Ready for warfare in the aisles

HONG KONG, SHANGHAI AND SHENZHEN

For both domestic and foreign retailers, China is a market of unprecedented opportunity. But it is turning into a battleground

TIRED after a long day helping to propel the world's most dynamic economy to new heights? Then relax under a luxury duvet, filled with the chest fluff plucked from 3,000 Icelandic wigeon, priced at a mere 110,000 yuan ($14,000) and lighter than the bag it comes in. Sam's Club in Shenzhen, China's richest city, sold its entire stock of three (only 50 are made each year) during the Chinese Spring Festival. Or choose a solid gold bottle of *baijiu* liquor for the equivalent of $11,000 or a 65-inch television for $15,000. It is not so much the high prices that are surprising, but that the Shenzhen superstore is part of America's giant Wal-Mart, which is famous for selling Western consumers cheap goods made in China.

Luxury puts the shine on Chinese retailing, although the business is mostly about selling more mundane things. Hence the Shenzhen Sam's Club also stocks gallon drums of cooking oil, plastic cups and other everyday items at rock-bottom prices. The sprinkling of expensive stuff among the bargains says much about the aspirations of modern Chinese consumers, as well as the heroic efforts of the world's retailers to win a share of their wallets. The scramble to open stores has made China a paradise for shoppers, but for shopkeepers it has become a brutally competitive market in which only the strong will survive.

Enormous numbers are luring global retailers to set up shop in China and take on a growing band of local operators. China's retail sales are set to expand by 13% to the equivalent of $860 billion this year, making the mainland the world's seventh-largest retail market. Annual compound growth rates of 8-10% will push this to an enormous $2.4 trillion by 2020.

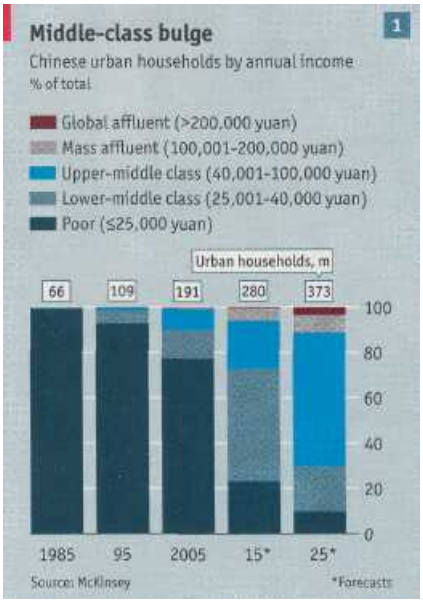
Here comes the middle class

There are more than one million affluent urban households, earning more than 100,000 yuan a year, who regularly buy luxury goods. But their spending power is rapidly being dwarfed by a vast emerging middle class. These households earn between 25,000 yuan (the threshold for becoming a serious consumer in China) and 100,000 yuan, says McKinsey. The consultancy estimates that the number of such households will rise from 42m in 2005 to 2Oom by 2015 (see chart 1 on next page).

Stores like the one in Shenzhen show how much has changed in Chinese retailing. Just two decades ago, shops had surly staff offering a few drab items, often locked safely away in glass cases. Yet there is still a long way to go. Even today, much of the population buys from daily markets or directly from producers. Organised retailing remains relatively new. Most Chinese stores are tiny, family-run outfits. China's top 100 chains account for just a tenth of total retail sales.

When China's economic reforms began, state-owned department stores, such as Dalian Dashang and Wangfujing, dominated. Only in the late 1990s did specialist supermarkets and electronics and home-decor chains emerge. Yet even the largest is not national. Local protectionism raised bureaucratic hurdles to moving goods across provincial borders. Many constraints remain, says Joe Hatfield, the president of Wal-Mart Asia, who has spent 12 years working in China. With few national retailers and national brands, economies of scale are hard to achieve. Most retailers use a myriad of small suppliers operating through wholesalers. This raises costs and lowers efficiency.

