Opportunities for Action

Retailing in China: Bring Your "A" Game

The economic boom in China's major cities—where most global companies are concentrated—has been going strong for 25 years. Now that wealth is spreading to second- and third-tier cities. By 2008 more than half of China's high-income households will be located outside the 45 biggest cities. That is also where nearly 60 million households are joining an expanding middle class. The growth in middle-class disposable income is expected to fuel an increasing demand for color televisions, cosmetics, and other consumer goods.

Retailers are rushing to stake a claim in this frontier, and many are consolidating. In the process, they are boosting modern trade formats, such as hypermarkets and supermarkets, over traditional sales channels. Wal-Mart's recent acquisition of Taiwanese-owned Trust-Mart and Tesco's decision to increase its stake in its Chinese joint venture are examples of intensifying competition in the wake of relaxed regulations on foreign ownership. Best Buy, The Home Depot, Walgreens, and many luxury-goods retailers are pouring in as well. Although their share of the market is still small, it is expected to grow significantly as they expand beyond the first-tier cities.

Domestic retailers are also on the move. Leveraging funds raised from capital markets, companies such as GOME in electronics and Wumart in groceries are expanding to take advantage of a steadily growing market and considerable "white space." Both foreign and domestic players are seeking an early-mover advantage by capturing the loyalty of traditionally fickle Chinese consumers as spending patterns change.

Those that succeed are likely to be rewarded handsomely. Companies such as Yum! Brands, a retailer based in the United States, have built a significant franchise in China. Other players, such as The Swatch Group, derive a high percentage of their global sales from China. Private-equity players are also coming on strong, betting on possible winners in retail sectors such as electrical appliances and sports apparel.

But realizing these opportunities won't be easy. Winning in the scramble for China's retail customers will depend on how quickly a retailer—especially one from outside China—understands the economic, geographic, and cultural landscape of its markets. Here is a brief look at the most immediate challenges.

Competing with Traditional Trade

It isn't inevitable that modern trade will win out. Although retailers are finding opportunities to displace China's traditional trade formats, some traditional stores are putting up a strong fight. In electrical appliances, for instance, 35 percent of sales still come from independent and neighborhood stores. In home decoration, a whopping 83 percent come through the traditional channel. For personal computers, it's 70 percent, and for mobile phones, 55 percent.

Although Western retailers may not realize it, traditional sales channels—typically marketplaces or bazaars that house many small mom-and-pop stores—can trump modern formats in assortment and pricing. Longtime customers believe they offer more variety and lower prices. Recently, real estate companies have begun to develop category-specific shopping malls, such as Easyhome (Beijing), Redstar (nationwide), and Yuexing (the Changjiang Delta) for furniture. Not only do these malls provide a better environment than the older bazaars, they offer product guarantees and after-sales services in order to compete more

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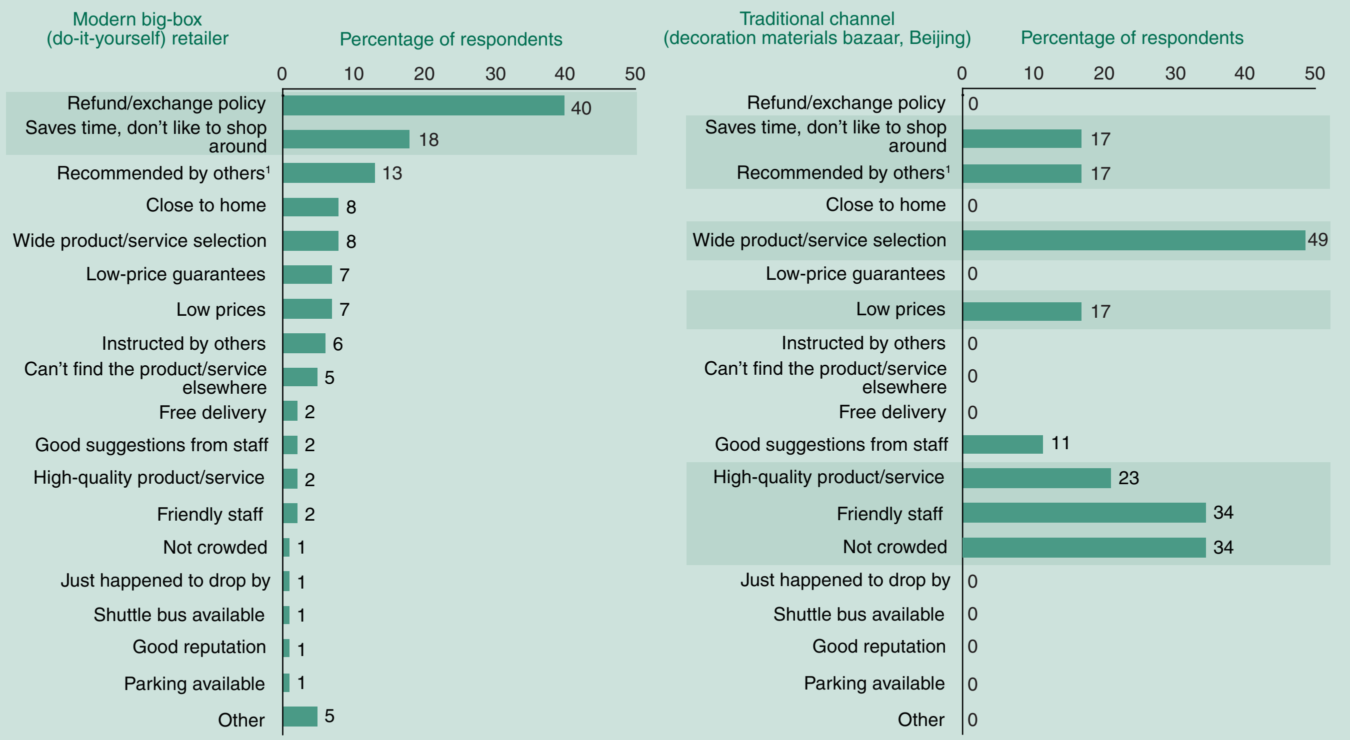
effectively. Modern retailers are fighting their traditional competitors with transparent refund policies and one-stop shopping, but traditional formats are still winning on price, variety, and products and services in many sectors. (See Exhibit 1.)

