FSSA Investment Managers

Client Update

China's e-commerce companies are eating the big grocers' lunch

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The country's biggest bricks-and-mortar grocery chains are fighting back against online competition.

The pandemic has accelerated certain long-term shifts in consumer behaviour, such as using more online orders for everything from clothing to food. The latest battleground appears to be groceries, but the disrupter emerged from a not-so-new technology – WeChat groups.

China's online e-commerce giants such as Meituan[1] and Pinduoduo are now taking market share from the traditional grocers via community group buying (CGB), which began only four years ago and went mainstream during Covid-19. In this form of e-commerce, leaders of WeChat groups – or other platforms which recently entered the market – collect orders and have the goods delivered the next day to pick-up spots in their members' communities. In between, the orders are aggregated by the platforms and transmitted to the upstream suppliers which deliver the goods.

This offers many long-term benefits for platform companies – a sticky user base, last-mile delivery for fresh groceries, and penetration into lower-tier cities. But the downside is the price competition that has heated up, causing margins to be minimal or even negative in many cases.

At first, three start-ups – Xingsheng Youxuan, Nice Tuan and Tongcheng – emerged as regional leaders. By the middle of 2020, this model gained wide adoption after meeting consumers' demand for fresh groceries during the lockdown. That's when Didi, Meituan and Pinduoduo entered the market with significant financial backing, making the landscape more challenging for all players.

We are also watching the traditional grocers, which are investing into technology and fighting back as the new underdogs. These include Yonghui and Sun Art, two of China's largest retail supermarket chains.

For **Yonghui**, new CEO Li Songfeng brings a technology background, having joined earlier this year as Chief Technology Officer after 10 years at JD. This shows the company's focus is on technology going forward, as it aims to increase digitalisation to a level close to e-commerce platforms. Besides digitalisation, management's main goal this year is to bring back lost traffic.

Management is also experimenting with warehouse membership stores, a concept similar to Sam's Club and Costco in the US. In Fuzhou where the company is headquartered, management converted 50 supermarkets into warehouse membership stores. As a result, Fuzhou's same-store sales accelerated but at the expense of margins.

What's encouraging is that the chairman bought significant shares in the open market recently, and has plans to buy more. The company has also been buying back and cancelling shares. In our view, this shows confidence in company's outlook, or at least alignment with shareholders.

In the case of **Sun Art**, management will continue to open new stores despite the challenging environment. Both mini stores and supermarkets are currently loss-making, while hypermarkets are facing a big profit decline.

Alibaba seems to have taken the driver's seat following its majority share purchase a year ago. Sun Art's digital transformation was given a boost from the resources and technology in Alibaba. For example, all of Sun Art's physical

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stores in China have been integrated into Alibaba's Taoxianda and Tmall Supermarket platforms, providing one-hour and half-day on-demand delivery.

New CEO Lin Xiaohai came onboard after being a Vice President at Alibaba. Out of the four non-independent directors, three are from Alibaba. While many grocers have received investments from the internet community (Tencent bought a 5% stake in Yonghui in 2017), Sun Art has embraced the motto, "If you can't beat 'em, join 'em."

Keeping an eye on sector consolidation

The competitive environment remains tough for food retailers due to intense competition from CGB, and there are even signs of consolidation among CGB players. For example, Tongcheng Life filed for bankruptcy this year and other companies are reducing their investments and laying off employees. However, internet giants such as Pinduoduo and Meituan continue to ramp up investments. Reported investments add up to RMB 100bn, which give these CGB platforms a big stomach for eating losses. As a result, price competition remains heated.

Despite gaining market share in online groceries, there have been numerous headwinds for the internet companies this year. There are also regulatory risks for the CGB model, from an anti-monopoly standpoint, so the tide is still shifting.

Looking ahead, Yonghui is still a highly competitive food retailer in China and has a big advantage in fresh food supply chain; however, we think it's too difficult to invest now with the disruption from CGB. Similarly with Sun Art, we prefer to stay on the sidelines but are keeping an eye on the sector.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 31 October 2021 or otherwise noted.