

InterChina Insight

InterChina

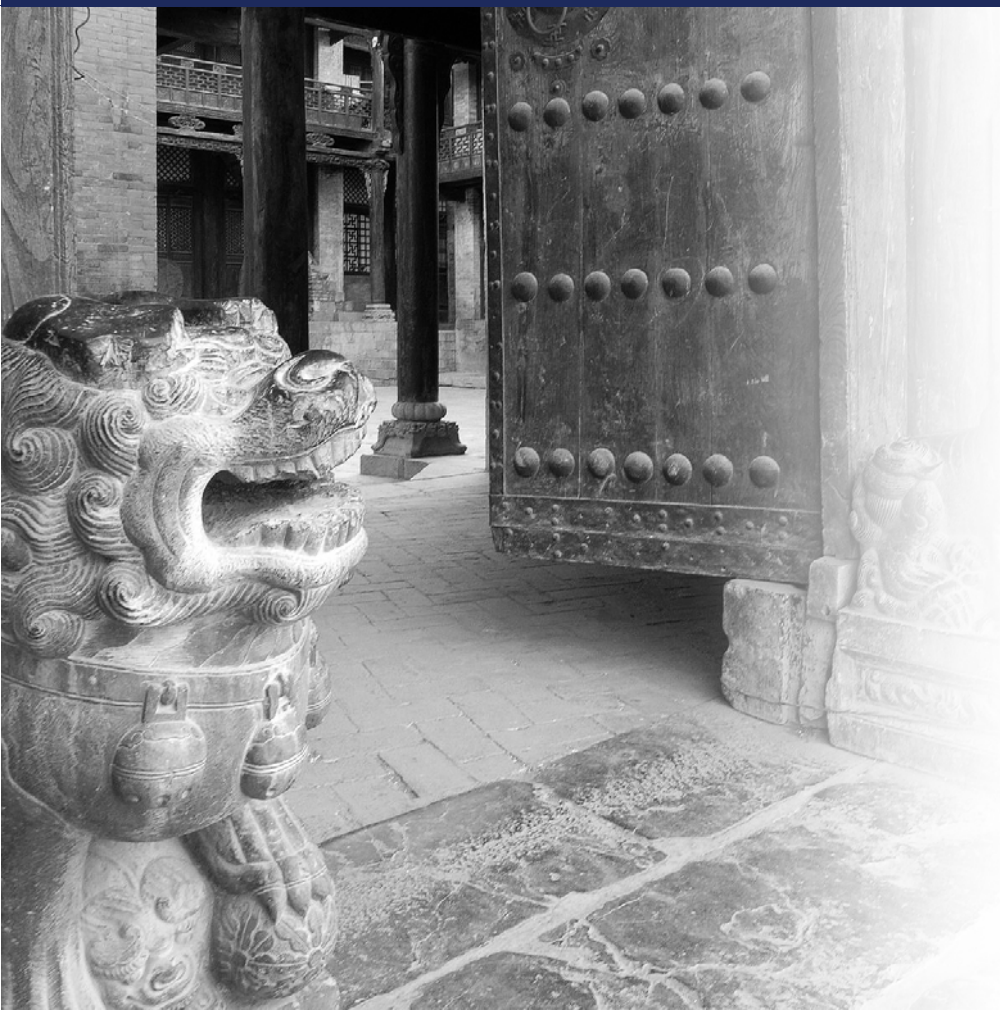


英特华

Cornering China's Market

The Battle of the Supermarket Chains

By James Sinclair | August 25, 2011



InterChina Consulting
英特华投资咨询有限公司

Beijing

Shanghai

Madrid

Milan

Washington DC

Management Consultants
www.InterChinaConsulting.com

@2011 China Consulting All Rights Reserved

Take a walk around one of Beijing's neighborhoods, and you're more than likely to see a Wal-Mart and a Carrefour, as well as many other hypermarket and supermarket chains from around the world.

Indeed, first-tier cities are fast reaching saturation, with fierce competition between stores and little room left for newcomers. So the international chains are now turning to China's dozens, if not hundreds, of smaller cities, tapping the consumption growth that's emerging across the country.

Yet this expansion is exposing new challenges. China has hundreds of local hypermarket and supermarket chains, each with their own territorial stronghold, and many with aggressive growth ambitions.

