

Markets Mass

Big stores and large networks have been the nam of the game for foreign retailers in China.

The gamble is whether customers can buy enough to make them worth it

-----By Daniel Inman

It is not hard to see what attracts foreign retailers to the Chinese market. For the company that has already captured its market back home, it appears to offer virgin territory for modern retail outlets, and its much-mythologized billion customers are bound to whet the appetite of any retailer, no matter how misleading the number.

Foreign retailers arriving with business models tried and tested in their home countries have not found China an especially easy nut to crack. There are the needs of the Chinese consumer that need to be met, and then there are China's notoriously low profit margins. "It's without doubt one of the toughest markets in the world. Most retailers will have to accept a thinner profit margin in China than anywhere else," says Ian Duffy of Ikea. "You need to really understand the Chinese and their preferences in order to succeed. That takes time. International retailers must have an offer that distinguishes them from their competitors. [For] many international retailers the difference is price, and to differentiate yourself in the country of low prices is very difficult."

Despite the hurdles, foreign retailers have made serious efforts to make their brands as famous in China as they are at home. Especially prevalent are the "big box" retailers, companies that set up large one-stop shops usually, though not always, away from the centre of town. France's Carrefour and America's Wal-Mart both have a strong presence in China, as do British do-it-yourself store B&Q and German cash-and-carry firm Metro Group.

Talk to the brand

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foreign store, and they trust it a little bit more," says Alessandro Duina, a Partner at JLJ Group, a company that advises foreign companies entering the Chinese market. He also thinks that foreign retailers are more likely to provide a higher level of customer service as well as products that might not be available in China.

Along with the positive perceptions that the Chinese might have of a foreign retail brand, there comes the negative. Chinese consumers often think that foreign stores are more expensive. This was Ikea's experience. "When they came to China, they brought a very fresh way of shopping to young people. Things are different now," says Fan Yang, a research analyst at Euromonitor International. "Their prices were far too high. But after making heavy price cuts, their prices are still seen as too high for a product of a similar quality."

Duffy admits the initial high prices were problematic. "A lot of customers remember the time when we came to China and they remember us as an expensive foreign brand rather than as an affordable Swedish furniture company," he says. "The price level that we have in China is significantly lower than anywhere else in the world. j- Due to the economic situation of China, a lot of people don't have a lot of money, so in order to reach them we've had to lower our prices."

Foreign retailers therefore need to keep themselves competitive while at the same time maintaining their image as high-quality shops with something extra to offer over their domestic competitors.

New kid on the block

One company that is banking on the appeal of high levels of customer service is Best Buy, an American retailer with over 1,000 stores in the United States and Canada. In January, Best Buy entered China's US\$100 billion (?77 billion) electronics market with the grand opening of its first China store in Shanghai. It is a market that is as competitive as it is large. Domestic retailers are already established and they have outlets peppered across the country: Gome, the market leader, has around 800 outlets (see chart on page 34).

So far, Best Buy's Shanghai store stands out next to its domestic competitors. For a start, it is enormous, with floor after floor of products. Shoppers can play with any gadget they want to for as long as they want. There is an entire area of the shop exclusively dedicated to warranty issues and repairing products. But what really separates it from Gome and other domestic stores is the level of after-sales support: Geek Squad, Best Buy's "24-hour computer support task force", has no equivalent among the local competition - so far, anyway.

But just how successful will this customer-friendly model be in China? There are varying opinions on the subject thus far. Ultimately, price sensitivity rules, according to Paul French, co-founder of Shanghai-based market research firm Access Asia, who is not sanguine about Best Buy's prospects. The American store claims it will match any competitor's price, he says, "But what are they going to do when 100 people who've met on the internet all come in demanding the same low price? That's happening now in China."

Rivals' prices could also be somewhat lower than Best Buy bargained for, says Yang. "In a big city like Shanghai, within one square kilometre there could be at least three of the same retailer. All the other retailers have hundreds of outlets and these large retail networks provide them with a very strong position to negotiate prices with suppliers."

This probably explains Best Buy's purchase last year of Jiangsu Five Star Appliance, China's fourth-largest appliance and electronics retailer. By purchasing the Chinese retailer for \$180 million, it was able to acquire 136 stores across eight provinces. A strong distribution network, combined

with their pre-existing financial muscle in the US, should help keep the store competitive. It has already announced plans to open one or two more Best Buy stores in China within the next 18 months, and to expand Five Star by another 20 to 25 stores.

