



China's Retail Market: How the West Will be Won

China's booming retail market is heading westward, evoking images of limitless expansion – a retail Manifest Destiny. China's burgeoning middle class has driven increased consumption and discretionary spending throughout the country, which in turn have spurred rapid growth in the national retail sector. The Ministry of Commerce (MOFCOM) forecasts a 16% increase in retail sales for 2010, and China now ranks second only to the United States in total retail sales. Multinationals such as Carrefour, Wal-Mart, and Tesco already pervade the megacities on China's eastern seaboard, so the **retailers are now forging into the hinterlands, seeking an underserved middle class with a voracious consumer appetite.**

But operating in the hinterlands may not be as smooth as in Beijing, Shanghai, and Guangzhou. In July 2009,

ethnic clashes between Uighurs and Han forced at least one hypermarket in Urumqi to shut down for more than two weeks. Civil unrest aside, simply meeting the needs of local consumers has proven to be a challenge for retailers. **In July 2010, Carrefour was forced to close its store in Xi'an** because it "wasn't the right size and format," explains Matthew Crabbe, leading expert on China's consumer and retail markets. The store consistently lacked the food selection that local customers demanded and consequently had to "struggle to regain consumer interest."

Given the various challenges facing China's hinterland markets, how can companies expand wisely?

Ergo engaged five experts to assess the opportunities – and pitfalls – as retailers head westward in China.

Supply Chain Issues

A successful move into China's deep interior will entail overcoming considerable supply chain hurdles, the most significant of which is the sheer distance from coastal hubs. **Moving cargo by truck is the only option** to and from most interior cities, so retailers are often hostage to horrendous road conditions and epic traffic jams, like the 60-mile, 10-day back-up on the Beijing-Tibet highway that grabbed international headlines in August.

Hinterland markets also face **complex transportation regulations** which stipulate that trucks can only be on the roads at certain times in certain cities. Bradley A. Feuling, a leading Chinese supply chain expert, believes that city-specific trucking codes undoubtedly influence "logistics costs and the model for distribution within a city, be it in Shanghai, Xi'an, or Urumqi."

Supply chain problems don't stop with distribution. Allan Liu, Managing Partner of Pacific Alliance Equity Partners, a Hong Kong-based private equity firm, says that retailers must contend with subtler issues as well. "A lot of these physical issues overshadow what are equally important 'soft' supply chain issues," he explains. "The distributors are only as good as the dominant corporation that they might work with. They are fixed to that model and those systems, making it hard to work with new partners" when the time comes to switch.

Some retailers have learned to make the best of a bad situation. They lease out their excess logistics capacities in order to boost efficiencies in rural areas. These supply chain partnerships have been profitable, too. Crabbe adds, "Such non-core business has been a boon to many provincial retail chains that have needed to raise profitability where retail business margins have been initially weak."

Local Governments

Supply chain issues will continue to pose challenges to retailers, but local governments in interior cities have facilitated the expansion of retail chains. "Basically, I think **the local governments are open – they are quite liberal in terms of trade** with, or investment from, international firms," says Felix Li, President and CEO of Orient Homes, the largest home improvement retail chain in China.

In addition, regulations in interior cities are not as stringent as in the coastal hubs. Permits for large retail outlets (over 5,000m²) in major coastal cities often require public hearings and testimony from executives. Liu says these burdensome processes often dissuade retailers from entering the coastal cities that are already more saturated and competitive.

Although local governments may be willing to help, Li still believes that firms need to invest in adept managers. Without effective management teams who can work with local regulators and government officials, he thinks it will be more challenging to achieve support for new retail outlets. Crabbe agrees: "The key to moving into any regional market is local government, market research, and local government again."

COMPARING KEY RETAIL FIGURES: FROM THE COAST TO THE HINTERLANDS

	CITIES		
	Shanghai	Xi'an	Urumqi
Population (millions)	13.91	7.72	2.36
GDP (100 million yuan)	13,698	2,190	1,020
GDP Per Capita (yuan)	98,477	28,368	43,233
Total Sales of Consumer Goods (100 million yuan)	4,537	1,154	419

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	REGIONS		
	Shanghai	Shaanxi	Xinjiang
Total Population (millions)	18.88	37.62	21.31
-Rural	2.15	21.78	12.86
-Urban	16.73	15.84	8.45
Gross Regional Product (100 million yuan)	13,698	6,851	4,203
Household Consumption (yuan)			
-Rural Household	12,202	2,993	2,661
-Urban Household	29,250	10,965	9,975
Total Length of Highways (km)	11,497	131,038	146,652
Length of Railways in Operation (km)	316	1,195	2,761
Number of Retail Stores	16,913	444	2,369
Retail Operating Area (10,000 m ²)	730	74	190

Source: China Statistical Yearbook 2009

ERGO'S VIEW

Although there are obstacles facing retail's westward expansion in the short term, new consumers in western China will drive the market for years to come. In 2008, the five provinces with the highest retail sales – Guangdong, Shandong, Jiangsu, Zhejiang, and Henan – were all located in the eastern portion of the country; retailers will need to find less saturated markets with fewer mature consumers. Expansion, however, will not be without risks. In order to capture opportunities in these new markets and mitigate risk, retailers will have to:

- Identify market niches (e.g., gift-giving during particular Chinese holidays) and target specific cohorts (e.g., the unique consumer needs of Uighurs in the XUAR).
- Employ managers who can work well with local governments and understand local regulations to ensure compliance.
- Develop short term supply chain solutions, such as improved demand forecasting models and additional inventory locations to streamline the flow of goods to and from rural areas.

Over the past decade, foreign investment in China's retail sector has been minimal: no more than 5% of the country's approximately 1.4 million retail outlets have foreign backing, and nearly all of that investment has come since 2004. However, the investment climate will improve as new national regulations ease the entry of foreign retailers into China's hinterlands. The Administrative Measures for Foreign Enterprises, which took effect in March, allows for partnerships between foreign investors and domestic retailers, potentially ushering in a wave of JVs. With fewer regulatory hurdles encumbering access to the untapped markets of China's interior, expect outside investment in China's retail sector to increase markedly in the coming years.

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