

# Regoverning Markets

Small-scale producers in modern agrifood markets

## Innovative Practice

**China**

**Supermarket penetration in rural China:  
the Suguo model and its impacts on  
smallholders and SMEs**

**Naiquan Sang**

Nanjing University of Finance and Economics



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**2007**

## **Regoverning Markets**

Regoverning Markets is a multi-partner collaborative research programme analysing the growing concentration in the processing and retail sectors of national and regional agrifood systems and its impacts on rural livelihoods and communities in middle- and low-income countries. The aim of the programme is to provide strategic advice and guidance to the public sector, agrifood chain actors, civil society organizations and development agencies on approaches that can anticipate and manage the impacts of the dynamic changes in local and regional markets.

### **Innovative Practice**

Innovative Practice is a series of country case studies from the Regoverning Markets programme providing examples of specific innovation in connecting small-scale producers with dynamic markets at local or regional level. Based on significant fieldwork activities, the studies focus on four drivers of innovation: public policy principles, private business models, collective action strategies by small-scale farmers, and intervention strategies and methods of development agencies. The studies highlight policy lessons and working methods to guide public and private actors.

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These are short studies addressing a specific policy innovation in the public or private sector that improves the conditions for small-scale producers to access dynamic markets at national, regional and global level.

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These provide a summary of market changes taking place at national level within key high- value agrifood commodity chains.

### **Policy Briefs**

These are short policy-focused summaries targeted at each stakeholder group.

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## **Summary**

Suguo supermarket is a Nanjing-based local supermarket under China Resources Enterprises – Vanguard Stores (CRE). It has successfully penetrated into the rural areas of the six provinces nearest its headquarters. Consistently ranked in the top ten supermarkets in China over the past ten years, its annual sales in 2006 were Y22.8 billion from all its 1,612 stores. Some 50 per cent of total sales were from rural stores, a feat accomplished mainly by persuading rural cooperatives to become franchises of the supermarket. Using this rural-oriented business strategy, Suguo successfully expanded its market share in the region. It is the main supermarket in Nanjing, with 50 per cent of market share, mainly from more than 400 owner-operated Suguo chain stores in the city. Suguo plans to open 100 of these owner-operated stores in 100 counties around Nanjing, while their rural franchise stores spread into town and villages gradually during the next five years.

This case study of Suguo supermarket is one of 32 case studies of innovative practice in connecting small-scale producers and SMEs with dynamic markets as part of IIED's Regoverning Markets Programme. The case study focused on Suguo's supermarket business model and its impacts on smallholders and SMEs. The innovations in this case are twofold: the supermarket penetrated the rural market by extending its network of stores gradually from metropolitan cities into the countryside, and it expanded its market share by offering franchises to cooperatives. This rural-oriented business strategy had a positive impacts on both production and consumption for smallholders in the region. Chinese Premier Wen Jiabao recommended Suguo supermarket as a successful model and the Chinese television station CCTV broadcast a five-programme series about Suguo model in August, 2005. Inspired by the Suguo model, the Ministry of Commerce has created a project called 'Markets for 1,000 towns and 10,000 villages'. This project aims to open 250,000 chain stores at village level in next three years.

## **Killer facts**

Suguo, a local supermarket headquartered in Nanjing, the provincial capital of Jiangsu, has been moving into the countryside of six nearby provinces since 1998, just two years after its foundation. The supermarket consolidated its headquarters by opening more than 400 owner-operated chain stores of different sizes and reaching different market segments. It then gradually expanded into the nearby countryside by making the cooperatives Suguo franchises. During the past ten years, the supermarket has won more than 50 per cent of the Nanjing market and absolutely dominated the countryside of six provinces, including Jiangsu, Anhui, Shandong, Henan, Hebei, and Hubei. Its sales volume ranks it in the top ten supermarkets worldwide, and it is currently ranked in the top three in China. More than 50 per cent of its sales volume is from the countryside. The small rural chain

stores – county level or below – made up more than 50 per cent of all the supermarket's stores. Suguo supermarket has significantly promoted the production and consumption of the rural areas nearby, for which Chinese premier Wen Jiabao praised them after visiting one of their supermarkets. CCTV ran a series of five programmes on 'Stories from Suguo supermarket' in August, 2005.

The Suguo model has brought positive impacts to smallholders and SMEs. First, it provided opportunities for small traders, the majority of whom are also farmers. These small traders collected fruit and vegetables from the small farmers in their area, usually in the same villages, where trust had been cultivated after a period of unstable transactions. Suguo signed contracts with the small traders, while small traders have oral agreements with small farmers, which significantly stabilize agricultural production. Second, the expansion of Suguo supermarket provided an excellent platform for SMEs, which stimulated small farmers to get into commercial production. SMEs and Suguo established some production bases, which actually promote agricultural commercialization.

