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Retail

Modern grocery and the emerging-market consumer: A complicated courtship

In some emerging markets, the response to modern grocery formats has been tepid. What's a modern grocer to do?

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Just 20 years ago, modern grocery retail appeared poised to conquer every consumer market in the world. Ambitious European grocers, having blanketed their home countries with supermarkets and hypermarkets, began setting their sights on growth both within and beyond the continent. They held particularly high hopes for China, India, and other emerging markets, where fast-rising consumer spending seemed to presage an unprecedented demand for gleaming new stores with large assortments, wide aisles, and bright lighting.

In the 1990s, the term "modern grocery retail" was essentially a proxy for a small group of multinational grocers including Ahold, Aldi, Auchan, Carrefour, Costco, Lidl, Metro, Tesco, and Walmart. It was widely presumed that these retailers' entry into any market would lead to the demise of the traditional trade—the family-owned grocery chains, small independent stores, and informal merchants that at the time accounted for the vast majority of grocery sales in emerging markets. The prevailing expectation was that although there would be local differences due to cultural specificities, in every country the retail landscape would eventually consist of a combination of modern formats: full-line supermarkets and hypermarkets, convenience stores, and discounters.

These assumptions have been proved wrong. Global grocery giants are struggling to grow profitably in many emerging markets. Traditional trade has proved remarkably resilient. And the market and channel structures taking shape in individual emerging economies are distinct from one another, following no obvious pattern.

Why did this happen? What, if anything, did multinational grocers do wrong? And what does it mean for the future of modern retail in emerging markets?

The hypermarket's shortcomings

To understand the disparity between early expectations and the current reality, it's useful to examine the roots of the two quintessential modern-trade formats: the supermarket and the hypermarket. The hypermarket in particular—whether in its European form (in which food anchors a massive selection of nonfood items) or its North American one (the "supercenter," which represents the successful injection of food and grocery into a general-merchandise discount store)—was widely regarded as unbeatable. By offering tens of thousands of products in an immense building just outside or on the edge of a town or city, a hypermarket could operate at a level of productivity that other grocery formats struggled to match. Hypermarket operators passed on these efficiency gains to consumers in the form of lower prices, which served to reinforce hypermarkets' advantage.

In their first forays into other developed markets abroad, major retailers relied heavily on the hypermarket format. When French retailers Auchan, Carrefour, and Promodès opened hypermarkets in Spain during the first years of Spanish economic reform, they quickly captured a large fraction of that country's overall grocery sales and dictated the market structure that remains in place to this day.

Expansion across Europe was an exciting growth prospect, but even more enticing to retail leaders and investors was the growth potential of emerging markets. Over the years, that potential has become even clearer: by 2025, we expect emerging markets to account for $30 trillion in consumer spending, or nearly half of global consumption.[1]

When multinational grocers entered emerging markets, they again relied on the grocery formats that were working so well in the developed world. But, in retrospect, it's clear that the countries in which the hypermarket prospered had several characteristics in common: good road networks and high or fast-rising car-ownership rates, a large middle class that enjoyed decent wages and stable employment, and a high proportion of rural and suburban households with enough room at home to store groceries bought in bulk. Also, those markets had grown to maturity at a time when many women didn't return to work after having children and therefore had time during the day to drive to and from the store. The hypermarket format draws heavily on consumers' time, ability to travel, and storage capacity.

