
INDUSTRY OVERVIEW AND REGULATION

THE PRC ECONOMY

Population growth and urbanization

At approximately 1.3 billion in 2008, the PRC has the largest population of any country. It also has one of the world’s fastest growing economies. China’s GDP has grown from approximately RMB8,440 billion in 1998 to RMB30,067 billion in 2008, representing a CAGR of approximately 13.5%. During the same period, GDP per capita in the PRC increased from approximately RMB6,796 in 1998 to approximately RMB22,098 in 2008, representing a CAGR of approximately 12.8%.

The rapid growth of the PRC economy has led to improved living standards and increased purchasing power, particularly in urban households. An increase in disposable income affects the level of retail sales. The per capita annual disposable income of urban households in the PRC increased from approximately RMB5,425 in 1998 to approximately RMB15,781 in 2008, representing a CAGR of 11.3%. Urbanization has also increased as part of the rapid growth and development of the PRC economy. During the 10-year period ended 2008, the urbanization rate increased from approximately 33.4% in 1998 to approximately 45.7% in 2008.

The following table sets out China’s (i) population, (ii) urbanization rate, (iii) GDP, (iv) per capita GDP and (v) per capita annual disposable income of urban households for the periods indicated.

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	Compound annual growth rate (1998–2008)
Population (million) . . .	1,248	1,258	1,267	1,276	1,285	1,292	1,300	1,308	1,314	1,321	1,328	0.6%
Urbanization rate (%) . . .	33.4	34.8	36.2	37.7	39.1	40.5	41.8	43.0	43.9	44.9	45.7	3.2%
GDP (RMB in billions)	8,440	8,968	9,921	10,966	12,033	13,582	15,988	18,387	20,941	25,731	30,067	13.5%
Per capita GDP (RMB)	6,796	7,159	7,858	8,622	9,398	10,542	12,336	13,958	15,973	19,524	22,698	12.8%
Per capita annual disposable income of urban households (RMB)	5,425	5,854	6,280	6,860	7,703	8,472	9,422	10,493	11,760	13,786	15,781	11.3%

Source: China Statistical Abstract 2009

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Growth in disposable income of urban households

The average per capita disposable income of urban households for all economic classes has increased in the nine years ended 2008. The following table sets out the average per capita disposable income of the different economic classes and the respective CAGR for the periods indicated.

	Low	Lower Middle	Middle	Upper Middle	High
	<i>(in RMB, other than %)</i>				
Percentage of PRC population	20%	20%	20%	20%	20%
2000	3,143	4,624	5,898	7,487	11,373
2001	3,330	4,947	6,366	8,164	12,745
2002	3,032	4,932	6,657	8,870	15,460
2003	3,295	5,377	7,279	9,763	17,472
2004	3,642	6,024	8,167	11,051	20,102
2005	4,017	6,711	9,190	12,603	22,902
2006	4,567	7,554	10,270	14,049	25,411
2007	5,364	8,901	12,042	16,386	29,479
2008	6,075	10,196	13,984	19,254	34,668
CAGR (2000 to 2008)	8.6%	10.4%	11.4%	12.5%	15.0%

Source: China Statistical Abstract 2009

THE RETAIL INDUSTRY IN THE PRC

Strong retail sales growth

The significant size of the PRC population represents a large consumer market for the retail industry. Over the last decade, during which the PRC has undergone rapid economic growth, the PRC government has instituted reforms in the retail industry to promote domestic consumption, including gradually opening up the domestic retail industry to foreign investments. Today, a wide range of retail formats for consumer goods, manufactured locally or imported from overseas markets, are available to PRC consumers. The retail formats in China generally include department stores, hypermarkets, supermarkets, convenience stores, specialty stores, shopping malls, small scale retail shops, and other retail outlets. As a result of the increased disposable income of consumers and the choices available to them, consumers increasingly are aware of the services and merchandise available to them at the various retail outlets.

As a result of China's strong economic growth in the last decade, the retail industry also has been experiencing significant growth. Retail sales of consumer goods in China increased from approximately RMB3,338 billion in 1998 to approximately RMB10,849 billion in 2008, representing a CAGR of 12.5%. The following table sets out total retail sales of consumer goods in the PRC in nominal terms.