As this battle between the international and local chains plays out, the hypermarket and supermarket sector will be significantly transformed. Many FMCG companies are wondering whether today's frontrunners will be the ones left standing when the dust eventually settles.

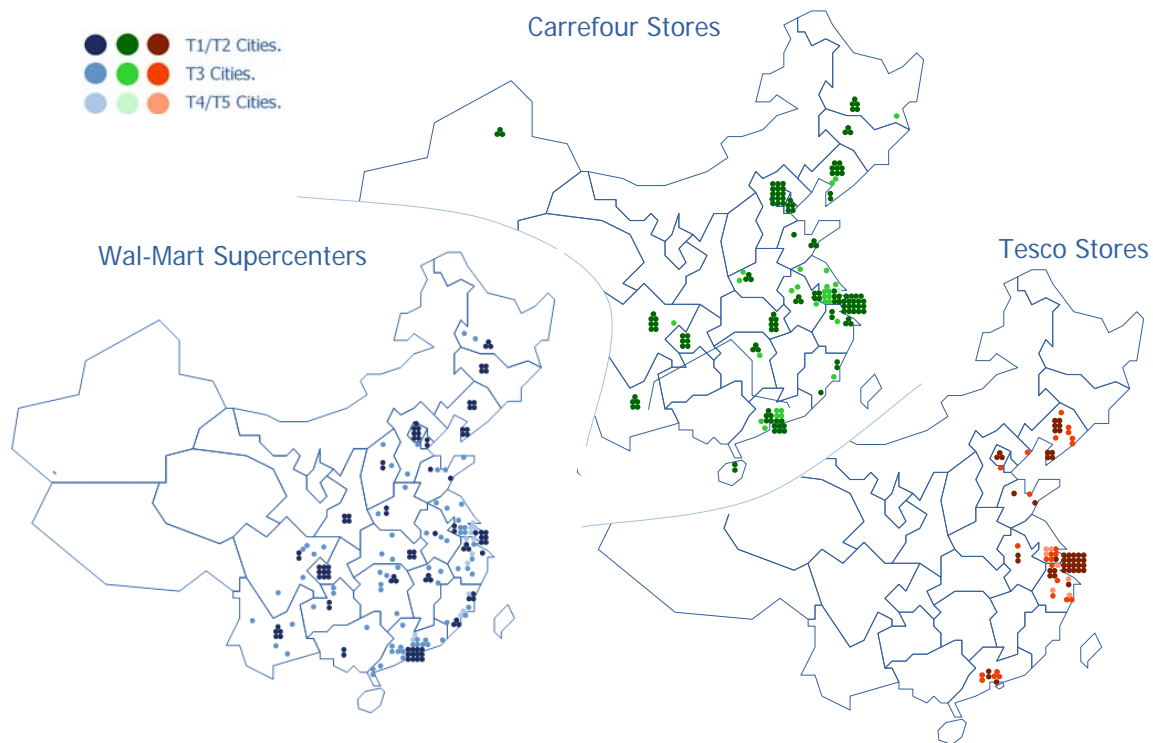
Expansion of International Chains

Most of the world's leading hypermarket and supermarket chains are in China. For Wal-Mart, Carrefour and Tesco, the three global giants, China is now their fastest growing market worldwide.

Wal-Mart has developed the largest footprint of the three. By the end of 2010 it had 219 stores in over 100 cities generating revenues of RMB 40 billion (USD 6.2 billion). Carrefour had 182 stores and RMB 42 billion (USD 6.5 billion) in revenues, while Tesco had 109 stores and RMB 16 billion (USD 2.4 billion) in revenues.

While China only accounts for a small share of their global revenues at present, with the highest being Carrefour at 5%, this will change. Together the three global giants added 100 new stores in 2010, and this expansion will continue well into the future. Tesco plans to open more floor space in China in the next five years than it has done in eight decades in its home country, the United Kingdom.

China Footprints of the Global Giants



Source: Company Websites, InterChina Analysis (Sept. 2010)

In addition to the global giants, there are many other international chains also in the chase. Among China's top 20 FMCG retailers are Auchan from France, Metro from Germany, Lotte Mart from South Korea, Lotus from Thailand, as well as Trust-Mart and RT-Mart originally from Taiwan.

