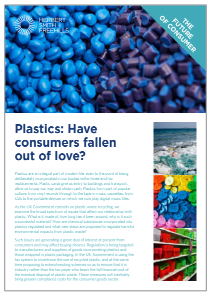

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