Making business with giants- impact of retail internationalization in Central and Eastern Europe

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Abstract

Due to increasingly globalized markets and internationalization, the food retail business has undergone a number of structural changes. Former nationally oriented retailers have suddenly become global. This process in the retail sector affects also new structures in the agribusiness, most notably as general retailers export their business models. A comparison of the development and the impact of globalization in the retail sectors of different Central and Eastern European countries reveal varied opportunities and threats for the participants of agribusiness.

Keywords: retail internationalisation, Central and Eastern Europe, agri food business

Introduction

Retail internationalisation has become a prominent topic of scientific and professional discussions in the recent years. Many authors suggest that it is the main driving force of the development of the agri food business in transition economies. Many recent studies of management consultancies highlight the potentials for retailers in the Central and Eastern European countries (CEEC). For example, analyzing variables such as country risk, market attractiveness, market saturation, and time pressure the consultancy A.T. Kearney (2006) states that five of the most attractive countries for retailers are from this region. Even though KPMG (2004) used slightly different variables, they derived a similar picture. In both studies Russia was the second most attractive country.

In this context the first aim of this paper is to discuss the contributions of internationalization to the development in Central and Eastern Europe. This includes a detailed analysis of the current situation and an outlook for future development in general, and with particular reference to different CEEC. We will elaborate on the consequences for the participants of the agri-food business using secondary data. Our aim is not to investigate the future of retailing in CEEC in general, we will focus only on the consequences of the internationalisation, we ignore other factors e.g. increase of salary.

Retail Internationalization in the CEEC

It was less than 20 years ago that almost all of the world's retail firms were pure national firms with a negligible share in foreign markets. That scenario has changed dramatically. Taking a look at the top 200 global retailers, almost all players except those in the US operate in numerous countries, having established a noteworthy business capacity in foreign markets (Deloitte, 2006). In general, retail firms start with a geographical expansion across the national borders but shortly thereafter move into more distant countries (Fernie et al., 2006). As outlined previously one of the most attractive regions are the Central and Eastern Europe.

There are several push and pull factors which determine the retail internationalisation:

1. The most important reason can be found in the stagnating domestic food market and the resulting enforced competition (AT Kearney, 2006; Burt, 1993; Davies and Finney, 1998; Fernie et al., 2006; Robinson and Clark-Hill, 1990)
2. Financially strong retailers have the capability of disrupting the structure of any foreign market so that they can successfully install their own business ideas in new market environments, such as Wal-Mart in the UK and Lidl in France (Fernie et a.,l 2006; George and Diller, 1993; Wrigley 2002).
3. The collapse of the socialistic central planning system in Central and Eastern Europe left behind an economic vacuum that offered the unique opportunity to establish an entirely new retail system modelled on western ideas. The western retail firms took this opportunity and established subsidiaries all over the countries (Rapp, 1995).
4. The increasing incomes and as a consequence the increased purchasing power and quality demand in the CEEC made more attractive this region in the recent years

5. The internationalized retail sector also profits from considerable progress in WTO negotiations regarding quality and safety standards that noticeably facilitate the trade of intermediate and convenience food products across borders (Fieten et al., 1997).

In the context of retail internationalization, verticalization can be regarded as a major force that drives structural change. Swinnen (2005) shows that vertical coordination in agri-food chains is an important and growing phenomenon in transition countries in Europe and Central Asia. He also indicates that in these countries vertical coordination is even more widespread in scope and complexity than in western economies. One major reason why verticalization is implemented is that private contractual initiatives can be formed to overcome supply disruptions. Traders, agribusinesses, and food companies contracted with farms and provided imputes and assistances in return for guaranteed and quality supplies (Dries and Swinnen, 2005; Swinnen, 2005). Quality can be particularly regarded as a main catalyst for the development (Gorton et al., 2006). Reardon states that retailers and foreign direct investments can be regarded as more powerful sources of structural changes in transition countries than WTO and trade policy (in Swinnen, 2005).

Due to the differences in the degree of verticalization in transition countries, Dries et al. (2004) refer to the concept of ‘retail waves’. They characterized “first wave” countries as those whose supermarket sector went from a tiny niche of around 5% of food retail in the mid 1990s to 40–50% by the mid 2000s. Examples are Hungary, Poland, or Czech Republic. They defined “second wave” countries as those in which the sector grew to a share of 20–30%. Examples are Bulgaria or Croatia. “Third wave” countries are those where the share remained in a ‘luxury’ niche of 5%. An example is Russia.

