An Overview of Mobile Phone Distribution Channels in China

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1 China Mobile Phone Market

China is now the largest market for mobile phones in the world. According to MII, by end of 2002, the number of mobile phone users rose to 206.616 mln, an addition of 61.394 mln users during the year, with a penetrate rate of 16.19%. The Ministry of Information Industry (MII) predicts that the number of mobile phone users is likely to surpass those of fixed-line telephone users by 2004. However the speed of growth has slowed over the last two years and the market has entered into a steady and mature stage.

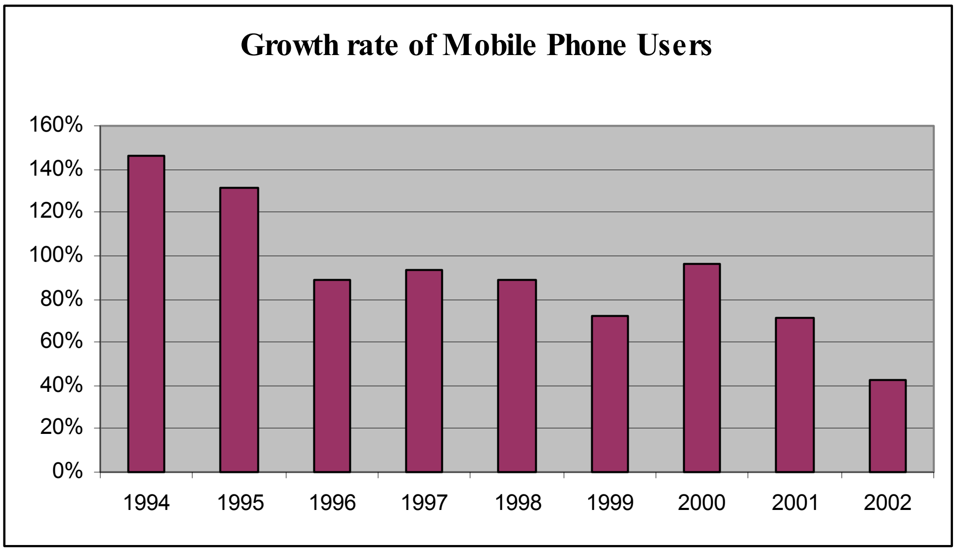

Chart 1. Growth of Mobile Phone Users in China (1994 to 2002)

Data Source: MII, 2003

By end of Nov 2002, the total sales volume has reached in total 113 mln units, including both GSM and CDMA phones. According to MII statistics, the latest ranking of handset sales volume in China by end of 2002 is as follows: Motorola, Nokia, Bird, TCL, Siemens, KeJian, Amoisonic, Konka, EastCom (Samsung is excluded due to problem with statistics). Motorola still leads the market (66%), far ahead of Nokia (18%) and Bird (10.4%).

Most of the handsets manufactured are sold in China. In 2001, 67% were sold at home, 31% were exported and only 2% remained as stock. However due to increasing overcapacity of production, exports have been increasing in the last year and reached 45% in 2002.

In terms of geographical distribution of sales, the share of Eastern China is 62.7%, Central China 19.3%, and Western China 18% in 2002 (see Chart 2). However recent trends show that the market share of Eastern China is decreasing, while those of Central and Western China are rising. Some estimated that mobile phone subscribers will reach about 360 million with an annual increasing rate of 26.2% by the end of 2005, of which 24.5% will be in the eastern provinces, 26.7% in medium provinces and 31.6% in western province.

