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China's Great Retail Race

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South Korea’s Lotte conglomerate became the last in a series of multinational retailers to seek their fortune in China. In June, Lotte bought 100% of CTA Makro, which operates six supermarkets in Beijing and two in Tainjin, under the Chinese brand name Wankelong. In addition to supermarkets in Beijing, Shandong, Lianing and other provinces, the South Korean company plans to open 300 hypermarkets in China over the next 10 years.

Even before Lotte’s move, China was the only retail market on earth where the top four global players—Wal-Mart, Carrefour, Tesco and Japan’s Seven and I Holding Company—compete in a significant way.

Yet scratch beneath the expansionist euphoria and you find that China really is a tough place to stay in business. Despite 11.4% year-on-year GDP growth in 2007 and dynamic growth in consumer spending, retailers across China are suffering due to overcapacity and inefficient operations.

Bain & Company projects growth in modern trade (hypermarkets, supermarkets, chain convenience stores and discount stores) in China will face a significant slow down over the next four years. Already by 2007, modern trade had reached the point of market saturation in China’s Tier 1 cities and some Tier 2 cites.

For example, in Shanghai and Fuzhou, the retail space per household ratio, an indicator of market saturation, exceeded that of France and other developed countries. In fact, CTA Makro’s acquisition by Lotte reflects the industry consolidation and restructuring that is happening in the retail sector throughout China.

As sales growth slows and the retail market becomes increasingly crowded, the winning companies will be those that make the most of scale to lower overall costs and the prices they charge in leading product categories. They’ll also need to streamline operations and learn how to make the most of their basic business model while adapting it successfully to local specificities.

When Bain & Company analyzed nearly 300 attempts by more than 60 U.S. retailers to expand into adjacent businesses during the period between 1989 and 2004, we found that only 29% of the moves contributed to profitable growth. Just 15% hit the jackpot—defined as moves that had a positive net present value and added more than 5% to revenues and profits. Successful movers tend to be those that enter new businesses that are closer to their "core" business activities, with success rates rising sharply for those moves involving expansions into adjacent businesses with few variants in the companies’ current cost structures, target consumers or capabilities.

Chinese retailer Wu-Mart has deployed a successful strategy of concentrating in one region at a time—a geographic core—and then selectively expanding as it gained market share and learned how to address regional preferences. The company uses multiple store formats to drive market share dominance, making selective acquisitions along the way. Using this approach, Wu-Mart has captured more than 5% of retail market share in Beijing, a leading position in a fragmented market. A full 90% of its stores are concentrated in three closely located areas: Beijing, Tianjin, and Hebei Province.

Similarly, France's Carrefour has emerged as a major multinational retailer in China by learning how to take a carefully honed core operating model and adjusting it to the specificities of a new market. Carrefour, the world's second-largest retailer, took a measured approach. As of June 2008, the company operates more than 110 hypermarkets throughout China and 283 discount stores in Beijing and Shanghai, for total revenues of around €3 billion (around $4.8 billion) in 2007.

When Carrefour entered China in 1995, it opened its first hypermarket through a joint venture with a local partner. The relationship helped the French retailer learn the local characteristics to which it needed to adapt before moving its higher-margin hypermarket format to China. This partnership approach has been pursued since then, with different partners in the different regions of China to better adapt to regional variations.

Like Wu-Mart, Carrefour was painstakingly careful in its expansion strategy. The French retailer started out in selected Tier 1 cities throughout China. Only after it established itself in those cities and felt confident it could transfer its operating model did the company enter affluent second-tier cities such as Dongguan and Zhuhai. In particular, it learned how to adapt its product offerings to an average basket of about 100 yuan (around $14), whereas it can reach more than 160 yuan in the most affluent suburbs of Beijing and Shanghai.

The company went to great lengths to understand how retailing in China would be different than anywhere else. For starters, it knew that less than 10% of its potential shoppers would drive cars. Instead of following its more typical model of locating stores in relatively remote locations, Carrefour opened most of its stores in dense urban areas, even if it meant two-level stores. Also, Carrefour knew it had to allow suppliers to manage their own logistics, instead of setting up Carrefour's own logistics arm and charging suppliers for logistics services as it does elsewhere in the world. The reason: Chinese suppliers often don't know their logistics costs.

Carrefour also identified which of its accepted business principles and processes it needed to maintain while adjusting to the new market. Among the unchanged principles: Its store operating model, its management-information system, and its employee career-management and training programs would be the same as they are in the other countries where it operates.

Knowing what to change as it moved beyond its geographic core has been a key factor related to the retailer's success. Carrefour determined that its internal store design could be similar to that of its hyperstores in other regions throughout the world. But for Chinese customers it allocated more space for bulk products and snack foods, and it also stocked fresh fish in an aquarium—catering to Chinese shoppers' preference for purchasing live seafood. And while Carrefour's location criteria and overall store size was unchanged, it made some distinct adjustments for China: The company opted for two-level stores over a single level, and—catering to China's relative shortage of automobiles—allocated a large share of its parking lots for bicycles and even provided a bus to pick up shoppers.

Attention to cultural differences is helping distinguish the retailing winners from losers in China and elsewhere. Our study found that only one in every three international expansion by retailers results in profitable growth. But companies have discovered that the very strategy that has contributed to their growth over the decades—standardization—now can hurt the bottom line. In response, companies like Carrefour are replacing standardization with localization, the fine art of stocking store shelves based on an area's ethnicity, wealth, lifestyle and values. As an example, for Chinese consumers, shopping has to be a fun and enjoyable experience; so Carrefour stores have several "retail-tainment" events and promotions every day.

For retailers, learning how to localize stores requires striking a tricky balance. Too much customization drives up costs. Too little attention to regional trends and product preferences leads to stagnation, sending customers into the arms of more innovative competitors. Our analysis of 30 localization leaders found that these pioneers use three criteria to achieve an optimal balance: They figure out which elements of a business should be localized, how costly they are to customize, and how much impact they'll have from store to store.

As the competition heats up in China, Lotte and other players would be wise to take a lesson from winning retailers like Wu-Mart and Carrefour. Both have learned that what it takes to succeed in

China is not very different from elsewhere in the world. In addition to making the most of scale and honing operations, winning companies stay close to their core as they honor cultural differences. That can spell the difference between capturing share in China's magnificent growth—or being acquired or closing up shop.

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