The by-products of the Suguo model are very important for China. First, the presence of Suguo in the rural areas could improve the consumption environment, for example by providing genuine goods and a quality shopping environment. This could stimulate rural consumption, a crucial topic in China right now, where exports are increasingly facing anti-dumping and technical barriers. Domestic consumption, especially domestic rural consumption, was identified as the growth point of the current phase. The Chinese Ministry of Commerce has a project called 'Markets for 1,000 townships and 10,000 villages' that aims to open 250,000 rural chain stores in three years (since 2005). This project was inspired by Suguo's experiences. Suguo started with the cooperatives, and made the most of their existing networks as its social capital. However, before being awarded a franchise, each cooperative had to conduct institutional and managerial reforms, which actually promoted the privatization of these cooperatives.

Chinese Premier Wen Jiabao made three recommendations on the Suguo Model. On 29 January, 2002, he wrote that supply and marketing cooperatives should take full advantage of their networks and transform their cooperatives through modernization. Such a transformation is crucial for rural commerce, especially for the supply and marketing cooperatives. The Suguo model is a valuable example. On 13 July, 2005, his second recommendation on Suguo was that retailers be encouraged to explore the rural market, to modernize rural commerce, and to improve the rural consumption environment. Suguo's experience has been recommended. The third recommendation about Suguo, in February 2006, said that urban retailers will be supported in the expansion of their chain store operations into the rural areas. The existing cooperatives network should be fully used to provide farmers with a

convenient shopping environment, and to further establish a modern rural commercial system, such as was done by Suguo supermarket.



Chinese Premier Wen Jiabao visits a chain store of Suguo supermarket



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# 1 Introduction

Nearly three decades of market-oriented reforms and endogenous development of the economy has led China to a new stage of industrialization and urbanization. The result has been rural–urban migration on a huge scale, the emergence of a growing middle-class, changing lifestyles, improved transportation systems, and a maturing agribusiness market. All of these changes are altering food consumption, production, and distribution patterns. Supermarkets have emerged and quickly spread from metropolitan cities to secondary cities and since the mid-1990s even to towns (Hu et al., 2004). This rapid spread of supermarkets is reshaping the way the agri-food system is governed, and supermarkets are playing an increasingly important role in the Chinese agri-food system.

The mainstream literature on supermarkets claims that the rapid rise of supermarkets can bring significant challenges and also potential opportunities for smallholders and small and medium-sized enterprises (Reardon et al., 2003; Boselie et al., 2003). The most critical challenge could come from the shift of supermarket procurement systems away from traditional wholesalers and markets toward specialized wholesalers, preferred suppliers, distribution centres, and even private grades and standards. Large commercial farmers are preferred and contracted as outgrowers, while small farmers may be marginalized if they cannot meet the supermarket’s requirements. This accepted theory has been challenged by other researchers based on field survey data from Greater Beijing (Rozelle et al., 2005). The authors claim that big changes had occurred in the retail industry and between retailers and wholesalers, but that nothing had changed in terms of farm gate procurement, and that the supermarket revolution has had little impact on small farmers.

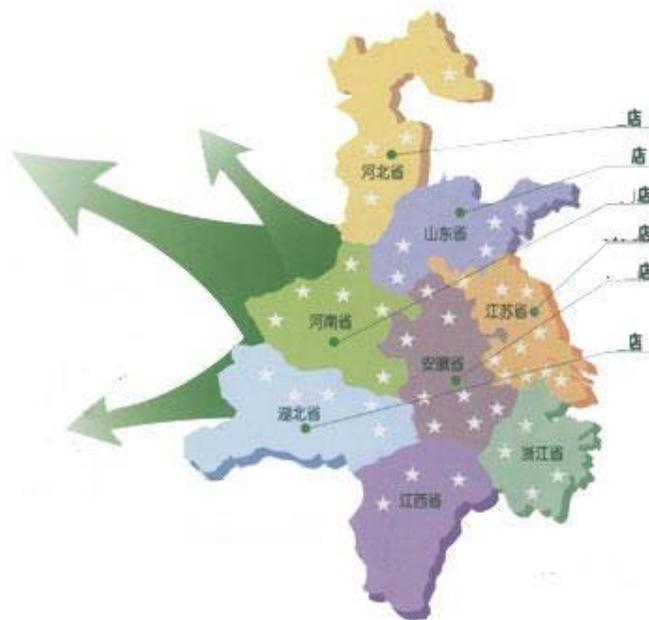
In contrast to these two extreme points of view, this study proposes that the supermarket revolution could have significant impacts on smallholders and SMEs in China if the definition of ‘impacts’ includes both production and consumption effects. We know that procurement is a critical linkage between farmers and supermarkets. However, even without direct contact between supermarkets and farmers, farm production could be influenced by supermarkets through their agents or small traders. The consumption effects are particularly important right now, as domestic consumption has been found to be a new growth point at a time when foreign trade conflicts are intensifying. Based on a study of Suguo supermarket, this report demonstrates that smallholders and SMEs can benefit significantly from the supermarket revolution, especially when the supermarkets penetrate into the countryside.