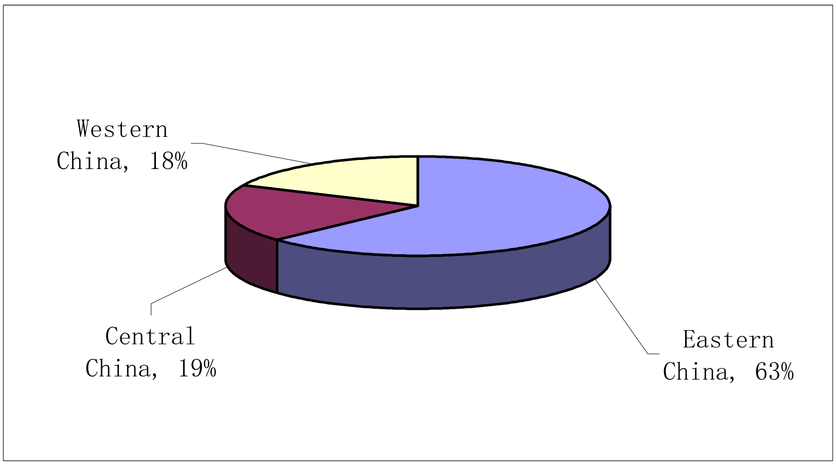

Chart 2. Geographical Distribution of Handset Sales

Data Source: ***CCID 2002***

2 Classification of Current Handset Distribution Channels

The distribution/retailing channels discussed in this section are mainly used by JV brands such as Motorola and Nokia and Chinese indigenous brands. Imported brands will be discussed later in the report.

There are mainly three categories of distribution channels.

2.1 Conventional Handset Distribution Channels

This category covers first tier distributors, including handset retailers, specialist handset distributors, specialist handset agents, and operator outlets. They are acting as main forces of handset distribution, amounting to total 82% of sales in 2002 (see Chart 3). Most agents or distributors often handle more than one handset brand. For example, Shanghai CellStar International Trading Co., Ltd. deals with many handset brands.

2.2 Conventional IT Distribution Channels

This category refers to the IT products distributors, who distribute all kind of IT products, such as computers, printers, and routers, etc. These types of distributors have their systematic distribution channels. With their increasing understanding of China handset market, distributors such as Digital China (a member of Legend Group) and Ingram Micro China (a subsidiary of Ingram Micro) are becoming more powerful in distributing handsets through their existing channel coverage. This category has accounted for 6% of total sales in 2002.

2.3 Household Appliances Chains

This category, consisting mainly of household appliances chains, have wide geographical coverage, can hold large stock, operate flexibly, enjoy direct interface with end users, and make flexible pricings. Thus they have been the emerging force in handset distribution. Well-known examples are GoMe Household Appliances and SuNing Household Appliances.

Chart 3 presents the proportion of handset sales volume sold by different channels in 2002 (data by June 2002).

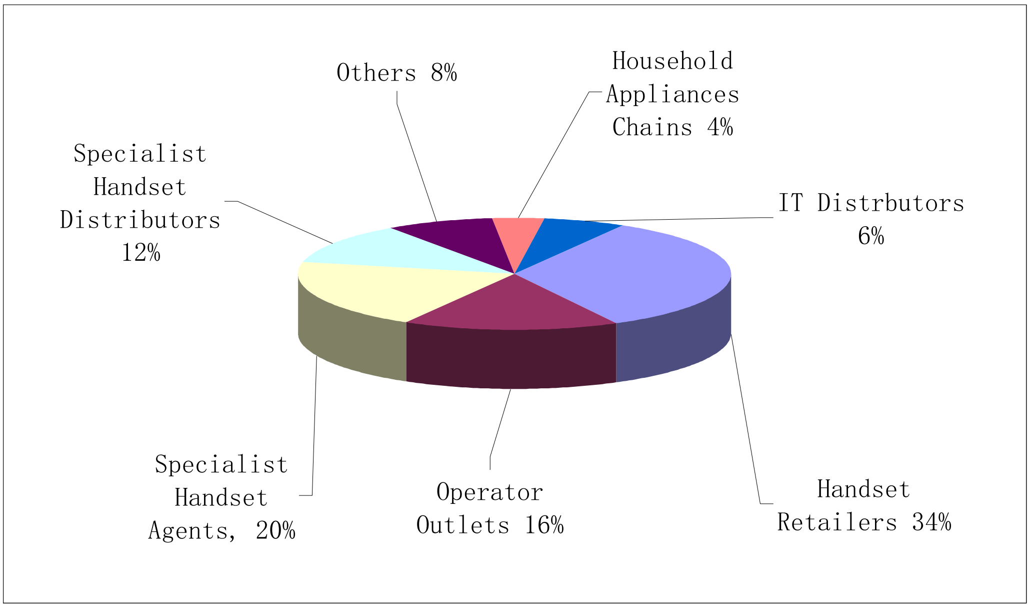

Chart 3. Distribution of Sales among Major Channels

Data Source: CCID, June 2002

Note: The "Others" category in the chart includes retail supermarkets, handset supermarkets and on-line handset shops, etc.