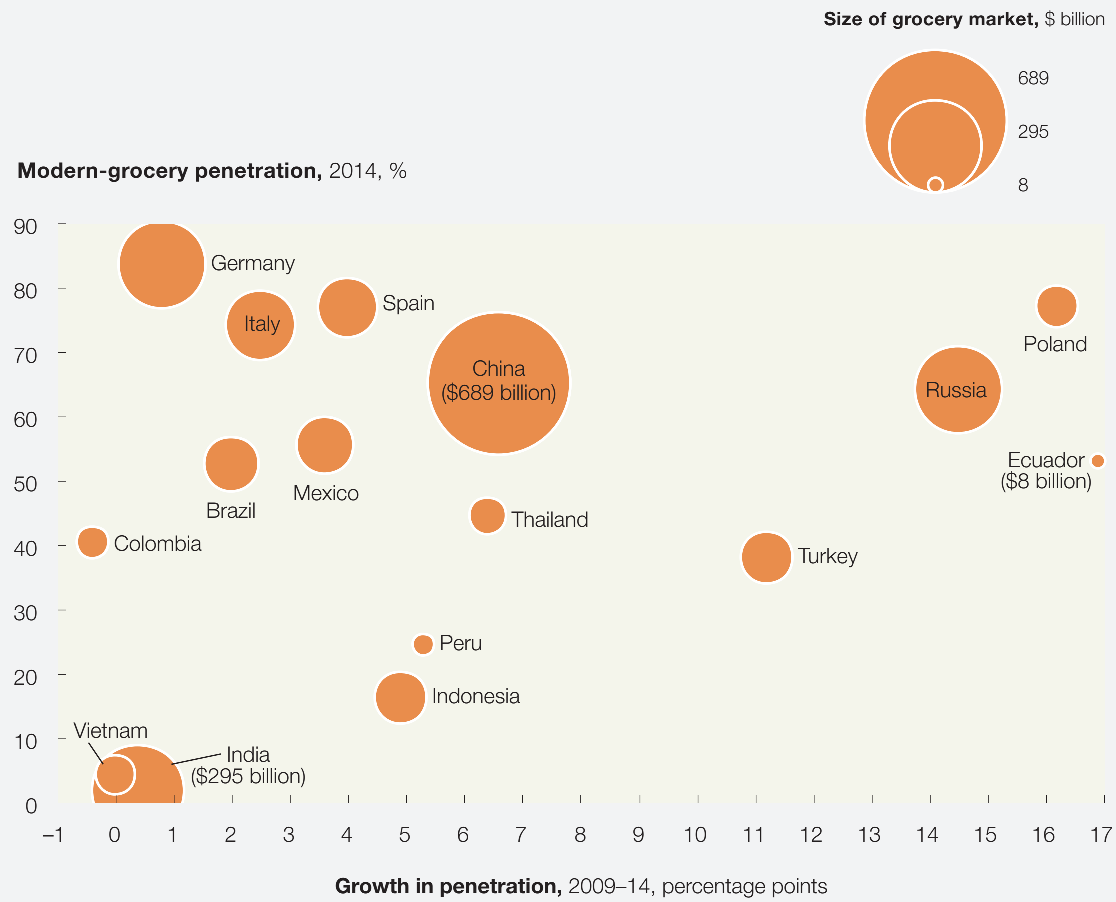
In emerging markets, retailers encountered an entirely different context. Consumers were less affluent and lived in urban areas; many didn't own a car, couldn't afford to travel to and from a relatively far shopping destination, had no room at home to store purchases, or all of the above.

A new respect for localism

Further complicating matters, emerging markets weren't just different from developed markets; emerging markets also differed from one another in nontrivial ways. That was true in the 1990s and it remains true today. Based on our research—which involved in-depth study of the retail sector in ten developing countries in Asia, Eastern Europe, and Latin America, as well as interviews with more than 20 local retail and consumer experts and analysis of channel-growth data in these markets—we've developed a perspective on the factors that have hampered the growth of modern trade in emerging markets.

On both the demand side (what customers want from retailers) and the supply side (the means by which retailers can deliver what customers want), different factors shape the retail ecosystem in each country. Together, these factors produce wide variability in the level of modern-trade development in countries around the world (Exhibit 1).

Exhibit 1 **Modern-trade penetration and growth vary widely by market.**



Source: Euromonitor International; McKinsey analysis

On the demand side, for instance, food-shopping habits have turned out to be largely localized and deeply entrenched. Emerging-market consumers tend to prepare their own meals and cook more than their peers in developed markets do, and they are accustomed to shopping at open-air market stands or small neighborhood grocery stores that offer a familiar selection of fresh food and household staples. They don't necessarily perceive customer service at modern retailers as superior to that of the traditional trade. Customers of India's *kirana* stores—small, family-owned retail shops in or near residential areas—already benefit from personal service from the store owner, free home delivery, and credit and cash rebates if they remain loyal.

On the supply side, a big factor is the informality of traditional trade: many small retail businesses rely on unpaid labor from family and friends, pay no rent because they own their storefronts, and don't pay corporate taxes. Modern retailers cite this informality as a major challenge when competing with local retailers. A European hypermarket chain found that its considerable operating-cost advantage from better sourcing and supply-chain processes was canceled out by the fact that it was paying taxes while local competitors were not.

Another major factor affecting modern trade is public policy. India's restrictions on foreign direct investment have limited the growth of modern retail there; in China, by contrast, city governments are assessed on the level of economic activity and foreign investment they attract, which makes them biased toward supporting modern trade. As a result, modern-trade penetration in China's largest cities has grown significantly over the past 15 years.