Finding a Balance in China's Fragmented Markets

Outside Beijing, Guangzhou, and Shanghai, China's market is widely dispersed among more than 600 cities, creating tremendous challenges for retailers. Furthermore, there is no typical Chinese consumer. Most global retailers understand the differences between Eastern and Western preferences, but there are many nuances that will continue to affect shoppers' choices within China. Such diversity often calls for customized products and services, as well as a different product mix from one city to another. For example, we found an 80 percent difference in the number of SKUs for bar soap carried by two stores owned by the same chain—one in Beijing and one in Shanghai. Moreover, some stores offer brands that only they carry. The trick is to find the right balance between uniformity and customization. Too much uniformity will hurt sales productivity, whereas too much customization will lead to lower margins.

Exhibit 1. Modern Retailers Offer Refunds and One-Stop Shopping, but Traditional Stores Win on Price, Variety, and Other Benefits

Reasons Why Consumers Shop at a Modern Versus a Traditional Store



SOURCES: BCG exit interviews, Beijing, 2005 (sample size = 209).
[1]Includes friends, family, employers, and clients.

Another challenge is realizing economies of scale. There are few national suppliers—even in branded categories—so retailers have to work with numerous regional or local suppliers. Thus, although scale in purchasing is possible, it cannot be achieved through greater national market share. Rather, it will come from higher share at the regional and local levels and from well-orchestrated supplier management.

Balancing Growth and Productivity

Although there are only four foreign players (Carrefour, Parkson Retail, Wal-Mart/Trust-Mart, and Yum!) among China's top 20 modern retailers, most of them—as well as many others (including B&Q, Best Buy, Metro, and Tesco)—have announced aggressive expansion plans. Most of these companies are enlarging their footprint rather than increasing productivity per square meter. They hope their profit margins will catch up once they have more stores.

In fact, as their network of stores grows, these retailers will find it harder to improve productivity and respond to local competitors and customers. Over time, if same-store productivity continues to weaken, these expanded networks will become a burden on the bottom line. A rapidly growing network and falling sales per square meter are a dangerous combination and should serve as a warning signal to retailers that focus more on footprint than on productivity. (See Exhibit 2.)

One solution is to develop local leadership. Retail economics will favor players with strong, defendable positions in local markets over a national leader. But that will require a greater focus on same-store productivity and an appreciation for the value of local supplier networks in planning new stores.

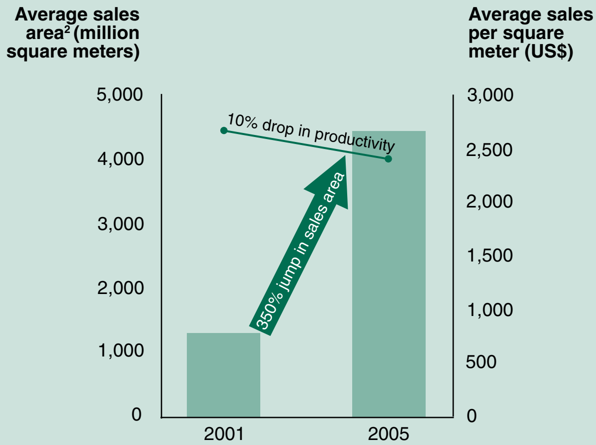
Working with Supplier Representatives

In their early days in China, many big-box retailers offered their suppliers' brands before they established their own. Consequently, the model of the supplier (or manufacturer) representative is common there today, especially with domestic big-box retailers.