Competition Posed By Local Chains

It was only three decades ago that China's retail sector started to emerge from the planned economy (see box: "From A Seller's To A Buyer's Market"). Yet while hypermarket and supermarket concepts were then introduced to China from the West, it is the local chains that now dominate. They account for around 80 of the top 100 FMCG retailers in China, and the two largest chains are Chinese: CR Vanguard and Lianhua Supermarket.

CR Vanguard generated revenues of RMB 72 billion (USD 11.0 billion) in 2010, almost twice the size of either Wal-Mart or Carrefour. Many of its 3,155 stores are smaller format, but of the 450 stores it

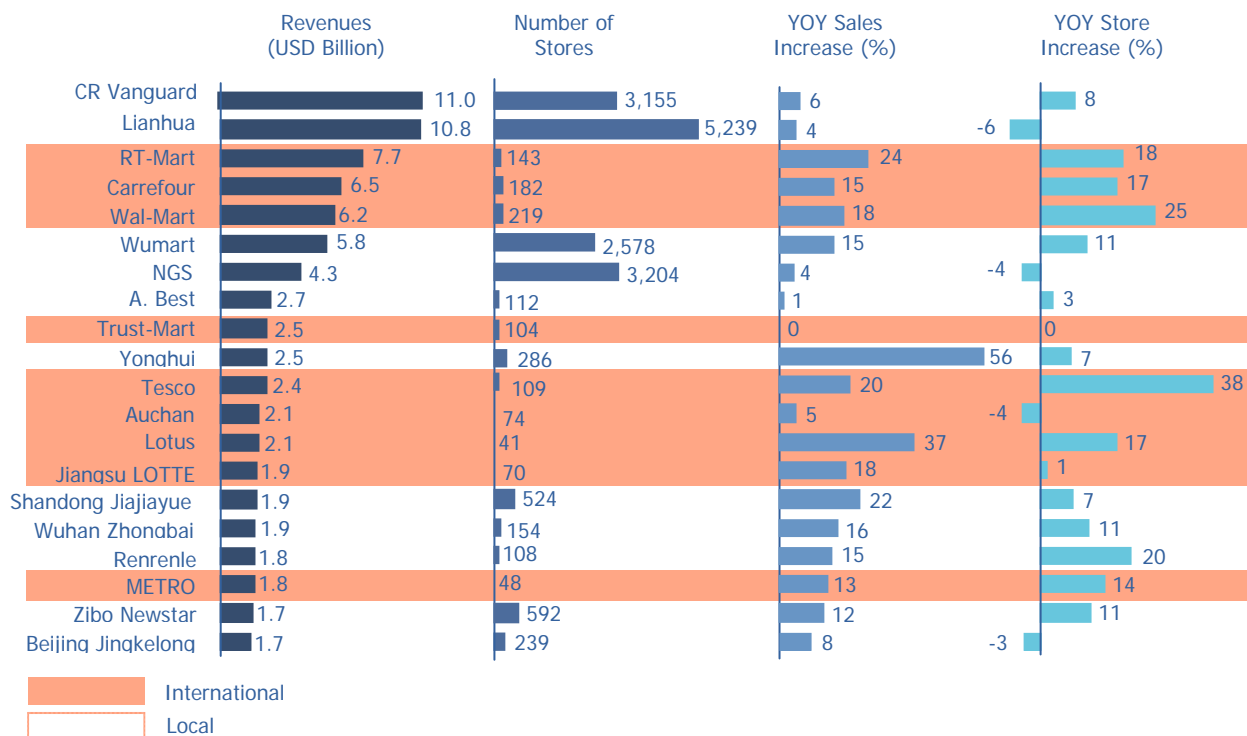
opened last year, 60 were large supermarkets. It plans to open a further 70 to 80 large supermarkets this year.

Similar to CR Vanguard, Lianhua Supermarket's revenues were RMB 70 billion (USD 10.8 billion) in 2010. Of its 5,239 stores, 143 are hypermarkets and 3,014 supermarkets, with the hypermarkets contributing RMB 16.1 (USD 2.5 billion). While Lianhua Supermarket has been rationalizing its footprint, it still opened 550 new stores last year, including 12 hypermarkets and 320 supermarkets.