Yet the arrival of foreign retailers is changing things. Apart from Wal-Mart, other successful giants have set up shop, including France's Carrefour, Britain's B&Q and Malaysia's Parkson. Foreign firms now account for 23% of the sales of the top 100 food retailers in China. More are arriving with the lifting of rules restricting for-1



eign chains to a handful of big cities. In 2005, over 1,000 new retailers received approval, of which more than half had foreign investors. There are now over 1,000 foreign retailers in China compared with just 314 two years ago.

Local rivals have responded ferociously. Crippling price discounts can be accompanied by dirty tactics: some stores send fake "customers" to rivals' new stores to snap up all the promotions before genuine customers can get them. Another trick is to jam the doors of the lockers used by shoppers to store their purchases. Meanwhile, retailing costs are rising. As China urbanises, commercial-property prices are soaring and retailers face a doubling or tripling of rents on renewal. Marketing expenses are also growing. Between 2002 and 2004, advertising spending rose by 50% a year across all categories of consumer products in China. And wage growth is outstripping productivity gains.

Product prices, by contrast, are hardly growing. Severe overcapacity means that prices for electronic goods are declining and even food-price inflation has eased significantly. Last month, Suning, China's second-biggest home-appliance chain, announced a 25% cut in the prices of air conditioners in response to discounts offered by Gome, the market leader, and China Paradise. Store density is already high in urban China: Shanghai's Gubei district has seven hypermarkets-one for 34,000 people compared with one for 48,000 in France, where Carrefour invented the hypermarket. Yet customers can spend little. The average spend per visit in Shanghai is tiny, just 50-70 yuan ($6.30-8.80).

Michele Mak, a China retailing analyst at Credit Suisse First Boston, says these mounting pressures are already showing in the industry's 2005 financial results. Store productivity is declining, sales per square foot are falling and profit margins are shrinking. Operating margins at Gome, China's second-largest retailer by sales (see chart 2), declined from 6.2% in 2004 to 4.4% last year. Those at Lianhua Supermarket, the main grocery arm of Bailian Group, the domestic market leader, fell from 2.4% to 1.9%.

Yet the headlong expansion continues, either through the opening of yet more new stores or through a rash of takeovers. Hong Kong-listed Gome recently offered HK$5.3 billion ($680m) to buy China Paradise (also known as Shanghai Yongle), which earlier this year swallowed Beijing Dazhong. The deal will give Gome, which dominates Beijing and the north, a leading position in Shanghai and on the prosperous east coast. Its national market share in appliances will rise to more than 10%.

Gome's move is a swift reaction to the arrival in China of America's Best Buy, which in May bought Jiangsu Five Star Appliance, China's fourth-biggest appliance chain. In food, Wumart, a hypermarket operator, is taking over Beijing MerryMart. Carrefour, Wal-Mart, Tesco and Lianhua are all said to be mulling an offer for Trust-Mart, a Taiwanese-controlled chain.

However, most of the growth in Chinese retailing is coming from the opening of new outlets. Gome's head of operations, Xiangwei Weng, says his company opens a shop every 30 hours. Lianhua aims to add 500 shops across all its formats. Wal-Mart's plans for 14 more stores in the second half of this year seem modest by comparison. Carrefour wants to open 40-50 more stores in Beijing alone by 2008, from its existing eight. Parkson will triple its number of stores to almost 90 within four years.

The reason behind the rush is partly to snap up prime locations. But there is another motive. In China, suppliers can pay heavily to place their goods on retailers' shelves. They also lease space for in-store displays, help pay for promotions and give rebates. So, each time a retailer opens a new store, it can demand more payments. This means new shops can be profitable in their first year. But without working harder to improve sales at existing shops, some Chinese retailers can become highly dependent on their suppliers to finance expansion. Last year "other income" (mainly fees charged to suppliers) made up 64% of gross profit at Wumart; 45% at China Paradise; 44% at Lianhua and 31% at Gome, calculates Merrill Lynch.