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Retail sales (RMB in billions)	3,338	3,565	3,911	4,306	4,814	5,252	5,950	6,718	7,641	8,921	10,849

Source: China Statistical Abstract 2009

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Retail sales in urban areas

With increased disposable income, urban households in the PRC have more capability and are more willing to spend in order to improve their living standards. As there are relatively more retail formats in urban areas, the proportion of retail sales in urban areas has increased over the years. According to the National Bureau of Statistics of the PRC, retail sales in urban areas as a percentage to total retail sales has been increasing over the last ten years. The following chart shows the relative retail sales of consumer goods in city areas as compared to county and sub-county areas.

Retail Sales of Consumer Goods at City, County and Sub-County Level

	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
	<i>RMB (billions)</i>										
Sub-County Level	886	899	972	1,042	1,119	1,190	1,317	1,460	1,639	1,886	2,254
County	422	446	483	525	557	601	664	749	848	994	1,221
City	<u>2,029</u>	<u>2,220</u>	<u>2,456</u>	<u>2,738</u>	<u>3,138</u>	<u>3,461</u>	<u>3,970</u>	<u>4,509</u>	<u>5,154</u>	<u>6,041</u>	<u>7,374</u>
Total	<u>3,337</u>	<u>3,565</u>	<u>3,911</u>	<u>4,306</u>	<u>4,814</u>	<u>5,252</u>	<u>5,950</u>	<u>6,718</u>	<u>7,641</u>	<u>8,921</u>	<u>10,849</u>

Source: China Statistical Abstract 2009

The impact of the WTO on the PRC retail industry

China became a member of the WTO in December 2001, which resulted in China opening some of its previously protected domestic markets to foreign investments. Prior to China's entry into the WTO, the retail industry in the PRC was heavily regulated and restrictive to foreign investments. Wholly foreign-owned enterprises were prohibited. As a result of the PRC accession to the WTO, however, all foreign retailers, beginning on December 11, 2004, are able to establish wholly-owned businesses in the PRC.

The accession to the WTO also brought about a reduction in import tariffs. This reduction in import tariffs has resulted in the provision of a wider variety of foreign goods, with reduced retail prices, to PRC consumers that were previously out of their price range. We believe the reduction in import tariffs benefits retail formats, such as department stores, shopping centers and supermarkets, that offer numerous brands and diversify the choices available to consumers.

THE DEPARTMENT STORE INDUSTRY IN THE PRC

Department store growth in the PRC

Euromonitor International, an independent provider of market and competitor intelligence, defines a department store as a retail outlet usually with a sales area of over 2,500 sq.m., selling mainly non-grocery merchandise and at least five lines in different departments. They are usually arranged over several floors.

Department stores in the PRC have been growing with the market to secure business opportunities as retail sales have increased. The following chart shows the historical market size of department stores in China for the periods indicated, provided by Euromonitor International.

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Market Size of China Department Stores (retail value excluding sales tax)

	2001	2002	2003	2004	2005	2006	2007	2008
	<i>RMB (billions)</i>							
Market Size	288	319	311	348	397	441	498	558

Source: Euromonitor International

Chain department stores

The chain retail format has been growing rapidly. According to the 2008 Statistical Yearbook of China Retail Corporations in Chain compiled by the National Bureau of Statistics, the Ministry of Commerce of China and the China General Chamber of Commerce Information Department, the number of department store chain outlets in China increased from 5,353 in 2006 to 6,064 in 2007, representing an increase of 13.3% over the previous year. Retail sales of department store chains increased from approximately RMB125 billion in 2006 to approximately RMB151 billion in 2007, an increase of 21.4%.

Trend of the PRC department store industry

As a result of an increase in disposable household income, PRC consumers are now more willing and better able to increase their consumption. According to Euromonitor International, retail sales by department stores in the PRC will continue to grow in the next few years. Euromonitor International estimates that retail value by department stores will reach approximately RMB830 billion by 2013.

Forecast of Market Sizes of China Department Stores (retail value excluding sales tax)

	2007	2008	2009	2010	2011	2012	2013
	<i>RMB (billions)</i>						
Forecast of Market Sizes	498	558	619	681	735	783	830

Source: Euromonitor International

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REGULATION

Retail industry foreign investment laws and regulations in the PRC

Since the 1990’s, the PRC has been gradually relaxing its restrictions on foreign investment into the retail industry.