Local Retail Innovation

International chains are bringing best practices to China, and continue to lead the way when it comes to retail disciplines such as category and shelf management, shopper marketing and loyalty programs, and joint value creation with suppliers. Nevertheless, local chains are fast scaling the learning curve and becoming more sophisticated.

China's Top 20 FMCG Retailers (2010)



Source: China Chain Store & Franchise Association

From a Seller's to a Buyer's Market

Planned Economy Era

Looking back 30 years, China was only just emerging from the planned economy. Its retail sector was strictly regulated, commodities were scarce and a ration system was still in place.

Coupons were issued not only for food and fuel, but also for bikes and televisions. Each coupon specified an item, quantity and sometimes retail outlet as well. Meat in particular was in short supply, rationed at 0.25 kilogram per person per month, and many Chinese had to eat vegetarian diets. Regardless of financial wealth, without coupons Chinese people simply couldn't purchase goods.

Retail was dominated by state and collectively owned stores, and while a few free markets continued to exist in the countryside, they were considered 'the tail of capitalism' to be cut off sooner or later. The level of protection afforded to retailers, and lack of competition between them, resulted in poor performance and consumer service. No new retail formats or service innovations had been introduced for decades.

Due to the scarcity of products and the planned price system, it was the suppliers that really had the upper hand. Although they could not raise prices, they could choose whether or not to supply, and specify the volumes they would supply. It was not uncommon for retail buyers to use back door relationships to get hold of much wanted goods.

Reform and Opening

With policy relaxation over the past 30 years, the transformation of the retail sector has been dramatic.

It began in the 1980s with the breaking of the stranglehold of the state and collectively owned stores, leading to an influx of individual retailers and reopening of the free markets. Meanwhile, the government took steps to abolish the procurement and sales system, and reduce the number of consumer goods subject to planned prices.

Moving into the early 1990s, international retail chains began to enter China, bringing new retail concepts and management know-how with them. Carrefour was one of the first, entering the year that international participation in China's retail sector was granted encouraged status, and the number has grown steadily since then. China's WTO commitments, which gradually lifted the remaining restrictions on international retailers, attracted further newcomers from the mid-2000s onwards.

As the retail sector has grown, China has flipped from a seller's to a buyer's market. From having next to no choice, consumers are now spoilt for choice, both in terms of what to buy and where to buy.

Retail Innovation

China's retail transformation still has a long way to go. It will no longer be driven by deregulation as in the past, but by the growth of consumption and competition between retailers, especially organized retail chains.

Retailers now have to strive to better understand consumers and satisfy their needs, and thus we are starting to see many of the world's best practices being adopted in China.

That doesn't mean to say that China's retail sector has lost its distinct characteristics. Indeed, before long we expect to see cases of China leading the world in retail innovation.

One of the most forward looking is Beijing Hualian, just on the fringe of China's top 20 FMCG retailers with 2010 revenues of RMB 10.3 billion (USD 1.6 billion) and 110 stores. It is seeking to differentiate itself against its international and local peers by developing a deeper understanding of the Chinese shopper, and using that understanding to provide a better shopping experience.

To meet this objective, Beijing Hualian has established what is claimed to be the world's largest retail innovation center, opened in Beijing in May 2010. The center is now collaborating with principals and suppliers, conducting shopper based design, and using its full-scale supermarket laboratory to test new concepts. P&G's former global director of retail innovation was brought onboard to head the center.

The first results are helping Beijing Hualian move up-market in first-tier cities. Given the growing stratification of consumer segments, and the need for a richer range of retail concepts, Beijing Hualian has launched a high-end supermarket brand: BHG Market Place. These stores, together with those under Blt and Ole banners of CR Vanguard, offer some of China's best supermarket shopping in terms of environment and merchandising.

RT-Mart's Success Story

While the stronger local chains are moving up-market in the bigger cities, the international chains are heading out into the smaller cities. One of the most successful has been RT-Mart, the joint venture between Taiwan-based Ruentex Group and the Auchan Group from France.

RT-Mart entered China in 1997, a few years after Carrefour, with a well-conceived approach. It pursued a pricing strategy that attracted value driven shoppers, developed balanced relationships with its suppliers, and offered an employee proposition that increased retention. Meanwhile, instead of concentrating on the bigger cities, RT-Mart secured prime sites in the smaller cities.