Distracted by expansion, most local retailers are doing little to control costs and boost same-store sales-vital for their long-term success. But foreign retailers are providing a model for those who want to learn. At Lianhua's Century Mart hypermarket in Shanghai's wealthy Gubei district, manager Wang Yue is borrowing ideas from Carrefour's profitable hypermarket, just 2.5km (1.6 miles) down the road. Carrefour's gleaming store is huge and, with 30,000 different products, has a range that would be impressive in the West. At half its size, Ms Wang's store struggles to compete and looks empty by comparison. But things are picking up. Ms Wang has copied Carrefour's larger shopping carts and raised her spending per customer by a fifth. Carrefour's use of consumer research has also persuaded her to offer shoppers more than just low prices.

Quality, cleanliness and safety, for instance, are still rare in a country where stories abound of fake baby milk and washed diapers sold as new. Ms Wang employs 30 cleaners (10% of her staff) to counter local prejudice that Chinese-owned shops are dirtier than foreign ones. B&O, meanwhile, tries to dispel suspicion about the low quality of Chinese-made products by letting customers touch everything it sells. Supermarkets cater to the same instinct by letting customers net their own live fish from tanks in the store.

Top shop 2

China's top retailers, 2005

	Headquarters	Sales		Stores	
		yuan, bn	growth, %	number	growth in number, %
Bailian Group*	China	72.1	7	6,345	15
Gome	China	49.8	109	537	100
Suning	China	39.7	80	363	88
Vanguard	Hong Kong	32.0	26	2,133	20
Wumart	China	19.1	44	659	8
Carrefour China	France	17.4	25	73	26
China Paradise (Shanghai Yongle)	China	15.2	40	225	81
Trust-Mart	Taiwan	13.2	10	96	9
Parkson China	Malaysia	11.0	49	36	20
Lotus	Thailand	10.1	36	61	49
Wal-Mart China	US	9.9	31	60	30
B&Q China	UK	5.2	156	48	129

Source: China Chain Store and Franchise Association *Including Lianhua

Specialist chains are fast cashing in on middle-class preoccupations: B&O and IKEA reflect China's growing level of home ownership and a passion for interior decorating. Parkson and Hong-Kong-owned Watson are expanding on the back of growing interest in health and beauty.

At the Shenzhen Sam's Club, 60% of the food is now imported, says Duan Lixia, the deputy manager, pointing to Chilean grapes, German chocolate and alligator meat from Australia. The store's customers can afford to own a car so there is parking for over 2,000. That helps to raise spending per customer. Car ownership in China is still low and most stores provide free shuttle buses, which limits what people can carry home. Sales per square foot at the Shenzhen store are more than double those at a typical Wal-Mart Supercentre in China. There are just three Sam's Clubs in China, but, excited by their success, Wal-Mart plans to open more.

Hong Kong-run Vanguard is experimenting with an upmarket format, Ole. Its store in Shenzhen boasts elegant wooden floors and exotic imported foods. Sales are rising by 40% a year. And China's own Lianhua is upgrading 100 dowdy supermarkets in Shanghai with great success. One in Shanghai's Xujiahui central business district outshines even Ole. It has had a lom yuan facelift by Japanese designers and now features a juice bar, bakery, wine room and hot-food stalls. Sales are up by half and the store is packed with expatriates and *hai* gut (returnee Chinese).

Frogs and turtles

Move out of China's big cities or even into the suburbs, however, and shopping habits become more traditional as income levels fall. At a Vanguard supermarket in an unfashionable part of Shenzhen, manager Hu Fan tries to satisfy traditional and modern tastes. On the ground floor people net live fish and pick through tanks of frogs, trussed turtles and glistening chicken feet. But next to the unwrapped meat (shoppers traditionally like to handle meat to test its freshness), are plastic-covered pieces with reassuring expiry dates. Shoppers can choose from 130 types of fruit, twice the number found in a typical market.

As organised retailers move to smaller cities and further inland to escape competition and soaring rents, they face huge variations in taste and extreme price sensitivity. This complicates distribution further and raises costs. Wal-Mart's buying teams arrive in a city five months beifore a new store opens to research local habits: "There are thousands of uniquenesses," says Wal-Mart's Mr Hatfield. People in Zhejiang like toilet paper "as rough as sandpaper"; the top seller in Kunming is spicy chicken feet; and Shandong natives like to buy whole steamed pigs' faces to slice up and dip in soy sauce and vinegar.