Typically, the retailer acts as a landlord, renting floor space to the supplier, which handles consumer interfaces such as merchandising, sales, and after-sales service, while managing logistics and promotions jointly with the retailer. Because the responsibility for management and store display belongs to the supplier, the retailer enjoys the benefits of low operating expenses and the ability to expand rapidly. Operations are also less capital intensive, so the retailer can share more risk with suppliers.

Exhibit 2. Retailers in China Focus More on Footprint Than on Productivity

Hypermarket Sales Area and Productivity[1]



SOURCES: Company annual reports; Planet Retail; BCG analysis.

[1]Data are based on an analysis of representative domestic and international hypermarket chains.

[2]Average sales area was calculated as an average of year-beginning and year-end figures.

A big disadvantage, however, is that supplier reps are trained to put the interests of the supplier over those of the retailer. From the supplier's perspective, for example, a representative helps to increase sales. But the outlet needs to carry some minimum number of SKUs to justify the cost of the rep: hence, SKU proliferation. Furthermore, because retailers have fewer ways to differentiate themselves from competitors under the supplier rep model, and because their gross margins are often lower, they tend to compete on price or convenience of location—which has led to price wars, exceedingly rapid footprint expansion, and declining productivity. And because supplier reps aren't motivated to cross-sell other brands, retailers lose additional sales opportunities. Finally, this model makes it difficult for retailers to introduce their own labels.

Despite those disadvantages, retailers have been reluctant to give up the supplier reps because that would require competencies retailers weren't able to develop during the land-grab phase. These include consumer insight, category management, promotions training, and visual merchandising. And it isn't easy to change business models. Gross margins might double, but fixed and variable costs would be significantly higher. It therefore seems likely that market fragmentation in many retail sectors will preserve the supplier rep model for some time, putting continued pressure on retailers' margins and productivity.

Overcoming Organizational Challenges

Because they are expanding so rapidly, many retailers that operate on a national or regional basis are finding it difficult to manage a large network of stores in China. The diversity of local needs would seem to favor decentralization—potentially all the way down to the store level. In contrast, a paucity of skilled managers and the drive for higher efficiencies argue for a more centralized approach. Making sure that tasks are properly apportioned among the organization's layers (headquarters, region, city, and store) and that decision making resides in the proper hands is crucial. Some retailers go from centralized to decentralized management and back again in a few years. Suppliers are feeling the same pressures. As a result, it is much harder than it used to be to get store-level assortment and execution right.

Domestic retailers, in particular, find that they lack key capabilities—such as category management and merchandising—partly because of their dependence on the supply rep model but also because of the lack of local retail expertise. In addition, they are accustomed to an entrepreneurial management style in which decisions come from the owner. In the past, that allowed for rapid decision making; but as the volume of decisions grows, this approach becomes a burden on the organization. Yet senior managers are neither empowered nor equipped to step in.

Implications for Retailers

China's emerging retail markets offer enticing opportunities for early movers but also some very real challenges—especially for global retailers. Many local retailers are reporting lower sales per square meter than their multinational peers, as well as lower gross margins. These problems are largely the result of industry fragmentation, the popularity of the supplier rep model, the vastness of the country, and competition with lower-price channels. Succeeding under these circumstances will depend on operating efficiency and scale, and on careful decision making about growth and format. Of course, these are goals that retailers always strive for, but to win in China's current challenging environment, they'll need to up their level of play.

To assess their ability to meet the challenges they'll find in China, retailers should ask themselves the following questions:

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- Which format will help us break traditional trade’s stronghold in certain sectors?
- Do we know how to balance the benefits of customization against scale advantages in China’s fragmented markets?
- Do we know how to seek opportunities in China’s white spaces without sacrificing same-store productivity?
- Do we understand all the pros and cons of the supplier representative model for our business?
- What capabilities do we need to better answer these questions?

* * *

Global retailers are tripping over one another to gain a foothold in China. But as exciting as the prospect of 1.3 billion consumers is, setting up shop (or shops) in this vast and varied country is no cakewalk. Getting products to the consumers who want them at the right price is still a formidable undertaking. Understanding China’s unique landscape and culture is a first step toward developing a winning retailing strategy.

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