We can see that handset retailers account for the largest share (34%), followed by specialist handset agents and specialist handset distributors. Household appliance chains only account for 4%. However, as we will discuss later, the trend is now changing and these chains are taking a more important role in the distribution business.

2.4 Number of Distributors/Retailer

There is no authoritative statistics as for the total number of handset products distributors and retailers. There are only roughly 30 large handset distributors in Mainland China, including chain distributors such as Shanghai CellStar, China Everbright Telecom, Beijing Zoomflight Telecom, and China Motion Telecom, and original computer and network products distributors such as China Digital. On the other hand, some large handset agents hold a rather significant market share. One example is that 3 national general agents, China Postel Mobile Communications, Chinatelling Communication. and ChangYuan Telecom hold a combined market share of over 50% among all handset agents.

If we look at the number of distributors or agents per handset manufacturer, there are usually only one or a few general agents for one manufacturer, but there are many more at the second tier. Household appliance chains and retail stores make up the greatest part of handset selling terminals. According to the estimation of Motorola China, there are roughly 150,000 retailing terminals around China, but that differs greatly from that by some other manufacturers, whose estimates are low as 100,000 or even below. The general feeling is that the number may be more than common perception.

3 Operations of China Handset Distribution Channels

3.1 Inter-Channel Relationship

The operation of handset distribution channel mainly involves flow of capital, logistics, business flow and information. The operation of handset distribution channel is different from that of other IT products mainly in its relationship with operators. The relationship is illustrated in Chart 4.

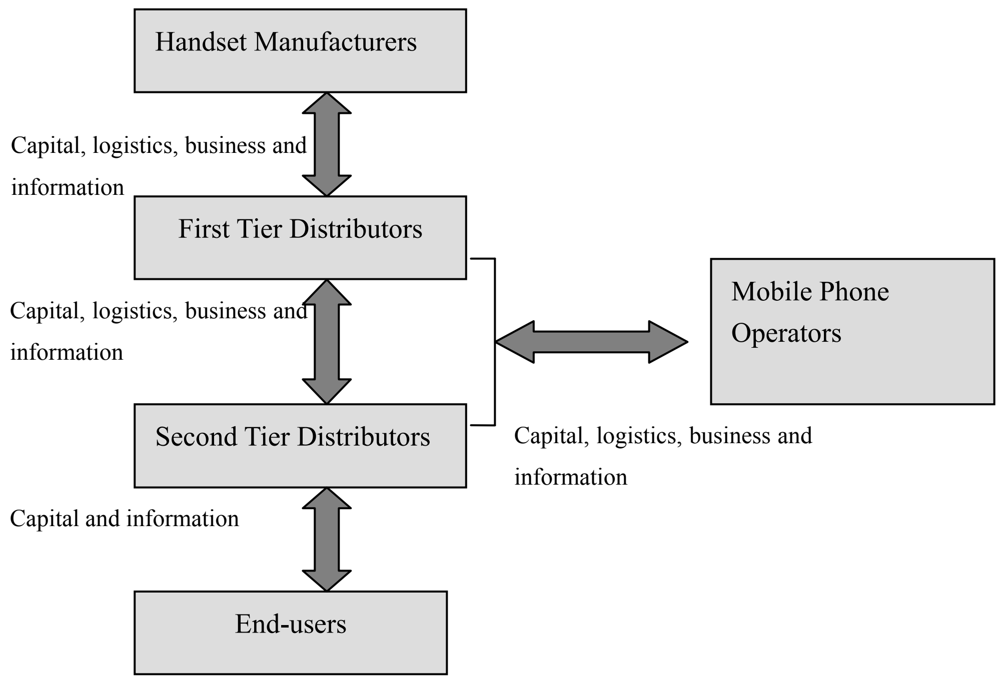

Chart 4. The operation of handset distribution in China market

Handset retailers not only sell handsets, but also provide network connecting services to customers through selling SIM cards on behalf of mobile phone operators. Specifically, for those services that require less complicated procedures to connect, such as prepaid services (e.g. *Shen Zhou Xing* Card issued by China Mobile, *Ru Yi Tong* Card issued by China Unicom), customers mainly choose operators through buying communication cards offered by these operators.