A further supply-side factor in emerging markets is the fragmented supplier base, which places a natural limit on the benefits of scale. A retailer can't source products as efficiently as it would in a mature market because it must buy from a complex network of regional and local entities. And even retailers with a national buying team won't easily find national manufacturers who are eager to partner with them—a point we pick up on later.

Incumbent advantage is yet another powerful factor shaping retail ecosystems. Today's market dynamics tend to become tomorrow's market structure—so, for example, in markets in which a highly efficient wholesale system serves the traditional trade, it becomes much harder for modern grocers to gain a foothold. That said, wholesalers can also be vanguards of modernization. In Turkey, for instance, some Bizim Toptan stores have developed a substantial retail business. These wholesalers-cum-retailers illustrate the fact that ecosystems in emerging markets are partly shaped by players that can concentrate and coordinate a critical mass of what otherwise is a complex set of routes to market.

Seven strategic levers for success

In parts of the world where the market structure is itself still in a formative stage, retailers need a bespoke strategy. Our research and experience suggest seven strategic levers that lead to success in emerging markets. These levers—having to do with delivering what consumers want, working effectively with other players in the ecosystem, and generating lasting productivity advantages—reflect perennial concerns for retailers everywhere, but they are especially critical in helping retailers secure a profitable future in the world's fastest-growing economies (see sidebar, "Questions to test your emerging-market strategy").

The levers are by no means comprehensive. For one, they don't touch on digital technology, which may well be just as important in emerging markets as in developed ones; indeed, rapid adoption of smartphone technology may allow emerging markets to leapfrog more mature markets and reconfigure the value chain farther upstream (for example, by giving smaller suppliers direct access to national and even global markets). Rather, we draw attention to areas that we believe require deliberate action in emerging markets.

1. Prioritize proximity.

Urban consumers with limited budgets and smaller homes often prefer to buy small amounts frequently, both for immediate consumption and for stocking up. And where trading space is constrained, proximity formats offer a more realistic prospect of economic returns for the retailer. Modern retailers can benefit from their experience operating smaller urban formats in developed markets—banners such as Albert Heijn's AH to Go in the Netherlands or Tesco Express and Sainsbury's Local in the United Kingdom.

One market in which small-format stores have been the major driver of modern-trade development is Indonesia. Sales through the convenience-store channel are growing at a rate of more than 25 percent per year across the country. In fact, the increasing dominance of convenience stores, known locally as mini-marts, has led to a contraction in the number of supermarkets and hypermarkets. The mini-mart chains mimic *warungs*, which are small family-owned retail or restaurant businesses that play a central role in Indonesian social life. Although the mini-marts are run by modern retailers—in addition to leading national chains Alfamart and Indomaret, international players such as Circle K and 7-Eleven have moved into the market—the customer's experience in mini-marts is not so different from that in *warungs*.

Questions to test your emerging-market strategy

Proximity

- Do you have a clearly defined small-store format?
- Have you built capabilities for local assortment tailoring?
- Do you have a nimble supply chain—one that can make small, frequent deliveries to stores with limited stockroom space?
- What is your property-acquisition plan for building a small-store portfolio? For example, have you identified independent businesses you could acquire or partner with?

Pricing

- How good is your price perception among consumers? Are you the acknowledged price leader in the market?
- What's driving price perception? Do you know what your "key value items" are? How well do you compete on basket prices for your main customer segments?
- Is your pricing philosophy understood by customers and evident in your stores day after day, week after week?

Productivity

- If local labor costs were to rise by 10 percent, would you still be profitable?
- Who in your organization is championing process improvement and labor efficiency?

Manufacturer relations

- Do you understand the cost structure and profitability of your major suppliers?
- Who are your most important suppliers for present and future growth?
- How should you propose sharing the proceeds of growth?

Government affairs

- How broad and deep is your network in and around government?
- Do you understand policy makers' concerns, and have you communicated yours?
- Who on your team is in charge of government relations? Are the primary objectives clear?

Traditional-trade partnerships

- How well do you understand the existing traditional-trade structure?
- Who are the best traditional-trade players, and what can you learn from them?
- Are there opportunities to build your retail brand through franchising, supply agreements, or earn-out acquisitions?

