Retail Evolution

Positioning for Modern Trade Growth

MVI takes a look at what causes retail markets to modernize and the different paths that markets take as modern trade (chain retail) evolves. We also highlight the triggers and rates of change as the market shifts from largely traditional trade to modern trade dominated. In particular, we describe how certain markets modernize as a result of foreign-owned, global players entering, while other markets have developed primarily due to local players accelerating modern trade growth. In a number of markets we've studied, a hybrid approach dominates—with global and local players growing in parallel directions.

India, Poland, Brazil, and South Korea provide interesting case studies of markets evolving rapidly. No doubt, government regulation has played a significant role in promoting domestic retailers. But will this trend continue? If foreign direct investment (FDI) restrictions are loosened or consumer purchasing power and shopping patterns change, which market evolution pattern will take hold and why?

Lastly, we will discuss the core capabilities successful retailers will need in developing markets. The growth of modern trade operators—whether global or local—will depend on their ability to leverage relevant capabilities while adapting to market conditions and changing consumer tastes.

Part I: How Markets Modernize

According to a recent in-depth study, MVI research shows that retail markets tend to modernize from largely traditional trade to modern trade dominated along a predictable continuum. As markets modernize, the share of traditional trade as a percent of total trade declines slowly; suppliers, however, will continually need to adjust the amount of resources allocated to manage the traditional trade versus the modern trade.

Smart suppliers manage this balancing act by accurately tracking (and often predicting) the pace at which key transitions or market evolution shifts are likely to occur.

Three overarching factors affect the speed and nature of market transition. They include (1) consumer trends and purchasing behaviors in the market; (2) factors related to modern retail consolidation; and (3) disruptive factors such as the economy, special interests, and

Figure 1: Comparing Macro Economic Indicators

Markets	2004 Chain Retail Sales	Retail Trade in South-East Asia Non-Chain	Retail Trade in South-East Asia Chain	2004 Formal Retail Sales	2004 Gross Domestic Product (GDP)	Formal Retail Sales as a % of GDP
India	5,720	98%	2%	78,785	661,046	12%
China	93,638	80%	20%	346, 808	1,649,387	21%
South Korea	21,527	85%	15%	114,812	681,469	17%
Indonesia	12,326	75%	25%	35,216	257,872	14%
Philippines	6,131	65%	35%	12,513	85,136	15%
Thailand	16,988	60%	40%	28,314	163,492	17%
Malaysia	10,229	50%	50%	15,737	117,776	13%

In current USD millions
Source: IMF, MVI retailer database, various national statistics agencies

government regulation, e.g., FDI. Our research suggests that these consumer trends, retail consolidations, and disruptive factors heavily influence retailers' growth strategies as well as the formats they are most likely to develop to sustain growth over the long term. As markets evolve, retailers adjust their formats and operational strategies to cater to differing shopper needs and trends-and thereby maximize retailers' reach in an evolving market.

Figure 2: Poland's Top 5 Retailers

Rank	Home Market	Retailer	2005	2006E
1	Germany	Metro Group	3,994,556,017	4,272,466,503
2	Portugal	Jeronimo Martins	1,658,944,856	1,894,170,703
3	United Kingdom	Tesco	1,639,857,024	1,911,520,454
4	France	Carrefour	1,331,946,849	1,469,145,926
5	France	Casino (Rallye)	1,236,584,778	1,305,869,861

In current USD
Source: MVI retailer database, company reports

In India's case, **consumer trends** have been the greatest influencer in forcing modern trade to develop. A significant demographic transition is now underway with a large, young, working population (median age of 24); more nuclear families in urban areas; an increase in the number of working women; and emerging opportunities in the service sector. Urbanization, higher household disposable income, and convenience one-stop shopping are other factors that are fueling this modern trade growth.