Section 2 briefly describes the growth of Suguo supermarket and its business strategies. Supermarket penetration into the countryside, the so-called Suguo model, is introduced in Section 3, while the macro and meso context of the innovation is analysed in Section 4. The potential impacts of the business model on smallholders and SMEs is explained in Section 5. Suguo supermarket is compared with the export-oriented food processors in Shandong province in Section 6, and the determinants of extending the Suguo model nationally are studied in Section 7. The report ends with discussions and conclusions.

## 2 The growth of Suguo supermarket

### 2.1 Suguo supermarket's current position

Suguo supermarket is a Nanjing-based supermarket under CRE – Vanguard. It is unusual in that it has successfully penetrated into the rural counties of the six provinces nearest their Nanjing headquarters – Jiangsu, Anhui, Shandong, Henan, Hebei, and Hubei. Since 1996 it has consistently been ranked in the top 10 supermarkets in China. Annual sales in 2006 were Y22.8 billion from all of its 1,612 stores (with 50,000 employees), and about 50 per cent of total sales were from stores in rural areas. Using a rural-oriented business strategy, Suguo has successfully expanded its market share within the region. It is the dominant supermarket in Nanjing, with 50 per cent of market share, mainly from more than 400 owner-operated stores in the city. In 2004, these stores sold Y1 billion of food products such as meats, milk, eggs, vegetables, fruits, seafood, rice, and other grains. Suguo plans to open a hundred owner-operated stores in a hundred counties around Nanjing, while their rural franchise stores will gradually be extended to towns and villages during the next five years.



## 2.2 Regionally intensive development strategy

Suguo supermarket offers a variety of services in each region. In Nanjing this regionally intensive development strategy successfully enabled Suguo to compete with foreign-owned supermarkets. The strategy was then copied in other medium-sized cities, such as Yang-zhou, He-fei, Ma-anshan, Huai-nan, Gao-chun, Li-shui, Jiang-yan, and Bao-yin. Suguo's services include:

**Convenience shops:** Suguo first opened a convenience shop on 14 February, 1999 at No.63 Sanpailou Street. So far more than 200 convenience shops of 110m<sup>2</sup> have been opened. They are all open around the clock, and supply more than 20 kinds of free services, which has made Suguo popular with consumers.

**Large warehouse supermarkets:** In 2000, Suguo began opening large 'warehouse' supermarkets, referred to in the press as 'rural Wal-Marts', but with Chinese features. The first warehouse supermarket opened at the Eastern Bus Station on 3 September, 2000. At 1,000m<sup>2</sup> and with more than 3,000 products the supermarket easily satisfies consumers' wish to do all their shopping in one place. On 10 January, 2001, Suguo opened warehouse supermarkets at North Zhongshan Road and Xinglong, so they now have warehouse supermarkets in the east, west, and north of the city.

**Community shops:** In 2002 Suguo opened its first community shop, which has a traditional food market, an agricultural products market, non-staple food shops, grocery, small stores, and so on. The Suguo Yingyuan community shop, for example, is 5,000m<sup>2</sup> and carries more than 20,000 products.

**Home Kitchen Project:** In October 1999, Suguo started to provide a cooking service covering fresh food, bread, and other food processing and cleaning services. The 'Home Kitchen Project' moved the kitchen into the supermarket, which has changed peoples' customs and consumption patterns. As peoples' living standards improved and their demand for supermarket commodities changed, Suguo constantly modified its product lines, bringing in, bit by bit, thousands of essential products such as food, washing products, clothing, and electrical appliances.

Figure 1. 1997–2006 sales figures for Suguo supermarkets (total sales vs sales from owner-operated stores).