The result: RT-Mart recently surpassed Carrefour to become the largest international chain in China, with 2010 revenues of RMB 50.2 billion (USD 7.7 billion) generated from its 143 stores. More importantly, its average sales per store were RMB 351 million (USD 54 million), far surpassing those of the three global giants.

Territorial Strongholds

RT-Mart aside, it is generally the hundreds of local chains that are strongest in the smaller cities. They are a mix of regional, provincial and municipal players, each with their own territorial stronghold. This is true even for the largest local chains, such as CR Vanguard and Lianhua Supermarket. Indeed, Lianhua Supermarket still has 86% of its 5,000 odd stores in East China.

As the international chains penetrate the smaller cities, they are coming up against these local chains and their strongholds. Firstly, they have benefited from being early movers, and securing the prime locations. Secondly, their concentrated footprints make for efficiencies in terms of management, marketing and supply chain. Thirdly, they have a better understanding of the local brand preferences and shopping behavior where they operate. This all adds up to pose stiff competition.

Some of the stiffest is posed by the provincial chains that aspire to become regional players. There is Yonghui Superstores, with RMB 16.0 billion (USD 2.5 billion) in revenues generated from 286 stores, and a major player in Fujian Province. Wuhan Zhongbai Supermarket, with RMB 12.2 billion (USD 1.9 billion) in revenues generated from 154 stores, is a strong force in Hubei Province. And Better Life, with RMB 7.6 billion (USD 1.2 billion) in revenues generated from 105 stores, is a big name in Hunan Province. Following in their footsteps are many municipal chains that have their sites set on becoming provincial players.

A Modern Supermarket In Funan (a typical fifth-tier city in Anhui Province)



Support of the IGA

As the municipal chains aspire to become provincial, and the provincial chains regional, they will need outside support to become more sophisticated. A new source of global expertise has arrived in China to do just that. The Independent Grocery Association (IGA), a US-based association of regional hypermarket and supermarket chains, recently established a chapter in China. It has 20 members operating 2,500 stores so far, and is already helping to make a difference.

It has joined the University Of Wuhan to found the IGA Institute and train its members in modern retail management disciplines. It is establishing direct links between its members and their suppliers to enable joint value creation programs, such as drawing on supplier expertise to run better in-store marketing programs. And it has begun using the combined scale of its members to generate greater negotiation power over suppliers than individual chains would have alone.

IGA's members are increasingly being regarded as important partners for international FMCG companies when it comes to smaller cities in China. Not only are they a channel to improve the availability of their products, but also a source of retail data to improve their understanding of local consumers. As such, we expect the IGA to be a force in the shaping of China's retail environment over the coming decade.

Acquisitions Ahead

Another force will be consolidation. In the West, the trend is for big box retailers to be situated on urban perimeters in sprawling single story buildings surrounded by huge parking lots. In contrast, the best sites in China tend to be in dense residential neighborhoods or multipurpose complexes, split on multiple levels with basement parking. Clearly there are a finite number of these sites with few left unoccupied.

International chains used to rely on the local contacts of their joint venture partners to gain access to good sites. Over the past few years, numerous chains have formed strategic relationships with property developers, or invested in commercial complexes themselves, all with the intention of their stores becoming anchor tenants. An emerging approach is the acquisition of established chains, and with them their market share and prime sites.

International Buyers

Acquisitions by international chains actually began in 2004, when Tesco entered the Chinese market by taking a 50% stake in Hymall, the hypermarket chain owned by Ting Hsin from Taiwan. At the time, Hymall only had 25 stores in China, and almost all of them were situated in East China around Shanghai. Tesco increased its stake to 90% in 2006.

Then in 2007, Wal-Mart acquired a 35% stake in Trust-Mart, another top ten FMCG retailer in China with 2010 revenues of RMB 16.5 billion (USD 2.5 billion) and 104 stores. Wal-Mart has since started to launch 'compact hypermarkets' under the Trust-Mart banner, half the size of its own 10,000 square meter Supercenters, and better suited to smaller cities. The buyout of the remaining stake from Taiwan-based Bounteous has been delayed several times, and is currently planned for January 2012.

