EXECUTIVE INSIGHTS

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Succeeding in China's Multi-Layered Retail Environment

The retail landscape in China is undergoing radical change, fueled in part by a substantial influx of foreign investment. The removal of most investment restrictions in December 2004 opened the door to foreign retailers looking to capitalize on the rapid emergence of a large and growing Chinese middle class with increasing buying power. Global players already in China are aggressively pursuing expansion strategies and setting their sights on less developed – and less competitive – urban centers.

While the allure of tapping into the Chinese consumer base is clear, the challenges involved in establishing and growing a retailing enterprise there can be significant. This issue of *Executive Insights* explores four major complexities to successful retailing in China: a multi-tiered socioeconomic landscape, a diverse consumer base, increasing competitive intensity, and the practical difficulties of operating in such a dynamic business environment. We offer insights into navigating these challenges and capitalizing on the enormous potential of this emerging market.

The Consumer Opportunity

With 1.3 billion people, China is the world's most populous country and commands the world's fourth-largest economy in real terms after the U.S., Japan and Germany. It has experienced the world's highest average GDP growth rate over the past 25 years and remains a favored destination of foreign direct investment (FDI). Despite its rapid growth, China is still a developing nation with a relatively low per capita income (under USD 1,000 per annum). This statistic, however, masks wide disparities in wealth.

China is experiencing the rise of an upper class and a subsequent boom in spending on luxury goods. However, it is the emergence of the Chinese middle-class consumer as one of the largest such groups in the world, and its accompanying adoption of aspirational purchasing attitudes, that is the most exciting story for global retailers. Delineating and quantifying this group is a critical challenge, given its scale and commercial potential, and as a result is the subject of some debate.

In an emerging market like China, defining the middle class is typically not just about sufficient disposable income – although this is an indispensable component. It is also about education levels and evolving purchasing habits and attitudes. China has approximately 60 million urban residents with household incomes over USD 5,000. The majority of these urban residents have adopted "modern" purchasing habits and have real purchasing power more than twice that of their nominal incomes.

This subgroup of "modern" consumers increasingly embraces brands as part of China's upwardly mobile urban society and is willing to "spend on myself," whether it be for a designer handbag at the high end or for an upscale shampoo on the low end. By most estimates, the size of the modern Chinese middle class is expected to quadruple to over 200 million in the next 10 years, eventually composing 15% of the population and becoming a critical factor in retailing globally. As a result, the question facing many global retailers today is not if to address the China market, but how.

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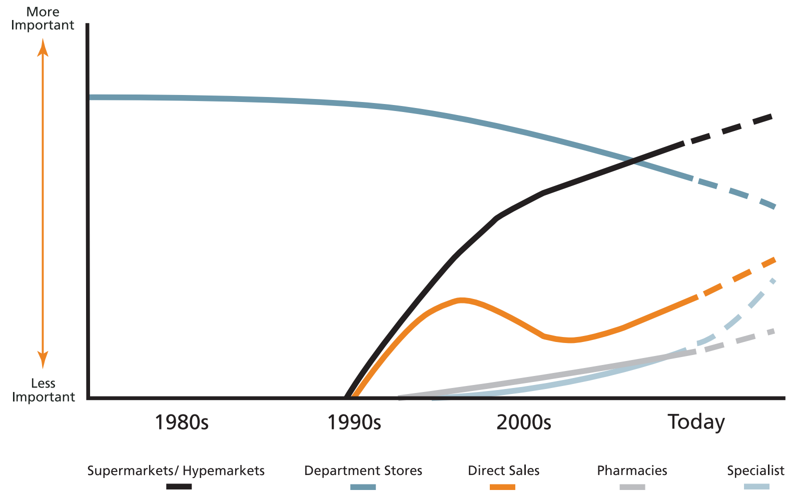
Foreign Investment is Driving Format Evolution

Until the mid-90s, the China market was dominated by large single-city state-owned enterprises with extremely poor service quality and limited product offerings on the one end and highly fragmented traditional retailers, such as mom-and-pop outlets, open-air markets and street stalls, on the other. The entry of global hypermarket retailers like Carrefour and Walmart significantly impacted the landscape by offering a previously unavailable price-value proposition presented in a well-lit, attractive and professionally managed retailing environment. The 10 years following the mid-90s marked the gradual adoption of more modern retailing formats among local urban retailers, government support for their consolidation into small and midsized chains, and the continued entry and expansion of a limited number of global retailers. These early foreign players faced a range of hurdles, including imposed partnerships, cumbersome approval processes, and ownership and operational restrictions.