SIM cards are classified into pre-paid cards (similar to "pay-as-you-go" type in the UK) and traditional SIM cards (similar to contracted type). The pre-paid cards are issued by operators to end users directly from operators' outlets and also to handset retailers through wholesalers. The traditional SIM cards, known as GoTone Cards, are only issued by operators directly. For this type of card, the user must be a local resident (with local ID) as the user pays a fixed monthly fee plus calling charges at end of each billing period (a month).

In China, mobile handset manufacturers cannot sell domestically unless they have been granted a Network Access License. For example, although Benq (formerly Acer) manufactures over 4 million units of handsets in Suzhou, China, it fails to obtain the Network Access License and therefore has to export all handsets. In a recent meeting held by China Mobile Communication Association in Ningbo, over 10 electronic appliances manufacturers (including Ningbo Sanxing-Aux and Guangdong BBK Electronics Communication) expressed their wish to obtain Network Access licenses.

When promoting a new technology or service, mobile phone operators often adopt bundled service packages alongside handsets. Specifically, such services can be available only on some newly released mid to high-end models. For example, the CDMA services provided by China Unicom and GPRS services provided by China Mobile are all sold through such a method. In such cases, operators order handsets directly from manufacturers, bundle them with the new technology or services they wish to promote, and then sell them to end users from their own outlets.

3.2 Distribution Modes for GSM Handsets

In China, the use of handsets distribution channels is closely related to the stage of development of telecommunication operations.

The development of GSM technology is comparatively advanced, and telecommunication operators are experienced with managing GSM services, therefore the corresponding distribution channels are also relatively mature. The common channel mode for GSM handset distribution is shown in chart 5.

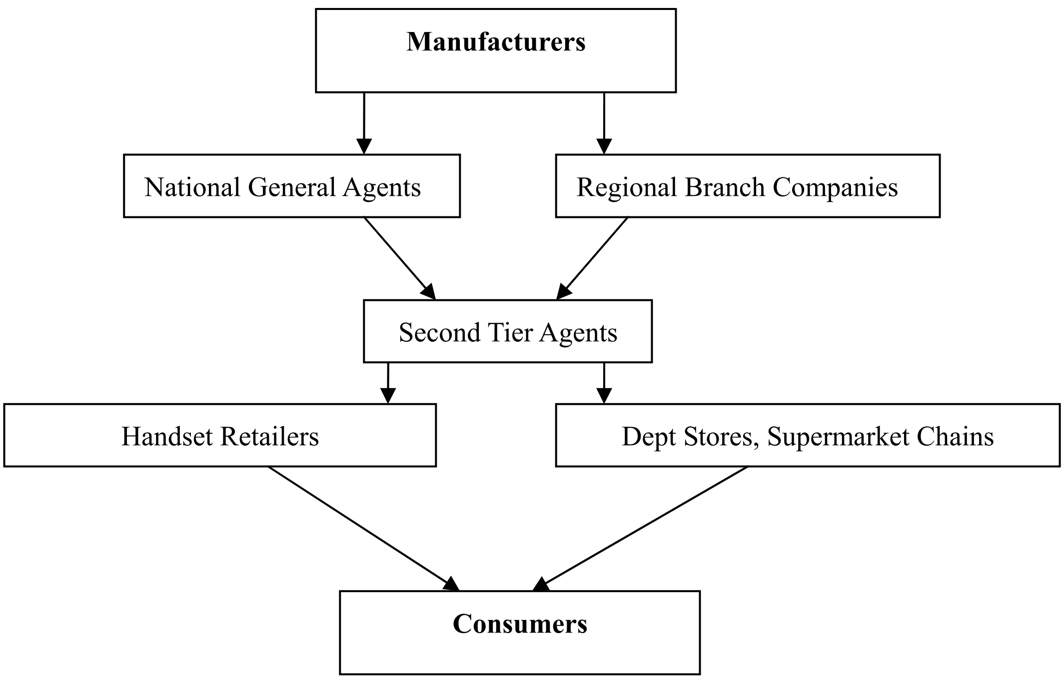

Chart 5. Common Distribution Mode for GSM Handsets in China

Notes: National General Agents include conventional handset distributors, conventional IT distributors and household appliances chains.