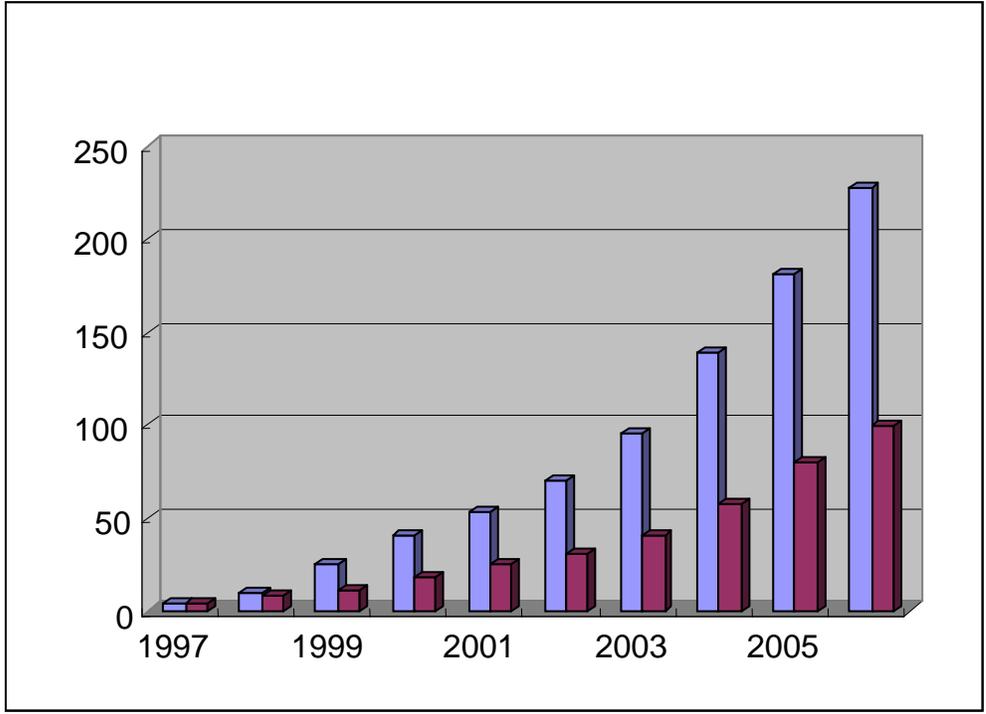
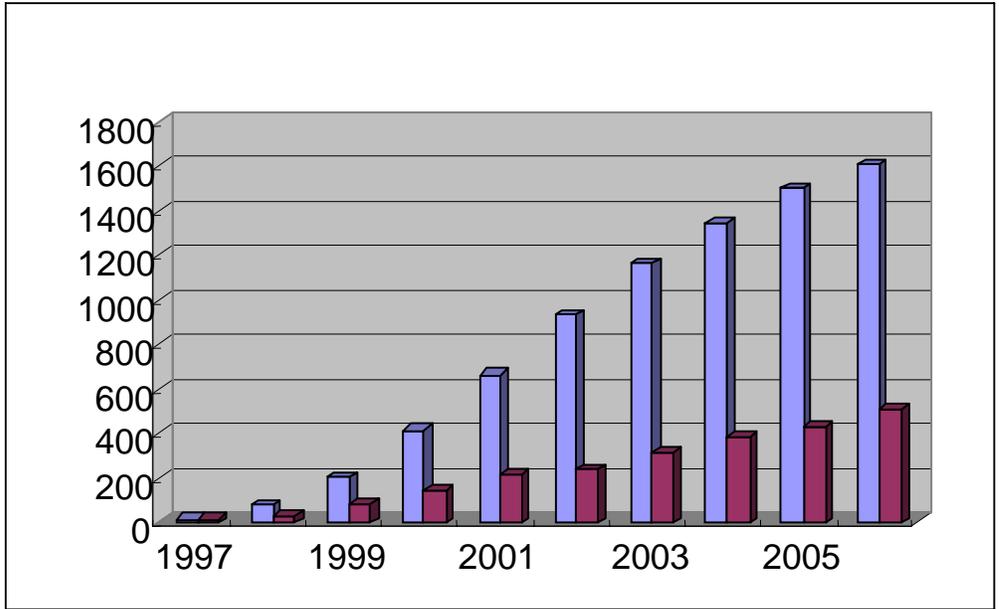


Figure 2. 1997–2006 sales figures for Suguo supermarkets (chain stores vs owner-operated stores).



### **3 The Suguo model: Penetrating the countryside**

#### **3.1 Supermarkets move into the countryside**

Two years after the company was founded, Suguo decided to move into the rural market by converting cooperatives into Suguo franchises. Why did Suguo adopt a rural-oriented business strategy? Four factors led to the decision:

1. The rural market was believed to have greater potential than the urban market. This is particularly true in the economically advanced Yangtze River delta region. Farmers' demand for both capital and consumer goods was not appropriately satisfied, so there was a business opportunity
2. Suguo grew by making use of the agricultural cooperatives and converting them into Suguo franchises, so it was able to take advantage of existing networks (the cooperatives). By franchising, little investment is required and little risk is taken by Suguo. On the other hand, these networks of co-operatives nearly collapsed during the market-oriented reforms. The fundamental issue lies in institutional and management capabilities. When contracting with the co-operatives Suguo requires them to conduct complete institutional and management reforms. This led to the revival of the co-operatives (which were originally state-owned firms).
3. While Suguo has the financial resources to expand on its own in the very competitive supermarket industry, they needed a less costly approach to spread their brand name. Franchising costs Suguo very little, but enables them to move into the rural market quickly and relatively cheaply.
4. Competition in the retail industry in metropolitan and large cities is very intense, particularly since China's entry to World Trade Organisation (WTO), after which foreign supermarkets rushed into the Chinese market. The supermarket diffusion model is like that; supermarkets first emerge in metropolitan cities, then spread to secondary and tertiary cities. Suguo was not competitive with the foreign-owned supermarkets in terms of funds, talent, and management capabilities; they needed time to learn from both the foreign and other excellent domestic supermarkets. Suguo realised that as the rural market was less competitive, they could gain first-move advantage in the countryside.