Operating profitably in poorer markets often means switching to smaller stores with a narrower range. Xu Lingling, chief financial officer at Lianhua, says that whereas big foreign players, such as Carrefour, have taken top sites in large cities, Chinese chains may be better suited to mid-sized towns where productivity is lower. And these may suit a different approach-such as the franchising of McDonald's, KFC and Tupperware, which lowers the initial level of capital investment. Avon is going further: having finally received permission to resume direct sales in February, the American cosmetics group has already recruited over 114,000 sales agents.

Nor can retailers in small cities expect the same appetite for brands as found in more cosmopolitan Shanghai or Beijing. In general, the Chinese are brand-conscious but not loyal. They are more interested in value and trying new things than Westerners are. McKinsey found Sony could charge a premium of up to 40% for televisions in developed markets, but even a 10% mark-up in China can put consumers off. And many Chinese are impulse buyers, susceptible to last-minute discounts.

One response is to shift to own label goods, which Wal-Mart is doing aggressively. Another is to move spending from general advertising to in-store promotions. In a typical Gome store, half the floorspace is dedicated to special product displays. These are manned by pushy salespeople, who are cheap to hire in China and are often paid by the manufacturer. Vanguard's supermarket in Shenzhen has 350 staff, and 500 other people promoting not just expensive electronics, but also cheap items like toothpaste and shampoo.

Stores hoping to increase loyalty are starting to promote giveaways and improve service, but often in vain. At Vanguard, buy hair dye and promoters will apply it free (customers browse its aisles sporting plastered hair and towels). Many "shoppers" happily accept freebies without spending. At the Shenzhen Wal-Mart, the buzzword is "retailtainment". Chairs are placed around a big television so shoppers can watch football matches in air-conditioned comfort. People with empty baskets lounge on benches and read. Upstairs, staff oversee a baby-crawling race. Zhang Hui Lan, 64, visits daily for free food tastings and to chat with staff, "who are much friendlier than in the markets."

On the front line

Yet getting people to spend more—or anything at all-is only half the task. Retailers must procure goods at the right price. In distribution and logistics, China is far behind developed countries. Strong regional tastes and lack of national scale stymie the development of national brands and efficient supply chains. Wal-Mart's 60 stores in China are served by 15,000 suppliers; its 3,800 American ones need only 61,000. Then there are the many layers of middlemen. Some foreign chains are starting to deal directly with manufacturers. Wal-Mart has introduced its notoriously hard-nosed negotiating tactics. At its Shenzhen headquarters, buyers bargain in rows of cubicles strewn with goods. Just like Wal-Mart's headquarters in Bentonville, Arkansas, the cubicles have no doors, in order to discourage the passing of bribes.

As they gain scale, big chains are also opening modern distribution centres. At the Wal-Mart centre near Shenzhen, a vast effort is under way to link suppliers electronically to the retailer's systems-only 30% have been plugged in so far, while the rest still need orders to be faxed to them. Just 20 trucks can fit in the loading bay and they can wait for more than an hour to be unloaded, largely by hand.

Wal-Mart will move to a new distribution hub in September. Its old one is outclassed by the cool efficiency of Lianhua's distribution centre in north-west Shanghai. There everything is automated and sorted on conveyor belts using barcode scanners and sophisticated lifts. Yuan Zhongmin, who runs the centre, says that with half his former workforce he can shift 60,000 cartons every ten hours, compared with 25,000 previously. The cash tied up in inventory has fallen from loom yuan to 27m and the rate of mistakes in orders has fallen from 1% to 0.0016%.

Such improvements show how rapidly China's own retailers can catch up with the best of the foreign chains. Competition is therefore bound to get even more intense. Some retailers' profitability could suffer as they wait for the spending power of the emerging middle class to increase. But there will be handsome rewards for those that can survive this battle of hypermarket proportions. •

Fonte: The Economist, v. 380, n. 8489, p. 59-61, 5 Aug. 2006.