3.3 Distribution Modes for CDMA/GPRS Handsets

While the technology of CDMA & GPRS is relatively immature, the corresponding telecommunication operation business has not fully developed in China. Their distribution channels are still being improved. Operators play an important role in handset distribution of such types of handsets. For example, China Mobile has been dominating the mobile market sales with GSM handsets. As a late comer in this market, China Unicom is seeking an opportunity to catch up and exceed China Mobile's market share by being actively involved in promoting CDMA handsets. The common mode for CDMA &GPRS handset distribution is shown in chart 6.

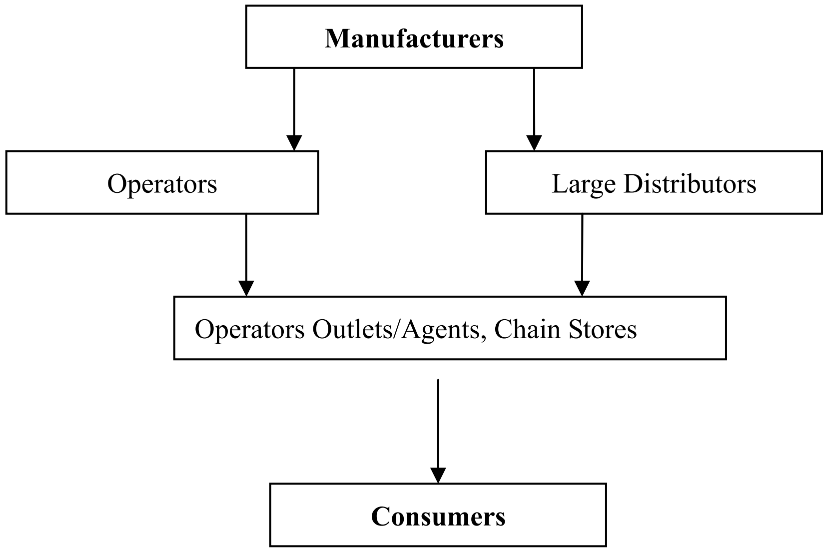

Chart 6. Common Distribution Mode for CDMA&GPRS Handsets in China

Notes: Large distributors refer to large specialist handset distributors/agents and the conventional IT distributors. Chain stores here refer to their subsidiaries.

However, it is worthwhile to point out that there is a trend to go for a flatter channel mode for all types of handsets, with household appliance chains joining in the distribution market. In particular, CDMA & GPRS handsets' distribution channels are comparatively more simplified than GSM handsets, and are mainly controlled by large specialist handset agents or distributors.

4. Characteristics of Handset Distribution Channels in China

4.1 High-end versus Low-end Handsets

Generally speaking, high-end handsets and low-end handsets share the same distribution channels. While household appliance chains sell both low-end and high-end mobile handsets, specialist handset retailers sell higher end handsets.

4.2 Major Cities versus Medium-to-small Cities

While branches and agents of handset manufacturers are well presented in central areas of almost all major cities, specialist handset retailers and house appliance chains have expanded to most medium-sized cities and even counties, most of which are associated with operators. Chains of the large specialist distributors are densely deployed in the major cities.

4.3 Rural Areas

Due to the great income gaps between urban and rural areas in China, penetration rate of handsets in rural area is much lower than that in urban areas. Rural market is mainly in the more developed regions including coastal areas and rural areas close to big cities.

In rural areas, people generally go to nearby towns and counties to buy handsets. Similar to the distribution channels in cities, distribution channels in rural areas are classified into three types: operators' outlets, specialist handsets retailers, and department stores / retail supermarkets. Most people tend to buy handsets through the former two types of channels.

4.4 Regional Differences in Distribution Channels

Due to regional differences in consumption pattern caused by the imbalance of economic development, the characteristics of handsets consumption are also different across regions. Manufacturers and general distributors use different strategies accordingly in their channel development. For example, Digital China classifies the geographical market into the following 4 categories. This classification is now generally adopted by many other national general distributors.