In April 1998, Suguo opened its first rural store in Lieshui county, awarding a franchise to the county's agricultural co-operative. It was Suguo's first step into the rural market. In December 1998, Suguo opened a second franchise store in Hefei, the capital of Anhui province. Since 1998, converting cooperatives into Suguo franchises

spread quickly to the six provinces around Nanjing – Jiangsu, Anhui, Shandong, Henan Hebei, and Hubei province. There are now more than 1,200 franchises in these regions, and since 2002 Suguo has expanded deeper into the rural market by opening owner-operated stores as well. The owner-operated stores target the county-level market while the franchises covered towns and villages.

The new presence of supermarkets in the countryside has significantly improved farmers' shopping environment and promoted rural consumption. For Suguo it has also been a business success; 50 per cent of their total sales came from these rural stores, with 70 per cent of sales being agri-food or related products.

### **3.2 Reforming the co-operatives**

Before they became Suguo franchises the co-operatives had to undertake institutional and management reforms. They used to be state-run firms with unclear ownership, so they had to be transformed into joint ventures or private firms. Through these institutional reforms most co-operatives became private or partnership businesses.

Management reforms are also crucial for efficiency and competitiveness, including recruitment, obligation of employee duties incentives, and sanctions . In practice the new ways of working resulted in remarkable improvements in performance, the stores' competitiveness improved significantly, and the image of the shops totally changed once the Suguo brand was introduced.

All the Suguo franchises have to observe seven operation principles, including standardized procedures for procurement, distribution, accounting, pricing, layout, management, and store image. When Suguo franchises a co-operative, it oversees the management and operation of the stores. It provides professional training to store managers to help them to resolve practical issues, including setting up their point-of-sale system. Suguo paid special attention to monitoring and evaluating new franchisees, carrying out an annual assessment of all stores at the end of each year.

### **3.3 Strategic plan to further exploit the rural market**

Suguo's strategic target in the next five years is to increase annual sales to Y26 billion and the number of stores to 2,200. Currently the 1,500 rural stores account for 70 per cent of total sales.

The basic idea of Suguo's regional development strategy is to 'open 100 stores in 100 counties around Nanjing'. In order to acquire 40 per cent of the market, each should have a shopping plaza with one or two large shops, preferential price shops and

some well-known supermarkets and convenience shops. Inspired by the Suguo model, China's Ministry of Commerce has created a project called 'Markets for 1,000 towns and 10,000 villages'. Through this project the government aims to enable 250,000 chain stores to open at village level in next three years by offering supermarkets financial subsidies and low-interest lending to extend their operations into the countryside. Encouraged by this, Suguo accelerated their own '100 stores in 100 hundred counties' project. Building 'Suguo convenience shops' in small towns and central villages is the first step in spreading the network to cover the whole rural market. The next step, is to establish Suguo stores in 100 county seats within Suguo's target regions within three years. Direct-marketing shops will strengthen the distribution to and management of the rural shops, further expanding Suguo's presence and improving the standards in rural areas. Starting in a county where an owner-operated Suguo store had already opened, some direct-marketing shops[see earlier comment, not sure what these are] spread to large towns, then developed allied shops in small towns and central villages, pushing forward gradually and thus creating a Suguo network that covered all the rural markets in that county.

## **4 The macro and meso context of the Suguo model**

### **4.1 Rural consumption as a new source of growth**

Since the beginning of market-oriented reforms at the end of 1970s, China's annual GDP growth rate has been more than 10 per cent. Such fast economic growth was pushed mainly by foreign trade and foreign direct investment. As a result, China became highly dependent on the world market, particularly after it joined the WTO. China's large trade surplus resulted in increasingly strong friction with major trading partners, however. As a result, China is now looking to domestic consumption, especially rural consumption, to be the new driver of economic growth. There are 1.3 billion people in China, 80 per cent of whom live in rural areas. The rural market is getting larger and larger due to farmers' rising income, improved public services and social security in rural China. The government's push to build a so-called 'new socialist countryside' will significantly increase rural demand for both capital and consumer goods.