Retail consolidation will slowly help drive modern trade growth as well. We estimated the Indian retail industry to be worth about USD286 billion at the end of 2004; yet India remains one of the most fragmented retail sectors in the world with only 2% of total sales deriving from the modern trade. Figure 1 presents a snapshot of retail trade and gross domestic product (GDP) across India and some of its neighbors in Asia, and highlights the tremendous opportunity for consolidation and growth. As that happens, India is likely to see a significant trend toward modern trade as retailers invest in data, technology, and infrastructure to exploit and escalate potential growth. (Figure 1)

Disruptive factors (particularly government regulation) are unquestionably the key "reason" foreign players have not played an influential part in triggering retail consolidation in India. However, there is no one path to modernization; markets are not dependent on global retailers as catalysts for modernization. However there are many markets where global retailers act as key catalysts, and, in fact, capture the lion's share of the modern trade. To understand India's potential future, it is useful to look at examples of three market types, and why they've modernized the way they did:

- Markets that have grown the modern trade through global players entering the market;
- Markets that have grown through a hybrid of global and local players; and
- Markets that have modernized driven almost entirely by local retailers.

Part II: Global, Local, or Hybrid?

Case Study - Global: Poland's retail industry modernized quickly following the opening of the market in 1991; almost all the major retailers in the country are now global operators. Lack of entrepreneurship and exposure to anything "foreign" during the communist era left little capability and structure for local players to grow. The market was liberalized quickly following 1991, opening up opportunities for international retailers to move into this market. In addition, Poland's proximity to European retailers looking for expansion opportunities allowed the market to be flooded with strong global operators (such as Metro Group and Tesco) looking to establish market leader positions (Figure 2).

The Polish government was also instrumental in facilitating this shift as regulations for FDI and store opening procedures were streamlined to encourage investment. With the current FDI restrictions in place, India is not likely to take the same path to modernization. However, even if these restrictions are lifted, the complexity and remoteness of the geography, diverse cultures, and variable laws from state to state will make it challenging for global players to thrive as easily as their counterparts in Poland.

Today, global operators dominate in Poland despite some local operator presence; this dynamic is due in large part to favorable policy toward international operators and a stable, high-growth market environment. Poland's attractiveness as an investment market is also aided by its accession to the European Union (EU) and Euro-Zone by 2009. While Poland is well on the path to establishing itself as a modern trade dominated market, one still-emerging market

Figure 3: Brazil's Top 5 Retailers

Rank	Home Market	Retailer	2005	2006E
1	Brazil	CBD - Pao de Acucar Group	6,007,912,154	7,335,696,371
2	France	Carrefour	4,860,004,674	6,479,014,466
3	Brazil	Casas Bahia	4,722,420,979	6,617,136,411
4	USA	Wal-Mart	2,137,681,057	4,407,499,496
5	Brazil	Lojas Americanas	1,833,449,147	2,069,625,133

In current USD
Source: MVI retailer database, company reports

Figure 4: South Korea's Top 5 Retailers

Rank	Home Market	Retailer	2005	2006E
1	Germany	Metro Group	3,994,556,017	4,272,466,503
2	Portugal	Jeronimo Martins	1,658,944,856	1,894,170,703
3	United Kingdom	Tesco	1,639,857,024	1,911,520,454
4	France	Carrefour	1,331,946,849	1,469,145,926
5	France	Casino (Rallye)	1,236,584,778	1,305,869,861

*Tesco has a joint venture with a local operator, Samsung Co. Ltd.
In current USD
Source: MVI retailer database, company reports

exhibiting similar traits is Vietnam. In the post-communist era, the Vietnamese government has opened its doors to foreign players in a similar manner to Poland, particularly as there is a dearth of modern trade; in fact, less than 10% of retail trade now occurs through modern chains. This—combined with its geographic adjacency to hubs of modern retail activity (Indonesia, Thailand, Malaysia, and China)—makes modern trade dominance by global players far more likely.

Case Study - Hybrid: Modern trade evolution has been propelled by a mixture of global players and local retailers in Brazil (Figure 3), largely due to the Brazil government's legacy behavior that historically protected local businesses, keeping the market open with a heavy regulatory hand. In addition, Brazil's vast, diverse geography; varying degrees of base infrastructure to support the modern trade; and disparate consumer income levels give local, small scale operators an inherent advantage in operating successfully. Therefore, while foreign retailers have experienced success to a certain degree—particularly in areas where the country's infrastructure allow the retailer to build scale and efficiency—they have been impeded by the lack of standard infrastructure and variable legislative regulation across Brazil's states.

Brazil's domestic "price champions" (in particular, the Pao de Acucar group, Brazil's leading retailer) have also been experts in consumer understanding and relevant format development, allowing them to reach a broad segment of Brazil's population with a more relevant retail offering than global competitors.