JLJ Group's Duina is confident that the approach that companies like Best Buy are taking will be successful, and that the foreign retailers will take a

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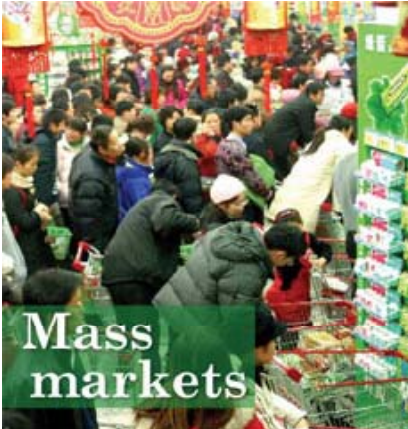
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larger share of the retailing market in China. "In developed countries, the trend is very clear: Modern trade outlets replace traditional (small) retailers. There's always going to be some level of traditional retailers, but Chinese retailers are going to have to improve or some of them will eventually go out of business. There will then be consolidation of the strongest domestic players."

Bigger is better

Put simply, the best way to stay competitive is to expand. "If a retailer is not selling the same product it's selling everywhere else in the world, then it needs to have to expand very quickly to gain a big enough local purchasing power," says Ikea's Duffy. "This puts an enormous demand on foreign retailers to expand as quickly as possible. Expanding quickly, with the right kind of stores in the right location can be very challenging."

"The cardinal rule of retail is, if you're doing well, open another store, and then another one," says Access Asia's French, who sees Ikea's lack of progress in China - three stores in eight years - as a clear sign that it has not done well. B&Q, by con



trast, has opened 51 mainland stores since 1999.

Being able to wield some power over suppliers is one way to supplement the small amounts in terms of sales revenue. It has become common

for retailers, foreign and domestic alike, to charge their suppliers with what are known as “other charges”. This nebulous term consists of the money charged to suppliers for a number of services: from an entry fee that is required for their products to be put on the shelf to a further charge for a product to be put on the shelf in a good position, such as eye level, to in-store promotions. These “slotting fees”, as they are also called, have become as important a part of the revenue stream as actual sales; in many cases they are the difference between a money-making and a money-losing chain. (Wal-Mart, however, does not charge slotting fees, but employs its influence by asking its supplier to give their first delivery of goods free of charge.) Slim profit margins encourage doing business on a large scale: if each individual customer does not bring in a large amount of revenue, then it pays to bring them in en masse. “In Beijing, we have our second-biggest store in the world,” says Duffy. “It is our intention to have big stores in China, to attract lots of people and to generate sufficient revenue to make the business a success.” It is not just big shops that are necessary, but lots of them.

Here lies the worry for foreign retailers in China. It is not the current return on investment that many of them have their eye on, but their expectations of the market in 10 or 20 years. The gamble is whether the middle class will grow to a size that meets expectations.

The numbers are important. The “billion customers” hyperbole needs to be cut through. Of China’s 1.3 billion people, well over half live in the countryside, and they are too poor to ever consider walking into a Carrefour or a Wal-Mart. To see who is going to be consuming in China, it is the urban

population that needs to be examined. A recent report by McKinsey classifies 43 percent of China’s urban population as “middle-class”. What is meant by this is a household with a disposable annual income of over RMB25,000. They further sub-divide the middle class into “lower aspirants”, or households with a disposable income between RMB25,000 and RMB40,000, and “upper aspirants” - households with a disposable income between RMB40,000 and RMB100,000.

The murky middle class

By 2015, McKinsey predicts that the middle class will have expanded to 69 percent of the population, and by 2020, the much wealthier upper aspirants will make up the majority of the population. The predicted aggregate disposable income of the urban middle class is RMB22.6 trillion by 2025, the result being that in 20 years China will become the world’s third-largest consumer market.

If this comes true, any retailer who is established by the time the middle class arrives will feel that his initial investment was worth it. McKinsey are basing their predictions on income growth catching up with GDP growth as China moves away from an investment led growth model to a situation where consumption plays a greater role in driving growth. They are confident enough to assert that it is only a matter of time until the middle class explodes onto the scene: if the economy takes a sharp downturn in terms of GDP growth, at about 4 percent, it will just take longer to come about.

Not everyone is convinced that McKinsey’s promised boom will come about. “Why is it that they assume that just because peoples’ incomes continue to grow that people will have more money to spend, considering that in every way the cost of living is rising?” asks French. Everything from transport to food is getting more expensive and, he claims, the cost of living is rising faster than average incomes. If he is right, and China’s middle class is putting its money into costly mortgages rather than big-screen televisions and plush sofas, then expectant foreign stores could still be around decades down the road, but they will still be waiting for their great middle-class boom to come.