### **4.2 Village-level chain stores pilot project**

Although rural demand is increasing, the retail industry in rural areas is quite backward and does not meet farmers' requirements. Co-operatives are a legacy of the command economy, and during the transition to a market economy these co-operatives nearly collapsed. Today the main retailers in rural areas are very tiny private family shops. The prices in these shops are high but the quality is low, and food safety in particular cannot be guaranteed. Clearly the current demand for both capital and consumer goods is not being properly satisfied in rural China. Some of the 'improved' seeds and chemicals on sale are fake, which seriously affects farm production, while poor quality and unsafe foods are dangerous to the farmers themselves. To change this situation, the government has encouraged the development of a modern retail industry in the rural areas, and in particular encouraged supermarkets to spread into the countryside. Suguo's experience showed that this could give farmers cheaper and better goods.

### **4.3 Government support for agro-industrialization**

Since the mid-1990s, the government has been addressing agro-industrialization by encouraging large-scale food processors and retailers to function as the captains of food supply chains. During this transformation Chinese agriculture has become increasingly commercialized and specialized. The average Chinese farmer has a

0.5ha farm, divided up over several different fields. Linking these small farmers to the market is difficult because their transaction costs are very high. Nevertheless, a number of forms of vertical co-ordination have emerged, and the government encouraged contract farming and outgrowers, for example. The captains of food supply chains are critical to improving vertical co-ordination of food production and marketing, so the government cultivated some large-scale food processors, wholesalers, and retailers through supportive policies. Suguo is one of 15 large marketing enterprises supported by the Chinese Ministry of Commerce, and one of 40 chain store operations appointed by the Ministry of Agriculture.

#### **4.4 Competition from foreign and domestic supermarkets**

Suguo's competitors in the Nanjing market include foreign and domestic supermarkets. Wal-Mart, Carrefour, and METRO are the top three supermarket chains in the world. Shanghai HuaLian is the largest domestic supermarket chain. These supermarkets have both financial and managerial advantages over Suguo. METRO and Carrefour are now in the Yuhua and Xiaguang districts of Nanjing and have monthly sales of more than Y100 million. Shanghai Lianhua opened more than 20 chain stores, and is now the second largest supermarket in Nanjing in terms of sales, or number of stores?. Huacheng supermarket expanded from 19 to 40 stores, and Jinrunfa supermarket and Beijing Hualian also opened stores in Nanjing. Some medium-sized and small supermarkets such as Jiahui also have some market share in Nanjing. So Suguo has strong competition, but it also has its competitive advantages. Suguo supermarkets aim to attract consumers with convenience and services, hence the community stores. Suguo also has the advantage in the countryside of good locations, low-cost expansion, and economies of scale because of its relationship with the cooperatives.

As the foreign and domestic supermarkets all have some advantages, they could become a threat to Suguo, either by expanding into the area currently occupied by Suguo, or by preventing Suguo from expanding into new areas. Based on Suguo's current capacity, it cannot compete against the big retail industries. Other commercial firms such as small shops, franchises shops, and grocery stores are also a potential threat to Suguo.

Faced with serious competition from more than 10 foreign supermarkets, Suguo neither retreated nor directly confronted them. Instead, it adopted a different business strategy, of 'differentiated competition'. The foreign supermarkets all work on a very large scale, and as a result could not create the dense networks to meet the demand of different consumers. Suguo, on the other hand, could open small stores to satisfy such needs.

Suguo's remarkable strategy was to consolidate at its headquarters in Nanjing, then transfer its focus to the countryside. Since 1998, just two years after the chain was created, the first rural Suguo store opened when a cooperative became a Suguo franchise.

## **5 The impacts of the Suguo model on smallholders and SMEs**

### **5.1 Providing a platform for SMEs**

The mainstream supermarket literature worries that small farmers and SMEs may be challenged or even marginalized by the shift in supermarket procurement systems from traditional wholesale markets to preferred suppliers and distribution centres. Supermarkets respond to consumer demands for food safety and quality by increasingly buying mainly from large commercial farmers. However, there is also evidence that small producers can benefit from the rise of supermarkets in developing countries. By extending its operation into the rural areas Suguo actually provides a new market for SMEs. The following case study, about 'A Dish of Pickled Vegetables', shows how agribusinesses have benefited from Suguo's presence in the countryside.

'A Dish of Pickled Vegetables' is the wholesale brand name of the Yunlu Pickled Vegetables Company, established in 1998. The company was originally established to create a brand that both producers and retailers could benefit from, but without cutting out the wholesaler. The founder of this company, Hu Xiaoping, originally suffered losses because of collusion between the producers and retailers involved. Now, using the wholesaler brand, the three sides of producer, wholesaler, and retailer are bound together and sharing the benefits of the increasingly popular brand name and growing market. The crucial element of this mechanism is to keep the market growing. Mr Hu decided to make Suguo supermarket the platform for his business, and fortunately it is a success story. With the rapid expansion of Suguo in both urban and rural markets, the demand for his pickled vegetables is also growing rapidly, which gives Mr Hu a chance to bring in more and more producers. There is a tradition of producing baby cucumbers in Mr Hu's hometown, but as there is not a great demand for them, the small farmers benefit very little from producing them. When there is a good harvest, the small farmers can even make a loss on production. Mr Hu believed that the processed baby cucumbers could be very popular with both urban and rural consumers, so he suggested setting up a factory to process them and encouraged small farmers to produce more. The plan was successful. They sold Y1.8 million worth of pickles in the first year (1998), and that has now grown to Y80 million a year in 2006. The area under cultivation has now reached 10,000 mu (15 mu = 1 hectare), and the local small farmers can now depend on cucumber production. After the successful start, Mr Hu began to increase his range of pickled vegetables to more than 200 products, including preserved szechuan pickle, sauerkraut, and many others. He has about 60 production centres