Casas Bahia has been an interesting example of a retailer leveraging local market understanding to grow. A large, non-food retailer that sells primarily in Brazil's smaller and more remote towns, Casas Bahia has a dominant market share in selling furniture and electronics to Brazil's lower income shoppers in these markets.

Similar to Brazil among the emerging modern trade markets is China. The Chinese government has championed opening up the market to foreign operators, but with limits. At the same time, the government has worked to aid local players to compete effectively with global players. Additionally, most local players are regionally focused, which gives them a significant advantage in knowing local regulation as well as local consumer tastes and shopper preferences.

Case Study - Local: India's retail trade sector is modernizing gradually through its local operators such as Pantaloon and Foodland. For now, FDI restrictions are helping local operators along in this evolution. Will that change when FDI regulations are loosened in the retail sector? MVI believes that this will significantly impact the development of this market. Our research shows several instances of markets developing modern retail trade sectors through local operators despite liberal FDI policies. Examples include South Korea (Figure 4) and Chile. Both countries have encouraged local chain growth because of two significant reasons: (1) the difficult and intensely competitive real estate market as a result of few dispersed but densely populated urban centers and (2) complex government relations requiring a high degree of local understanding to manage operations. Local players in these markets have been more adept at navigating these challenges. Local retailers have also been able to do a better job of catering to shopper needs. At the same time, these local "factors" have worked to limit global operator penetration in-market.

Wal-Mart's exit from South Korea and Carrefour's exit from both Korea and Chile are examples of global players incapable of making inroads versus able local competitors. Key shopper dynamics come into play as well. For instance, South Koreans tend not to travel long distances to purchase food products-no matter how low the price. They are also less likely to shop at different stores as a result of advertising largely due to difficult traffic conditions. All of this makes store location extremely important. Therefore, Wal-Mart's and Carrefour's inability to leverage the "right" local connections to secure the best available real estate strongly influenced their recent market exits.

While these countries' geographic peculiarities have helped local retailers to thrive, these operators have used this advantage to build core capabilities as well. In South Korea, for example, local operators have successfully leveraged relationships with indigenous suppliers to procure and offer the right products at the right price.

Any study of the Korean retail landscape should trigger a pivotal question: "Why is Tesco successful where others have not?" As a global player, Tesco has proven very successful at being adaptable in complex markets such as Korea and Japan. Our analysis suggests there are three or four core reasons:

- **Format strategy -** Tesco is comfortable running a wide variety of formats, and it leverages whatever format represents the best opportunity to enter a market. For instance, its entry into both Japan and the US (in 2007) will largely be through convenience-oriented formats rather than its core supermarket/hypermarket portfolio. Few global retailers beyond Tesco are comfortable entering a new market with a format that was not the one they "grew up" with; thus Tesco's flexibility here makes its market success prospects much higher.
- **Utilizing local partners -** Tesco understands better than most retailers how to partner successfully. The retailer is adept at allowing competent local partners to guide or teach Tesco to understand local consumers, manage the complexity of navigating government and real estate regulation, and, where strong nationalistic sentiment exists, leverage a brand that resonates with in-market consumers (like Samsung, a Tesco partner in Korea).
- **People development -** Tesco believes its core competency is teaching people how to run a store, and that is the primary focus on entering a market. As a result Tesco shortens the executional learning curve most retailers face when entering a new country.

Part III: The Core Capabilities Required for Growth

A core takeaway from studying market evolution is that, regardless of whether the retailer driving the modern trade is global or local, the capabilities they need to do that are largely the same! In addition to the overall management outlined in the Tesco example in Part II, a great modernizing retailer will require capabilities in six core areas to win in the changing environment (Figure 5).

Finance

A retailer is best served having an operating model with two key financial criteria:

- Generates enough cash flow to fund its expansion; and
- Remains relatively low debt.

Retail is a cyclical and relatively low margin business. High levels of debt and interest greatly impede a retailer in growth mode and can make running the operation difficult. Most great retailers remain relatively conservatively financed.