Carrefour has also been acquisitive. In July 2010 it purchased 51% of Hebei Baolongcang, a regional chain of 14 hypermarkets in Hebei and Shandong, with revenues of RMB 1.06 billion (USD 163 million) in 2009. Carrefour has been keen to draw on Baolongcang's local consumer understanding, and thus not only invited its founder to continue as president, but also retained all of its store managers.

Local Buyers

We expect the main acquisition drive, however, to come from the local chains. They know they must grow to be competitive, and that organic expansion beyond their territorial strongholds will be tough. The most likely buyers will be the larger, cash-rich chains.

Among China's top 20 FMCG retailers, there has already been an expression of interest in acquisitions by CR Vanguard, Lianhua Supermarket, Wumart Holdings, Yonghui Superstores, Renrenle Commercial and Beijing Jingkelong. A number of outside investors, such as retail groups and property developers, have also expressed an interest.

The obvious acquisition targets will be the smaller chains, especially those that have not yet involved an external investor. Those that are facing cost pressures or lack of management expertise will be the most willing to do deals. They may also be attracted by the brand equity of a large buyer, as consumers are becoming more sensitive to product quality and safety, and thus keen to shop at branded chains.

One of the most acquisitive local chains to date has been CR Vanguard. It has closed six acquisitions since 2001, including Nanjing Suguo Supermarket, another top ten FMCG retailer in China and a major player in Jiangsu Province. CR Vanguard is now pursuing the acquisition of Jiangxi Hongkelong, a top 50 FMCG retailer and big name in Jiangxi Province.

While China's hypermarket and supermarket sectors are currently fragmented, acquisitions will help drive consolidation. As in other countries, the trend will be towards a group of strong players in each region, although the mix of players in each region will vary.

Far From Cornered

China's retail sector is, and will continue to be, one of the most exciting in the world. Over the coming decade, we expect to see competition between hypermarket and supermarket chains cascade down into China's thousands of towns. As this happens, the retail landscape will slowly but surely transform, with traditional retailers such as 'mom & pop shops' pushed to the margins.

That being said, there are still many challenges ahead for the hypermarket and supermarket chains. This won't only be a matter of expanding beyond current strongholds and acquiring smaller chains. It will also be about better understanding consumer needs in different regions and finding ways to better meet those needs. Overall, many chains will have to



improve same store sales while limiting upwards cost pressures in order to protect their margins.

So while both the international and local chains are full of ambition, and there are a number of strong frontrunners, the market is far from being cornered.

Note: Adapted from a set of articles that originally appeared in the China Daily.



Contributed by
James A.C. Sinclair,
Managing Partner,
InterChina Consulting

James A.C. Sinclair is a Managing Partner with InterChina. He advises international companies on market development and market penetration strategies in China, and is currently the leader of InterChina's Consumer & Retail Sector Group. He has lived and worked in China for the past 14 years.

James.Sinclair@InterChinaConsulting.com

InterChina Consulting

Specialist in China

InterChina is one of the leading advisory firms in China, and the number one alternative to the global consultancies and investment banks.

We were founded in 1994, and through our unique combination of capabilities, have delivered the highest quality of services to clients for 17 years.

Our team of 50 professionals has conducted over 500 strategy projects and closed more than 150 transactions, with an aggregate value of USD 3 billion.

Multinational and Chinese clients choose to work with us because we provide real understanding, deliver practical results, and know how to get things done.

Strategy Consulting

We work with clients to capitalize on top line growth opportunities while also addressing long-term profit protection.

Our practice of 25 consultants is organized around sector specializations with substantial project experience.

We pride ourselves on being practical, developing real understanding through fieldwork, and delivering workable results to an actionable level.

M&A Advisory

We provide full cross border M&A advisory services to multinationals expanding in China, Chinese companies investing overseas, and on strategic divestments.

Our practice of 25 advisors is comprised of senior Chinese negotiators with strong corporate development, investment banking, private equity and Big Four backgrounds.

We conduct ~40 mandates each year, providing clients with transparency and control from start to finish, with an annual closure rate of 4-6 transactions.

InterChina is also the exclusive China partner of IMAP, the oldest and largest global organization of independent mid-market M&A advisors.

Contact Us

We have two operations offices in China (Beijing and Shanghai) supported by two liaison offices in the West (Madrid and Washington D.C.).

For further information, please visit our website at www.InterChinaConsulting.com