The transition process of the retail sector from state-run retail shops and retail cooperatives and farmer's markets to western-style large format retailers was accompanied by heavy foreign investments, and therefore also by changes in the procurement systems. The following are the six major changes (Dries et al., 2004):

- shift from local store-by-store procurement to (nationally centralized) large and modern distribution centres;
- shift to regionalization of procurement over countries;
- shift from traditional brokers to new specialized wholesalers;
- shift to increasing use of global logistic firms;
- shift to preferred supplier systems;
- shift to high private standards of quality and safety.

In the following section we will describe the situation of different waves by the example of typical countries.

"First wave" countries

In the context of "first wave" countries we focus on Hungary because it has modernized the retail sector, starting in the 1990's, faster and more successfully than any of the other CEEC. Today one can assume that Hungary is home to the best developed retail sector in Central and Eastern Europe (BBE, 2006). Figure 1 states that modern retail formats in 2002 already had around 50% market share.

Figure 1: Development of the number of retail formats in Hungary

Retail format	2000	2001	2002
Hypermarktes	13	17	19
Supermarktes	15	14	14
Discounter	16	16	15
Supretten	35	35	36
Marktes and street vendors	5	4	5
Others	16	14	11
Total	100	100	100

Source: own source, modified of BBE, 2006

The rapid development of modern retailers was accompanied by heavy investment of western retailers in Hungary. In 2005 foreign retailers were dominating the Hungarian retail market, as Figure 2 shows.

Figure 2: Sales volume in billion Euros of different retail formats in Hungary

Rank	Company	Sales 2005 in billion Euro	Number of outlets
1	Tesco-Global Aruhazak Rt.	1.89	89
2	Metspa Supply and Trade Co. Ltd.	1.83	181
3	CO-OP Hungary Rt.	1.50	4,970
4	Reál Hungária Élelmiszer Rt.	1.10	2,290
5	Provera	0.80	213
6	Auchan Magyarország Kft.	0.70	10
7	PennyMarket Kft.	0.50	148
8	Plus Elemiszer Diszkont Kft.	0.40	165
9	Honiker Kft.	0.23	1,970
10	Interfruct Kft.	0.20	22

Source: own source, modified of LZ-online 12.01.2007

However, in Hungary not only are the major players are foreign owned, but the first round of consolidation is also taking place.

Because the 'big players' in retail markets of "first wave" countries are more or less identical to those in western Europe, we believe that today there are no significant differences in regard to procurement systems and quality demands and thereby vertical coordination.

“Second wave” countries

Bulgaria – a “second wave” country –is about five to six years behind Hungary. Modern retail formats have been introduced but mainly by small local retail chains. Furthermore, the vast majority (97%) of the 102,000 stores have less than 120 sq. m and only 0.2% have more than 1,000 sq. m (BBE, 2006). In the course of the EU accession, international retailers have lately made their inroads to Bulgaria. The largest foreign retailer is Metro but other international retailers have already followed. The increased attractiveness of the Bulgarian retail sector is mirrored in the 13 position Bulgaria received in the AT Kearney Global Retail Development Index (2005). However, most foreign investments in Bulgaria are made in the capital city, Sofia. Even though international retailers are mainly located in urban areas, local retail chains do exist in rural areas.

“Third wave” countries

Because of its economic importance we have chosen Russia as the example of “third wave” countries. Even though the weight of the ‘organized retail’ is still increasing, street vendors, small shops, and markets dominate the sector. Recently it has been observed that supra-regional and regional chains are gaining in importance. However, as Figure 3 shows, in comparison to other CEECs, their percentage is rather low.

Figure 3: Comparison of the importance of different retail formats between Russia and Hungary

Retail Format	Russia %	Hungary %
Hypermarkets	1	21
Supermarkets	6	14
Discounters	6	15
Cash & Carry	1	4
Small shops	26	34
Street vendors/markets	32	4
Others	28	8

Source: own source, modified of BBE, 2006

In Moscow, retail chains hold 16 - 17% of the market and in St. Petersburg they hold 18 - 20% (BBE 2006). Currently no retail chains operate throughout Russia. Nevertheless, some of the larger chain from Moscow and St. Petersburg are expanding to other regions of Russia; some are even expanding to neighbouring countries such as Ukraine. The development of ‘organized retail’ has intensified since international retailers entered Russia in 2000. Today, e.g., Metro, Auchun, and Rewe operate in Russia and the entrance of Carrefour, Wal-Mart, and even some German discounters is expected soon. Thus, even though Metro is the top retailer in Russia, Figure 4 shows that Russian retailers continue to make the majority of sales.