In July 1992, the State Council issued Response to the Application of Foreign Capital on the Commercial Retail Industry (關於商業零售領域利用外資問題的批覆) (the “Application of Foreign Capital Response”), and agreed to carry out trial operations of one to two Sino-foreign equity joint venture or Sino-foreign cooperative joint venture commercial retail enterprises in each of Beijing, Shanghai, Tianjin, Guangzhou, Dalian, Qingdao and five special economic zones. Under the Application of Foreign Capital Response, foreign investment commercial enterprise projects became subject to the review and approval of the State Council through the reports of local governments. The operating scope of foreign investment commercial enterprises included department retail business and import and export business operations.

SAFE Regulation

Our PRC legal adviser has advised us that Alfred Chan and Edward Tan are not “Domestic Resident Natural Person” pursuant to the Notice of SAFE on Issues relating to Foreign Exchange Control on Fund Raisings by Domestic Residents through Offshore Purpose Vehicles and Round-trip Investments (國家外匯管理局於境內居民通過境內特殊目的融資及返程投資外匯管理有關問題的通知) promulgated on October 21, 2005 (the “Notice on SPV”), and that therefore the requirements of the Notice on SPV are not applicable to our Company or our Controlling Shareholders. This is on the basis that under the Notice on SPV the phrase “Domestic Resident Natural Person” refers to any natural person holding a PRC Resident Identity Card, or any natural person who does not hold a PRC Resident Identity Card but who normally resides in the PRC for economic gains. Alfred Chan and Edward Tan, who do not hold a PRC Resident Identity Card and who do not normally reside in the PRC for economic gains, are therefore not “Domestic Resident Natural Persons”.

In June 1999, with the approval of the State Council, the State Economic and Trade Commission (國家經濟貿易委員會) and Ministry of Foreign Trade & Economic Cooperation (“MOFTEC,” 外經貿部, later restructured into the Ministry of Commerce) issued Measures for Commercial Enterprises with Foreign Investment (外商投資商業企業試點辦法) (the “Commercial Enterprises Measures”) and expanded the permitted geographic coverage of sino-foreign equity and cooperative joint venture commercial retail enterprises to capital cities of the provinces and the autonomous regions, municipalities under the central government, special economic zones and Dalian, Ningbo and Qingdao.

On April 16, 2004, the MOFCOM issued Measures of Administration of Foreign Invested Commercial Enterprises (外商投資商業領域管理辦法) (the “New Commercial Enterprises Measures”), which was implemented on June 1, 2004. These measures abolished the minimum registered capital required for foreign invested commercial enterprises and the previous requirements for minimum asset amount and sales revenue of the foreign investor. Further, before December 11, 2004, foreign-owned commercial enterprises in the retail industry and their stores

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were restricted to capital cities of provinces and the autonomous regions, municipalities under the central government, special economic zones and Dalian, Ningbo and Qingdao. This regional restriction was abolished after December 11, 2004.

PCD Real Estate (Xiamen) has not been considered a foreign-funded retail enterprise since its establishment on April 28, 2002 and is not currently subject to any geographical restrictions. Zhongshan PCD Stores (Xiamen) was a foreign-funded retail enterprise at the time of its establishment on October 28, 2005 and is not subject to any geographical restrictions or the restriction requiring the establishment of sino-foreign equity or cooperative commercial retail enterprises. Based on the opinion of our PRC legal adviser, PCD Real Estate (Xiamen) and Zhongshan PCD Stores (Xiamen) and any domestic enterprises jointly invested by them are in compliance with the above laws and regulations with regards to the restrictions on foreign investment.

WTO's Impact on the PRC Retail Industry

Prior to the PRC's entry into WTO, foreign investors were severely restricted from providing retail services in the PRC for both their own proprietary operations and for third parties.

According to the Commercial Enterprises Measures, foreign companies or enterprises and domestic companies or enterprises were able to set up sino-foreign equity joint ventures or sino-foreign co-operative joint ventures (referred to as "Joint Ventures") in the designated experimental area within the territory of the PRC, but wholly foreign-owned enterprises were not allowed to be established in the industry at that stage. The area for establishment of Joint Ventures was stipulated by the State Council, which was only restricted to the capital cities of provinces and autonomous regions, municipalities under the central government, the special economic zones and Dalian, Ningbo and Qingdao. Moreover, the establishment of Joint Ventures had to comply with commercial development planning rules in the relevant area. To gain access to the PRC market, non-PRC retailers had to apply for permission from the PRC government in accordance with the Commercial Enterprises Measures, which had high market entry thresholds for foreign investment enterprises.

