COMPETENCE CENTER CHINA

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for Swiss SMEs

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Distribution in China Series – Exclusivity in Distribution

INTRODUCTION

CASE

RECOMMENDATION

Exclusivity in Distribution – finding the right way to your Chinese customers

Looking to China as a rapidly growing market – both for B2C and B2B businesses – is a trend that is expected to further intensify, in line with the optimistic words uttered by president Xi Jinping at this year's WEF in Davos. Having spent considerable resources on developing the country's infrastructure in the past decades, China seems poised to further facilitate market entry for foreign companies and brands. This allows foreign businesses to tap ever more remote regions and markets where substantial opportunities still loom.

Once the market potential and respective customer segments are identified and the regulations for selling in China in a given product category are well understood, companies devise a marketing strategy to ensure an efficient supply chain, a respective brand awareness and optimal sales revenue. Getting your product to the customer is of vital importance. According to a survey conducted among Swiss enterprises in China[1], 44 percent of respondents consider distribution an important factor for sales success in China.

To that end, collaboration with a local distributor may come in handy or might even be necessary (China's vast geographical span and regional differences mean that distribution remains complicated and localization is a must), as they ideally possess the right market understanding, relevant networks or established distribution channels for a foreign company to benefit from. Owing to the complexity of the Chinese market, such intermediaries may take the form (or a combination of) independent freelancers, agents, distributors/wholesalers/sub-distributors, or retailers until they reach the end-consumer. As shown in our previous newsletter, online distribution (e-commerce) is emerging rapidly as a new alternative, notably also due to the complexity of the traditional distribution channels in the country, but bears its own challenges. Distribution models are also becoming more diversified, including multi-channel retailing and distribution, in a pursuit to lower operating costs and achieve wider customer reach.

Both as a result of fierce competition and often unclear regulations, industry malpractices are commonplace in China. Price differentiation, counterfeiting and inconsistent commercial regulations provide headaches to foreign managers. Cost issues are another concern, with still higher transportation and logistics expenditures than elsewhere.

In this environment, foreign brands and companies need to evaluate how to market their products, and whether to grant national distributorship rights or even exclusivity to a Chinese distributor. The Chinese commercial environment currently still provides a considerable degree of uncertainty. Lacking clarity of the contract terms, not inclusion of certain provisions, incorrect interpretation of the Chinese legal system and the Chinese litigation system are some of the legal issues foreign companies need to find answers for.

An issue of particular concern is the issue of exclusivity. Companies have reportedly been asserted by Chinese companies that Chinese law requires exclusive distribution agreements for entire China between foreign and Chinese companies. However, there is no such exclusivity requirement! Exclusivity might be considered by a company, yet that may not be the best solution, and exclusivity might instead be granted only conditional on the distributor meeting the agreed sales targets. This needs to be clarified in the agreement. Another concern is that a distributor might market and sell competitor products, against which a training clause can be included in the agreement to train the distributor's staff. A further issue concerns the ownership of IPRs, which is also to be included in a distribution contract. Other important aspects are clauses on confidentiality, state and trade secrets, the term and termination circumstances.

As a result, the legal and regulatory situation and restrictions need to be considered and monitored carefully. Import and export licenses are often not held by the distributor, which is why a Chinese registered foreign trade agent is brought in. Customs clearance can be done by the company if it holds a foreign trade license, otherwise a customs broker is used. A commercial agent may be hired, however he would be legally restricted from buying and selling and could only do promotion and introductions. In case a foreign invested commercial enterprise (FICE) is established, the company would be allowed to do trading and distribution without the need of an agent. These issues all need careful attention.

Such clarity is important in a rapidly changing environment in distribution and logistics. With the growing brand awareness of certain brands, companies increasingly tend to remove intermediaries and take more ownership of the distribution model. This further intensifies the pressure on the distributors and forces them to constantly reinvent themselves to still provide an attractive business offering.

[1] 2016 China Business Survey

Captured in the exclusivity trap

A Swiss machine parts producer was told in their meetings with a distributor that he could cover entire China (showing an impressive and aggressive sales plan with shiny double-digit annual growth figures from the first year) and invest considerable sum of money to work in the market (e.g. buying a lot of parts directly after signature to build an initial stock in China) if only he got the exclusivity for selling their brand in China.

Tempted by the ease of the venture and collaboration, the Swiss company agreed to exclusivity for three years.

The down-payment for the first order (much smaller than initially promised, but nevertheless) was settled instantly and the Swiss company sent two pallets of parts to China, happy about this new collaboration and the outlook of the China sales

The import procedure went relatively smoothly, the necessary documents were provided by the Swiss producer to the distributor who handled everything, invoicing however a large amount to the Swiss company to cover import tax and transportation, as this was their understanding of the (needless to say undefined) collaboration agreement. The Swiss company, in view of the long-term collaboration covered the cost. The remaining payment was unsettled

After a year of this collaboration, the Swiss sales team made a visit to the distributor and realized that almost all of the parts were still on the pallets. In extensive talks, the distributor explained that one year to build the market presence was very short and that patience in China was not only a virtue but an absolute must. After another half a year, there was no real improvement still.

In the meantime, the Swiss company got approached by another distributor from another area, much smaller but in the exact same industrial niche. As business with the first distributor was stuck, they made a deal with the new one and sent one pallet to China, however, this pallet with all its items got stuck at the customs for several reasons:

- the first distributor was also the importer, so he registered all parts for the import procedure under his own name and blocked the import of other parts
- neither the new distributor nor the Swiss producer were the brand owner in China, the initial distributor did hold the rights to the brand
- the first distributor claimed and invoked exclusivity and accused the Swiss producer of breach of contract

Be diligent, consider options, know your partner and know what you sign

What this example illustrates well is that before embarking on a China venture, every business should do its homework and develop a solid understanding of the possible threats looming behind such contractual commitments and ramifications. Not knowing your contractual obligations and resulting limitations and then trying to benefit from another distributor when having signed an exclusivity agreement hardly works anywhere.

What it also shows is the importance of clearly defining whom you want to work together with when doing business in China, and how to go about that. First, when deciding to work together with a local distributor, companies are well advised to try to get an understanding of the credentials of a possible distributor, though that might not always be easy. Second, once a distributor is identified, in China it is important to establish a relationship of trust and one based on longer-term considerations (aka *guanxi*).

Most importantly it shows that there is different understanding of exclusivity. Whereas the Chinese side often asks for exclusivity to get a certain favorable gesture from its counterpart, European companies often expect a kind of a reciprocity and higher commitment when granting exclusivity to a distributor. Secondly, exclusivity shall be granted smartly: exclusivities can and should also in China be limited in time and territory, meaning that instead of an exclusivity for China and three years, it might well make sense to limit the exclusivity contractually to the Beijing region and a duration of six months. This way, several exclusivities can be given, comparisons of the different distributors can be made and the risk dependency to one single partner in China can easily be mitigated. Therefore, give limited exclusivities and best couple them with a conditionality of success.

As a general rule one could say: The more leverage you give one party, the more difficult it gets in China. And the more you can control yourself, the easier it gets. If you choose to work together with a distributor, you may well consider a multi-channel strategy in order to avoid putting all eggs in the same basket.

Finally, local knowhow might be an important factor to insource or to gather. Foreign companies often lack the experience, local understanding and resources to successfully tap the domestic potential.

The Competence Center China for Swiss Small and Medium sized companies is a joint initiative of sim (selective international management) Co. Ltd., ZHAW School of Management & Law and Swiss SME China (the representative of SKV in China).

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