China's entry into the World Trade Organization (WTO) has changed the game dramatically. WTO accession agreements established a December 2004 deadline requiring the removal of most commercial trade restrictions, including those related to full foreign ownership of retail outlets, distribution channels, and the number of foreign licenses. These and other changes have accelerated the current wave of global retailers entering and expanding in China. The number of foreign licenses granted grew nearly sixfold between 2004 and 2005 alone, and almost all of the big-scale entrants such as Carrefour, Walmart, Lotus, and Metro have outlined aggressive expansion plans in the region.

Figure 1

China Retail Channel Development



It is not just the hypermarkets that are expanding their market presence, though. The mix of retailers and their relative importance is also evolving rapidly (see *Figure 1*). New and relatively small specialty retailers, such as Mango, Zara, and H&M, have announced plans either to enter the market or to expand their existing footprint. In addition, the market has seen the rise of the direct sales format (which now controls as much as 30% of total sales in such sectors as nutritional products) and the increased importance of pharmacies as viable retail outlets.

The buzz of activity has not escaped the notice of financial investors. For instance, in 2006 the global private equity firm Warburg Pincus funded a 10% investment in China's largest consumer appliance retailer, Gome Appliance. Global specialty retailers, such as Best Buy, Toys"R"Us, Home Depot and Staples, have also invested or are reported to be evaluating large-scale investments in leading domestic players in the China market.

Achieving Success in China Retailing

The emergence of China's middle class and the more business-friendly operating environment present tremendous upside to companies that understand and plan for the challenges inherent in such a dynamic market. We have identified four critical complexities that must be addressed for retailers to succeed in China: a multi-tiered socioeconomic landscape, a widely diverse consumer base, growing competitive intensity, and the practical difficulties of operating within such a rapidly changing context.

Complexity #1: Multi-tiered socio-economic landscape

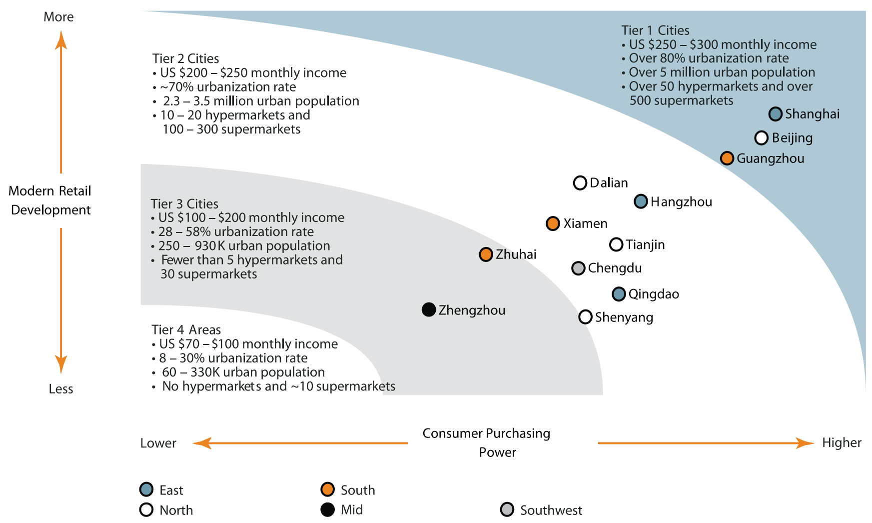
China's unrivaled path toward economic development has been based on policies encouraging export-oriented enterprises and foreign investment in select coastal urban centers. However, its 20 years of aggressive growth, coupled with an underdeveloped infrastructure and insufficient transportationroutes inland, has resulted in wide disparities in the pace and nature of development throughout the country.

For many retailers,when moving out of the most sophisticated cities of Shanghai, Beijing, Shenzhen and Guangzhou, the challenge lies in identifying which of China's less-developed cities are prime targets for expansion, and in knowing "how deep"one should go into China's mainland regions. With nearly 180 cities with populations over 1 million, and with the bulk of China's emerging middle class residing outside the more developed cities, getting the answer to this question right is critical.