However, to fulfil the PRC's WTO commitment in respect of the opening up of its distribution services sector, the Ministry of Commerce issued the New Commercial Enterprises Measures on April 16, 2004, which regulate foreign investments in distribution services such as wholesale, retail, commission agency and franchising. The Commercial Enterprises Measures were abolished when the New Commercial Enterprises Measures took effect from June 1, 2004.

There are a number of major changes in the New Commercial Enterprises Measures, including permitting foreign investors to engage in the operation of distribution services on a wholly-owned basis from December 11, 2004. The New Commercial Enterprises Measures will also gradually enlarge the geographical coverage of foreign-invested commercial enterprises and lower the market entry threshold. In terms of requirements for foreign invested commercial enterprises to set up stores, it is stipulated in the New Commercial Enterprises Measures that foreign investors can apply to set up both commercial enterprises and stores at the same time in accordance with simplified procedures and clear guidelines.

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According to the New Commercial Enterprises Measures, a foreign invested commercial enterprise must meet the following conditions:

- its minimum registered capital must comply with the requirements of PRC company law (RMB30,000);
- it must comply with the normal total investment and registered capital requirements for foreign invested enterprises; and
- in general, its term of operation may not exceed 30 years, or 40 years in the western region of the PRC.

Moreover, the foreign invested commercial enterprise must meet the following conditions to open retail stores:

- if applying to open a store at the same time as applying to establish the enterprise, the proposed store must conform to the urban development plan and the commercial development plan of the city where it is located; and
- If applying to open a store after the establishment of the enterprise, then in addition to meeting the above requirement, the enterprise must also (a) have undergone annual inspection on time and passed, and (b) have received all of its registered capital from its investors.

Any application for the establishment of a foreign-funded commercial enterprise (including project description, feasibility study and other relevant documents) shall be submitted to the local department entrusted by MOFCOM (a competent commerce department at the provincial level and the management committee of an economic and technological development zone at the national level) for approval, which is then sent to MOFCOM for recordation after the approval is granted by the authorized local department. In the event that the granting of such approval is beyond the authority of the local department, the application shall be sent to MOFCOM for approval. Additionally, any retail stores to be opened by an established foreign invested commercial enterprise must be approved according to the same process. The approval process together generally does not exceed four months given the satisfactory submission of application documents. The approved foreign invested commercial enterprise shall be registered with the competent Administration for Industry and Commerce within one month after the approval issued by MOFCOM or the local department entrusted by it. After the implementation of the New Commercial Enterprises Measures, we could engage in the retail business in the PRC on a wholly-owned basis and expand into geographical areas which were not opened to foreign investors for retail operations.

Under the New Commercial Enterprises Measures, the percentage of foreign investment in retailers in the PRC with more than 30 stores which are engaged in the sale of certain specific goods including books, newspapers, magazines, automobile (as for automobile, such restriction was cancelled on December 11, 2006), pharmaceutical products, pesticides, fertilizers, refined oil products, grains, vegetable oil, sugar, cotton and with such goods being of different brands and obtained from different suppliers, should not exceed 49%.

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Licenses

Apart from obtaining the necessary business licenses for operating department stores, operating a department retail business in the PRC requires certain other licenses and permits, which, depending on the products sold (and therefore not all of which may be applicable to us), include:

- “Cigarette Sales Permit” (煙草專賣零售許可證), for sales of cigarettes;
- “Medical Device Operation Enterprise Permit” (醫療器械經營企業許可證), for sales of various types of medical apparatus;
- “Audiovisual Products Operation Permit” (音像製品經營許可證), for sales of audiovisual merchandise; and
- “Hygiene Permit” (衛生許可證), for food sales.

A foreign-owned commercial enterprises may not be able to obtain a Cigarette Sales Permit and Audiovisual Products Operation Permit due to industry restrictions.

A department retail enterprise also needs to apply for other business licenses upon the request of the government’s public control departments. For example, it needs to obtain the approval of fire safety review when it opens a sale area for usage.