City-based growth

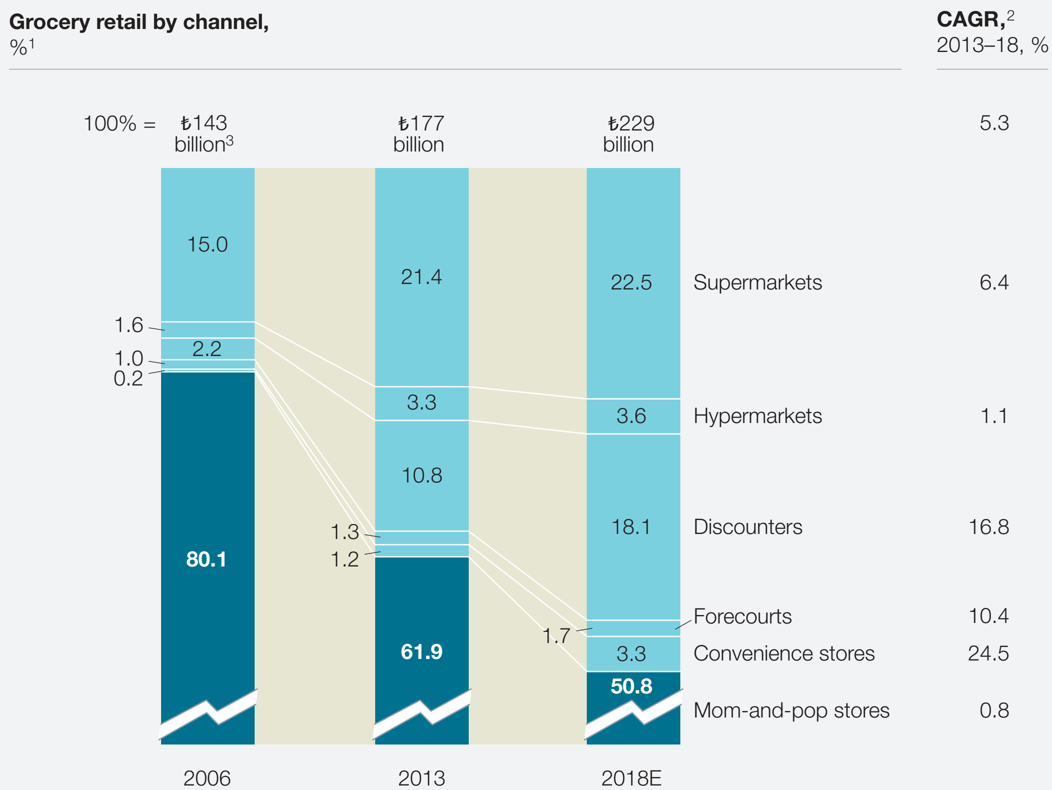
- Do your growth plans match the projected growth of cities and metro areas in your principal markets?
- Have you tailored your route-to-market and commercial models to each of your prioritized cities or city clusters?

2. Keep prices low—and make sure consumers know.

The prediction that emerging-market consumers would initially shop at discounters and then "graduate" to supermarkets hasn't come true. Discounters, or retailers that exhibit at least three of four core discounter characteristics—low prices, limited range, low-cost store retrofits, and ultra-simple operations—have more than held their own against supermarkets. In Turkey, for example, discount stores are the fastest-growing channel, largely due to the success of local companies such as A101, BIM, and Şok (Exhibit 2).

Perhaps the success of discounters shouldn't be so surprising, given the stature they enjoy even in one of the largest and richest retail markets in the

Exhibit 2 **The channel structure in Turkish retail is changing rapidly.**



[1]Figures may not sum to 100%, because of rounding.
[2]Compound annual growth rate.
[3]As of Aug 2015, $1.0 = ₺2.8.

Source: Euromonitor International; McKinsey analysis

world: Germany. Low-price stores can establish a dominant position in markets that are going through rapid increases in disposable income (as was the case, of course, in postwar West Germany). When the first modern-trade stores to open in a market are discounters, they can set price expectations permanently.

Other modern formats can also compete on price, but they have to work harder to get consumers to notice. Our research suggests most modern retailers don't get full credit for the value they offer. This is the case with Indonesia's hypermarkets, which typically are cheaper places to shop than *warungs* but haven't been able to convey that message to enough consumers. Some common modern-trade practices such as high/low pricing can actually undermine a retailer's value message. In Peru, where bodegas and market stands account for some 80 percent of grocery sales, we found that modern retailers—despite often having lower full-basket prices than traditional retailers—nevertheless lag behind traditional retailers by more than 15 percentage points in consumer perception of low prices.

3. Obsess over productivity.

In markets where labor costs are low, it can be difficult to retain a relentless focus on productivity. But wages are rising fast in emerging markets and bad habits are notoriously hard to unlearn. Retailers that have been obsessed with productivity have achieved striking results. BIM's decisions on new-store openings in Turkey are driven as much by logistics-network optimization as by local demand attractiveness. BIM follows a "mushroom" expansion model: it grows to high density in specific neighborhoods within a city, using retail formats that require low capital expenditures. The high density of deliveries has allowed it to solve the small-format logistics puzzle that has tripped up many big-box players.