Within this broader national context, the retail landscapes within cities are also constantly evolving. While the factors determining the potential for success within a given city can vary, two important dimensions indicating level of development or readiness are consumer purchasing power (based on average and top-quartile disposable per capita income) and modern retail development, or MRD (see *Figure 2*). MRD measures the extent to which traditional small-scale retail outlets have been replaced by chained "modern" formats. It is also a good indicator of the development of infrastructure and logistics capabilities necessary to support global retailer expansion. In addition, while Tier 1 cities such as Shanghai and Beijing are the most commercially sophisticated and developed, they are also increasingly saturated. We are now seeing a big wave of retailer expansion into the up-and-coming Tier 2 cities, which encompass roughly 12% of the total population in approximately 20 cities (compared with 4% in the Tier 4 cities).

Figure 2

China Complexity "Tiers" of Economic Development



Tier 3 cities, which are typically smaller provincial capitals with limited chains, are today predominantly in the sights of the more aggressive domestic retail chains and provide expansion opportunity in select sectors. For the time being, the approximately 60% of the population living in smaller Tier 4 urban or rural locations is largely out of reach of most modern retailers.

In the context of this complex socioeconomic environment, it is not surprising that few retailers are able to transport their business model wholesale to China and roll out across different city tiers.

Complexity #2: Diverse and price-sensitive consumer base

In a country as big and vibrant as China, it is no surprise that consumer preferences and buying habits are highly diverse. Consumer preferences are linked to both the level of urbanization (i.e., the city tier) and to the geographic region, with southern Cantonese-speaking consumers, for example, having tastes for product colors, food flavors, and apparel sizes that are distinct from their northern Mandarin-speaking counterparts.

In addition, Chinese consumers are generally very price sensitive. With many brands new to the marketplace – and more arriving daily – consumers exhibit an overall low level of brand loyalty and a strong willingness to try new products and retailers to get the lowest prices possible.

To be able to provide a broad selection of competitively priced, regionally specific products, many national retailers have adopted decentralized buying organizations with much of the buying authority pushed down to the local level. This of course adds another layer of complexity for foreign-owned retailers entering the market, as this decentralized structure may be at odds with corporate-centric preferences.

Complexity #3: Increasing competitive intensity

As foreign retailers gather steam and gain share, many Chinese retailers have responded in two ways: 1) by initiating a string of mergers to gain scale, and 2) by slashing prices to retake lost ground. Industry-wide margins have suffered as a result. Competition can be particularly severe within Tier 1 cities, which are often seen as "must have" brand-building locations for high-end and mid-range foreign companies. The struggle for scarce resources – limited and expensive Grade A retail locations, in particular – is already a serious barrier for many would-be entrants.

In addition to appreciating the impact of competition within cities, it is crucial that retailers also understand the competitive intensity across different city tiers. According to one leading international retail chain, the return on a typical store within a Tier 2 city can be many times that of a location in a seemingly more attractive Tier 1 city. It is not uncommon for global apparel retailers to establish loss-making flagship stores in Shanghai and Beijing, and to balance them with higher-profit department store concessions in Tier 1 and Tier 2 locations. In other words, some retailers are willing to accept a loss at a key location to capture an important brand advantage, reflecting the need to be aggressively competitive in certain city tiers.

Complexity #4: Practical challenges

A discussion of retailing in China would not be complete without noting the practical implementation challenges still facing foreign investors. While improvement is being seen along many dimensions, the following areas warrant especially careful consideration:

Logistics: China may have world-class deepwater port facilities for exports, but internal distribution and logistics capabilities are woefully underdeveloped. With few national logistics providers, most retailers and their suppliers must rely on a patchwork of regional and small-scale distribution networks or must make costly investments in building out their own infrastructure.

Human Resources: Labor is abundant and inexpensive overall, but sophisticated management talent is in short supply and increasingly expensive.

Intellectual Property: China's intellectual property regime now has tough regulations on the books, but can still fall down on implementation.

Conclusion

How will the new wave of global investment in China play out? The current era of investment presents several important advantages to today's retailers versus the groundbreakers of the past decade. It is still far from being a trouble-free landscape, though. Those retailers that emerge as leaders in their category – whether domestic or foreign – will be distinguished by their deep understanding of China's multitiered socioeconomic landscape, their agility in adapting to its highly diverse consumer base, an aggressive and intelligent approach to competing within cities and across city tiers, and their skill in managing the practical challenges of doing business in China.

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