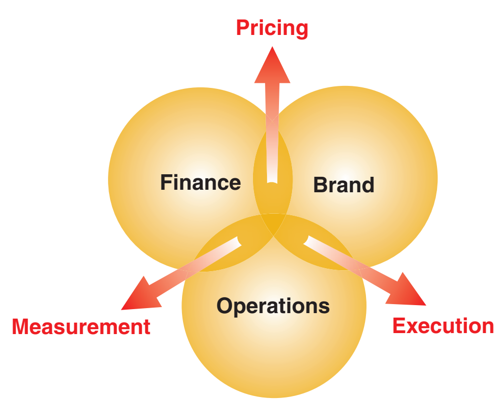
Operations

The retailer is able to manage the complexity of getting merchandise from factory to shelf. Indian conglomerate Reliance Industries Ltd. is aiming to get to this state through integration of an entire supply chain from farm to store, particularly with staple food commodities. Many great local retailers (e.g., HEB and Publix, two US regional grocery chains, and 7-11 in Japan) optimize their market position through a best-in-class supply chain, which gives them a significant competitive advantage in speed and store conditions.

Brand

Brand is all about a relevant and impactful connection to the shopper. It is imperative for retailers to have a systematic understanding of their shoppers and be able to execute, both in and out of the store, based on that knowledge. In addition, the ability to tailor a portfolio of formats to meet different shopper/consumer needs is very helpful-especially in geographically, culturally, and economically diverse

Figure 5: Retailer's Strategy Driven by Six Areas



Source: MVI research

markets like India. Pantaloon is one of the Indian retailers that has begun to develop the data and analysis capabilities to do just that. As India's infrastructure develops to support modern trade, the retailer will be able to do that more consistently. As the market evolves, both retailers and manufacturers will require the capabilities to consistently understand what motivates shoppers and consumers, in order to bring together a successful retailer strategy that serves both constituents well.

The intermingling of finance and brand is **pricing**; the right price doesn't necessarily mean the lowest, especially in some categories such as apparel, where a low price may be perceived as poor quality. Also, a rigorous understanding of which items are important to be low priced for competitive purposes versus which items can be margin enhancers, is one of the key criteria strong retailers use to grow in a market.

When discussing people, the discussion is incomplete without the right **measurements** in place. As people are trained to execute at the store, retailers will have to have the right set of measures to ensure great delivery to the shopper. In addition, the focus of high capability in-market retailers' corporate measures are usually geared toward selling to the consumer than on buying efficiencies and leveraging scale; however, our research shows that retailers who understand this and work proactively with suppliers to optimize their mutual business tend to grow faster than the market.

In-store **execution** should come together as a result of the right brand message and effective operations that facilitate having the right merchandise in the right place. Often the simplicity of the message and the operation generally results in superior in-store execution, and this largely depends on people development and training. Relentless focus on execution details is the final differentiating factor for success.

These six success criteria should help determine future market winners (especially in the Indian race to modernization-irrespective of whether they are the world's largest global competitors, or intensely focused and capable local players).

For more information on market evolution and developing markets, please email riyer@mventures.com or jleonard@mventures.com. To learn more about applying this research or working with MVI's Consulting team, please call Phil Bonanno, Chief Solutions Officer, at 310.318.9124. E-mail: phil@mventures.com.

About MVI

MVI's Retail Market Research, Analysis and Consulting Leadership

For nearly 20 years, Management Ventures, Inc. (MVI), a WPP Group Company, has provided comprehensive strategic retail insight and training focused on the top global retailers, based on robust data-driven research.

As the largest worldwide retail research and consulting organization, its renowned analysts build knowledge and share insights while tracking the strategic and tactical developments of over 800 retailers in 130 countries. Channels covered in the Americas include Mass Merchandisers, Grocery, Warehouse Clubs, Value Discounters, Chain Drug, Office, DIY, and more. Channels covered by MVI in Europe include Discounters, Cash & Carry, Hypermarkets, Supermarkets, Convenience, and more.

We help suppliers and manufacturers understand how different retailers grow, guiding them in aligning their business more closely and profitably for mutual success. This valuable insight can be accessed online, onsite, or in a classroom setting in the form of retail training events: interactive workshops, industry forums, or supersessions.

Financial services organizations, ad agencies, and marketing companies also attribute part of their growth to partnering with MVI.

MVI's global headquarters are located in Cambridge, MA USA with field offices nationwide as well as a major hub in London, UK.