- The first category includes metropolitans such as Beijing, Shanghai and Shenzhen, where chain retailing industry is well developed and the structure of distribution channels is very clear. In such areas, general distributors usually sell directly to chain stores (no second tier agents involved).
- The second category of areas includes provinces such as Shandong and He'nan, where population is large and there are over 10 big cities in each province. Two thirds of these cities have significant sales volume. In these provinces, there are no or very few powerful agents at provincial level, but strong local agents at city level. Taking He'nan Province as an example, there are agents in Kaifeng City, Luoyang City and Zhengzhou City mainly covering each city and surrounding areas respectively. The general distributors deal with each city-level agents separately.
- The third category refers to provinces where the sales volume is quite large but mainly concentrated in one or few big cities. For example, the sales volume in Xi'an, the capital city, stands at 70% of the total sales in Shannxi province. General distributors normally use a few key agents in one or two key cities to cover the nearby market.
- The fourth category of areas covers those provinces with small sales amount and great geographical difficulties in distribution, including Hainan, Qinghai and Tibet. In such provinces, general distributors usually use just one provincial agent.

5. Evolution of Handset Distribution Channels

Generally, the harsh competition in China mobile phone market has prompted manufacturers and distributors to seek a way of simplifying the channels. Meanwhile, chaotic situations like many agents fighting for one brand, no regional division of rights and lack of consistency in pricing are gradually being displaced by finely segmented and simplified distribution system with region-specific and brand-specific agency system. Regional exclusive agency system have started to become prevailing, and many city or provincial agents no longer procure handsets from national general agents but directly from handset manufacturers.

The channels used are different for the big foreign brands that are manufacturing in their China JVs, i.e. Motorola and Nokia, and domestic brands like Bird, and again for imported handsets like Samsung. We will look at each of them in the following sections.

5.1 Big Foreign Brands

Most of the multi-tier channel system we discussed before is applicable to the big foreign names that manufacture in China, i.e. Motorola and Nokia. However both companies are said to be seeking to restructure their distribution channels, by abandoning the original national general distributor system and using provincial distributors. In particular, Nokia has expressed that it would increase investment in distribution network in 2003.

5.2 Domestic Manufacturers

Bird is a good example to look at how domestic manufactures have developed their distribution channels. Before 2000, the market share of domestic handset brands was so tiny that large distributors basically ignored them and focused on foreign brands such as Motorola, Ericsson and Nokia. As a result, domestic brands had to develop their own sales/distribution network.

In 1999, Bird started by distributing through mainly regional exclusive agents and target at secondary or third-tier market that were mainly ignored then by foreign brands. It adopted ‘closed agency covering small areas’ system, - using many local agents in one city/province with each owning exclusive rights in a dedicated sub-market. No cross region sales are allowed. By end 2002, Bird has 28 branch companies and 310 offices in China, spreading over all big and medium-sized cities and most small cities, managing nearly 50,000 retailing terminals. It has established customer service centers in all branches.

Bird’s sales strategy of “countryside surrounding cities” (a famous quote of Mao Zedong) worked well – it saw its market share increased greatly in 2002 to become the largest indigenous handset manufacturer in China in terms of domestic sales.

Bird’s distribution model has become common for other Chinese manufacturers to compete with big foreign brands. Because this model is flatter, more profit room is available to distributors and retailers and hence better incentives to sell domestic brands than foreign brands. Apart from this, closer personal relationship between domestic manufacturers and distributors also contributes to success.

After more than 2 years’ efforts, domestic handset manufacturers have dramatically expanded their market share to over 30% by end of 2002 and in some western cities, their market share is as high as 50%. Although marketing costs keep soaring in such a competitive market, sometime accounting for 10% of sales revenue for new entrants, domestic manufacturers are not willing to give up efforts to maintain the distribution channels that they have developed from scratch. In fact, they put more bet on distribution channels in the hope to further grow their market share to over 50% in 2003. For example, taking the number of staff engaged in distribution as a proxy of investment, the average number of staff engaged in distribution in a domestic manufacturer is typically 10 times that of Nokia China, while the number of Motorola is 3 times that of Nokia.