nationwide, and more than 100,000 small farmers are growing fresh vegetables for his processing plants. Total sales volume reached Y80 million, Y30 million to Suguo alone.

The pickled vegetables case is just one example of Suguo's success in working with SMEs. Suguo has helped many other SMEs to become successful businesses too, such as the Jiangsu Meat Company, who sold Y35 million worth of products to Suguo, two-thirds of its total sales volume. According to Suguo's statistics, they buy from nearly 1,000 SMEs, and many traditional and special local products have been turned into successful businesses, promoted by Suguo according to consumers' wishes. The quality and standard of these products were upgraded, which also created more market demand.

## **5.2 Improving the rural consumption environment**

Suguo's original motivation behind their rural expansion strategy was to expand their market in a low-cost way. However, the standardization of chain-store operations could really improve the rural consumption environment overall. There are lots of counterfeit consumer and capital goods in the rural markets, including unsafe foods. The countryside not only produces but also consumes unsafe foods, which were reported to have harmed the health of the rural population. To provide cheap and genuine consumer and capital goods to small farmers, the rural commercial system needs to be regulated and modernized. Encouraging other businesses to extend their chain-store operations into the countryside could effectively reverse the prevalence of fake products in rural areas, because all the supermarket have their own safety and quality standards.

## **5.3 Making the most of small traders**

Suguo supermarket buys its fresh and processed foods through a procurement system, and small traders dominate that system. Suguo set up a small-scale distribution centre (DC) in a suburb of Nanjing in February, 2004, to manage the supply of fresh and processed food products to the 100 owner-operated Suguo stores in the city. A modern distribution centre in Maqun has also been launched, which has a fresh produce and processing section still under construction. Even if in future the stores are supplied mainly by DCs, the small traders will still be the main agents connecting small farmers to the DCs, so there is no reason that they should lose business. Suguo's food supply chains are not directly controlled by the captains through contracts or vertical integration, rather they are somewhat loose, which can result in huge transaction and enforcement costs. By making the most of the massive number of small traders instead of dealing directly with the even greater number of

small farmers, Suguo supermarket can save tremendously on transaction costs. There are few bureaucratic costs and great incentives in such a supply chain.

The small traders are usually farmers themselves who also buy a certain amount of vegetables and fruits to sell on. This created beneficial social links between the small farmers and small traders, after an initial unstable period of transaction. To maintain their standards, Suguo signed contracts with these small traders covering food safety and quality, and requiring third-party and spot checks. The small traders usually buy their vegetables only within a certain area, and so create a stable outlet for the small farmers.

#### **5.4 Establishing producer-owned production centres**

According to our fieldwork, 40 per cent of fresh foods are procured through preferred suppliers (most of whom are small traders), 40 per cent comes from production centres, 10 per cent is from wholesale markets, and 10 per cent is from markets.

Although Suguo supermarket chose to use flexible supply chains, it also set up production centres in suburban areas. These production centres could benefit participating farmers. A comparative study of the Suguo procurement system.

### **6 Suguo's distribution centres**

In 2004, Suguo supermarket established a small distribution centre to serve their owner-operated stores in Nanjing. The distribution centre employs 300 workers, and buys fresh foods from a variety of sources. One channel is through wholesale markets, such as Bai Yun Ting and Tian Yin Shan, but this accounts for less than 10 per cent of total procurement, and is mainly for out-of-season fruits and vegetables from Hainan and Shandong provinces. Another channel is the preferred suppliers or small traders with whom Suguo has signed contracts. The price is determined by the daily wholesale market price. These small traders collect fruits and vegetables mainly based on trust, paying the farmers when Suguo pays the traders. This channel accounts for 40 per cent of total procurement. The third channel is from so-called production bases, where many small farmers work together to produce the same products, which improves the economies of scale when selling and saves transaction costs. Suguo established several production bases around Nanjing, such as in Jiangpu, Luhe, Jiangning, Lieshui, and Gaochun. This channel accounts for about 40 per cent of total procurement. The fourth channel is markets. Although its value is declining overall, it still accounts for just under 10 per cent of total procurement.