Corporación Favorita in Ecuador offers another example of operational excellence: its just-in-time inventory model of daily deliveries essentially eliminates backroom stock. To ensure full control of store operations, it eschews direct store delivery, managing all flows through its central warehouses. This focus on operations has enabled the company to successfully manage a complex format portfolio.

4. Make the business case to manufacturers.

A rarely discussed obstacle to the expansion of modern trade in emerging markets is the fact that established manufacturers don't have much incentive to do business with modern retailers. Branded manufacturers enjoy high margins supplying small shopkeepers, who have little negotiating leverage. Why would they want to jeopardize that business in favor of modern-trade retailers with initially limited volumes and terms that are often less vendor friendly (especially if the retailer is a subsidiary of a global company)?

To woo major manufacturers, modern retailers may need approaches that are as creative, collaborative, and mutually beneficial as those they employ in developed markets. One argument full-line modern retailers can make is that branded manufacturers ought to support them rather than discounters. After all, in markets where discounters dominate, consumers can shift en masse away from branded products toward private-label goods.

5. Educate policy makers on the benefits of modern trade.

As mentioned earlier, government intervention can play a critical role in how, and how quickly, modern trade develops. In China, the strong central mandate to provincial and municipal authorities to create the necessary infrastructure for modern retailers—not just thousands of miles of new roads, but also urban planning that integrates modern-trade requirements into traffic patterns and real-estate zoning—has yielded extraordinarily rapid development.

Modern-trade players would do well to communicate the benefits of modern retail to government officials. They could, for instance, make a strong case that modern retailers can do a better job than traditional trade in providing safe and cheap access to high-quality food and household goods.

6. Consider partnering with the traditional trade.

One growth strategy for modern-trade players involves partnership with—rather than competition against—the traditional trade. The strategy has clear advantages: it allows a modern retailer to leverage the network and personalized service of the traditional trade while minimizing capital investment.

Eurocash in Poland is an example. Although its cash-and-carry stores and distribution centers play a wholesaler role, Eurocash also welcomes traditional-trade retailers as franchisees under its abc convenience-store banner (approximately 6,000 stores) and its Delikatesy Centrum banner (approximately 1,000 stores). This franchising approach has allowed Eurocash to grow quickly and profitably. Another example of partnership with the traditional trade comes from Grupo Éxito in Colombia: small retailers that join its Aliados Surtimax network receive Surtimax signage and fixtures, access to Grupo Éxito's portfolio of private brands, and business and management training. Grupo Éxito has rapidly built a network of more than 500 stores at an extremely low capital-expenditure rate of less than $500 per store.

7. Adopt a city-based strategy.

When a market is in a relatively early state of modern-trade development, national borders can be unhelpful in scoping and designing a retail network. Rather, retailers should concentrate on getting to scale in cities or city clusters.[2] Thus, Supermercados Guanabara, the market leader in Rio de Janeiro, has confined itself to the metropolitan area and operates just 23 stores—yet it outperforms formidable competitors, including Carrefour and Walmart.

In China, some retailers have chosen to concentrate first on one city or city cluster, be it Shanghai or Shenyang, before expanding nationally. Similarly, modernization in India's retail sector will most likely happen through a series of players expanding in individual cities and states, rather than through a "big bang" national expansion plan.[3]

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For any modern retailer, success in emerging markets isn't guaranteed. Our research confirms the complexity and local specificity of market development and the degree to which it depends on initiatives taken not just by retailers but also by governments, manufacturers, wholesalers, and others in the local retail ecosystem. International retailers thus need to become experts at local tailoring. That said, operating in emerging markets still unquestionably requires excellence in core retailing competencies: marketing, merchandising, supply-chain management, and talent development, to name just a few. Retailers that excel in all these areas in the context of markedly different emerging-market structures will, in a sense, have conquered the world. ■

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1 For more, see Yuval Atsmon, Peter Child, Richard Dobbs, and Laxman Narasimhan, "Winning the $30 trillion decathlon: Going for gold in emerging markets," *McKinsey Quarterly*, August 2012, on mckinsey.com.

2 For more on how to develop a city-based strategy, see Udo Kopka, Stefan Rickert, and Markus Schmid, "Pinpointing the markets with the highest growth potential," *Perspectives on retail and consumer goods*, Winter 2013/14, on mckinsey.com.

3 For more on growth opportunities in India, see "Understanding India's economic geography," October 2014, on mckinsey.com.

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