5.3 Imported Handsets

Among the imported brands, such as Samsung, NEC, LG, Phillip, Samsung has the biggest market share and therefore is used as an example in this report. Samsung sells its CDMA handsets in China through its joint venture with Chinese manufacturer Kejian. However they could not do so for GSM handsets. When Samsung handsets first entered China market, all GSM production licenses had been assigned already. Samsung had to enter China market by importing.

Currently Samsung has two Hong Kong agents to distribute its products in China. One is EZCom Holdings, which sells Samsung handsets through its subsidiaries in mainland China, EZCom New Technology. EZCom owns a sales network covering 37 major cities in China, and has developed relationship with 30 distributors and 2500 retailers. Another agent is York International Holding, whose sales amount in 2002 is near RMB 5 billion with a profit RMB 500 million from Samsung handsets distribution.

Samsung announced on January 1st, 2003 that Samsung has obtained production license in China for GSM handsets. Samsung will be able to distribute within China its GSM handsets made in its production base in Tianjin. Samsung China has mentioned that they would use Chinese agents to distribute Samsung handsets.

One of the reasons that imported brands use Hong Kong distributors is related to import procedures into China, which are complex and operate in a strict regulatory environment. Hong Kong companies are typically more experienced in dealing with such areas.

5.4 Role of Super Household Appliance Chains

According to China Postel Mobile Communications, one of the largest mobile phone agents in China, 2002 was the year when the greatest changes happened in China mobile handset distribution network. Before 2002, handsets were mostly sold through conventional handset distribution channels and household appliance chains’ share was insignificant; but during 2002, the number of specialist handset retailers, which had been increasing in years before, has first started to decrease, while the number of household appliance chains, such as SuNing and GOME, has seen a rapid increase.

We use SuNing as an example to show the increasingly important role of such chains. At the beginning of December, 2002, SuNing Appliances invited 10 handset manufacturers including Motorola, Siemens, Alcatel, Konka, Kejian, Haier, Panda, Amoisonic, TCL, Bird, and of 3 large handset agents to Nanjing and signed purchasing contract amounted to RMB 2 billion.

SuNing stated that it regards mobile phones as one of the pillar products in 2003, and would aggressively pursue exclusive selling rights for many brands. Meanwhile it would make bulk purchase in order to lower the cost and will reduce the retailing price by 10% to 20% or even 30% for some products for which it has exclusive selling rights. SuNing's target for handset sales this year is 2 to 2.5 billion RMB, which is 20% of the total target sales this year.

It is shown in SuNing's purchasing list that low-end handset with price below RMB1200 (roughly US$145) accounts for 25% in the total planned purchasing amount, and high-end handset with price over RMB 2200 (roughly US$265) also accounts for 25%. Among the high-end handsets, Color Screen, GPRS, CDMA handsets and other newly released model are the focus of purchasing. In the meantime, the purchasing amount of middle end handset with price between RMB1200 and RMB2200 is 50% in the total planned purchasing amount.

According to a statement by Sun Wei-min, the vice president of SuNing, the main purpose of SuNing's bulk purchasing is to rectify the handset distribution channels and to enhance the entry barriers for handset distribution industry through improving the cooperation among manufacturers, agents/distributors and retailers.

6. Trends of New Handset Distribution Channels

The mobile handset distribution channels in China will be more diversified and more integrated in the coming two years. The channel will also become flatter and the operational efficiency and management of channel will be improved.

Some people think there will be more specialist shops selling special purpose handsets, e.g., clock and watch shops may sell handsets with watch shape, jewelry shops may sell handsets enchased with jewelry, sports shops may sell handsets designed for mountain climbing or swimming.

In metropolises such as Shanghai and Beijing, on-line handset sales channels have been developing rapidly. Low price is the main reason that has attracted customers to buy on-line. There are three kinds of on-line handset suppliers: handsets manufacturers, handsets agents and other internet retailers. Motorola have a special handsets sales website 18900.net dedicated for China market and is the leader in this area. Internet retailers are gaining more and more acceptance from consumers and many have joined the on-line handset sales business, including leading internet portals such as sina.com, sohu.com, 163.com, and B2C websites such as Eguo, EC123, ENet, and handsets specialist B2C companies such as 5291.com.

At the time of the report, no distributors are selling their own branded handsets yet in China. This may well present potential opportunities with low cost handsets.

-End of Report-

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