In 2005, a modern 17-hectare distribution centre was built in Maqun to service areas up to 300km away. Within Maqun DC, a 10,000m<sup>2</sup> fresh-food distribution centre with cold storage for 1,000 tonnes of produce is under construction at a cost of Y50 million. According to Suguo's strategic plan, three distribution centres will be built – in Nanjing, Xuzhou, and Hefei – in order to support the large network of stores in the rural areas.

## **6.1 The procurement system of export-oriented agribusinesses**

The procurement system for food supply chains aiming for the export market, such as in Shandong province, can be quite different from the domestic retail channels. Because of the very strict requirements of foreign buyers, food processors and marketing enterprises are already very careful to ensure food safety and quality standards. Processors send their inspectors to farms to check if the production codes are being followed properly. In order to save on transaction and monitoring costs, the food processors prefer the large and commercial farmers, and usually set a minimum farm size. They also rent large landholdings for their farmers to use and employ people to monitor the farmers' work.

In contrast, food supply chains that supply the domestic market have significantly lower food safety and quality standards, because there is no requirement for them to do better. Basically this is because food safety and quality transaction costs are high and the willingness of consumers to pay for this safety and quality is too low.

Therefore expensive food safety and quality procedures will not be a priority for supermarkets who target the domestic market only. Suguu, however, has invested a lot to design a viable way to improve food safety by setting up a research project in collaboration with the Ministry of Science.

Based on these differences, the captains of export-oriented food supply chains may marginalize small farmers while the captains of mainly domestic food chains may not. Therefore, domestic and export-oriented food supply chains should be treated separately for policy reasons.

## **7 Discussions and conclusions**

The basic question of whether the rise of supermarkets will lead to the inclusion or exclusion of small farmers should be carefully defined. It is not just about production. Providing small farmers with a better consumption environment for both consumer and capital goods is also crucial for transition countries, such as China. Suguo penetrated into the countryside and brought opportunities for smallholders to buy better, genuine, and safe foods. Rural consumption has been singled out as the new growth point of the national economy, so any measures that stimulate rural consumption are important for policymaking in China.

Contrary to traditional beliefs, closer vertical coordination, or even vertical integration, may not be an appropriate choice for China, where land was distributed equally to every smallholder. Only in special cases is there a degree of choice with regards to producers' size; most smallholders have about the same amount of land, which means that any viable procurement system cannot discriminate against them. Even if supermarkets create distribution centres, small traders are still welcome and will prevail in future. These small traders can deal efficiently with smallholders, while maintaining some degree of food safety and quality considerations.

Middlemen or SMEs such as agro-processors can also stimulate the production of smallholders, as we demonstrated with the story of the 'A Dish of Pickled Vegetables' wholesale brand.

The Suguo model does successfully procure from both smallholders and SMEs. It also gives farmers a better consumption environment. This model has been highly praised by many national leaders. The Ministry of Commerce was inspired by this model to launch their 'Markets for 1,000 townships and 10,000 villages' project, but to what degree this model could be replicated depends on several factors.

The first is the potential rural market. It is huge and will continue to grow as the Chinese economy grows, but at the moment the gap between the urban and rural markets is still quite large. The level of rural purchases of food products is increasing but is still fairly low. Supermarkets can only supply some of this demand, however, so there are still opportunities for chain stores in the rural areas.

Secondly, success will also depend on reasonable logistics support. Chain store operations have the advantage of economies of scale, but without effective logistics support they cannot compete with other shops. There have been great improvements in highway construction, but the logistics companies have not caught up, and this is a limiting factor.

The last related factor is government support. Based on the ministry's market project, Y10 billion in subsidized loans and Y0.5 billion in financial support has been made available to enterprises that open chain stores in rural areas. Suguobear bears little risk in its rural operation because it only creates franchises and receives fees from the supply and marketing cooperatives. The rural chain stores are not, in fact, very profitable, so start-up funds are needed to encourage the spread of chain stores into the countryside.

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## Regoverning Markets

Regoverning Markets is a multi-partner collaborative research programme analysing the growing concentration in the processing and retail sectors of national and regional agrifood systems and its impacts on rural livelihoods and communities in middle- and low-income countries. The aim of the programme is to provide strategic advice and guidance to the public sector, agrifood chain actors, civil society organizations and development agencies on approaches that can anticipate and manage the impacts of the dynamic changes in local and regional markets. The programme is funded by the UK Department for International Development (DFID), the International Development Research Centre (IDRC), ICCO, Cordaid, the Canadian International Development Agency (CIDA), and the US Agency for International Development (USAID).

## Innovative Practice

Innovative Practice is a series of case studies from the Regoverning Markets programme providing examples of specific innovation in connecting small-scale producers with dynamic markets at local or regional level. Based on significant fieldwork activities, the studies focus on four drivers of innovation: public policy principles, private business models, collective action strategies by small-scale farmers, and intervention strategies and methods of development agencies. The studies highlight policy lessons and suggest working methods to guide public and private actors.

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