Figure 4: Ranking of food retailers in Russia according to turnover in 2005

Rank	Name of Retailer	Format	Turnover, $ mio. Euro
1	Metro Cash & Carry	Cash & Carry	1815
2	Magnit	Discounter	1553
3	Pyaterochka	Discounter	1359
4	Auchan	Hypermarket	1350
5	Perekrestok	Multi-format	1015
6	Diksi, Megamart	Multi-format	860
7	Sedmoy Kontinent	Multi-format	713
8	Lenta	Hypermarket	649
9	Kopeyka	Multi-format	646
10	Viktoria C & C	Multi-format	608

Source: own source, modified of Malkov, 2005

It is likely that Russian retailers will continue to improve the quality and prices of their goods. Changes in the retailer-supplier relationships have already been observed. In the past Russian suppliers dictated the rules of the exchange to the domestic retailers (Roberts, 2005). Suppliers were so powerful that they could afford to keep retailers waiting for 72 hours for goods that they ordered (Corstjens and Corstenjs, 1995). However, among western retailers it is essential to stick to their original business models when entering a new market (Roberts, 2005). By applying global sourcing strategies and particularly by providing interesting new markets, international retailers have been able gain some market power (BBE, 2006).

Consequences of retail internationalization on the agri food business in the CEEC

If retail procurement alternates from predominantly national sourcing to global sourcing, and if retail firms internationally centralize and re-organize the supply chain network, there will be serious consequences for food processing industries. In order to identify the organizational and strategic changes on the processing sector that are to be expected with ongoing retail internationalisation the classification of Hanf and Hanf (2004) were used, subdividing the processing industry into five categories of firms. The following categorization is very crude and imprecise but sufficient for our purposes.

- The *first category* comprises very large multinational food processing firms that traditionally dispose over a large number of subsidiary companies that are distributed throughout the world and are engaged in many different food branches.

- The *second category* includes firms that are more or less strictly concentrated on their kernel competence but produce and supply globally (Simon, 1996). These firms dispose over a remarkable market power that is based not on size but on consumers' appreciation.

- The *third category* is made up of medium-sized firms that produce diverse food for a national or regional market. A considerable share of their products is marketed as retail brands or as no-name products.

- The *fourth category* consists of small and medium specialized food processors that mainly produce by order of retail firms.

- The *fifth category* subsumes all small food processing firms that serve local markets or are provide special niches in regional or national markets.

The change distinctly increases the competitive pressure on suppliers because each firm must not only compete with its national antagonists but also with competing firms of several countries. If we consider the different firm categories, we can recognize remarkable differences within the food processing industry.

Firms of the *first category* are only marginally touched by the concentration of retail procurement. The multinationals dispose of strong brands in almost all relevant national markets so that increasing international retail procurement will not cause a substantial effect on the quantity of sales. Hence, the relative position is also not significantly changed.

Firms of the *second category* have more or less the same status as those of the first group. The volume of sales will probably not be seriously affected by the international pooling of retail procurement, assuming that they appropriately adjust their sales organization.

The most important effects of the change in retail procurement will likely ensue in the *third category*. First we will address firms that are national cost leaders and do not dispose over strong producer brands. If retailers unite their national procurement divisions and form a multinational division, national processors with cost leadership will lose control over competitors as they are confronted with cost leaders from other countries that are skilled in the same way. As a result, the market power and the price margin of national cost leaders radically shrink, and at least several of the former national cost leaders are forced out of the market. Firms, who are able to adjust to the new conditions, are innovative, reorganize their operation and increase efficiency will survive. Here is important to understand that cost leadership is not just price and profit reduction, rather the reduction of costs through organisational and technology innovation. The winners of the cost war reside in a relatively positive situation. Although they have forfeited some market power, in return they win sales and turnover.

The situation is clearly different if we look at processing firms that use product differentiation to compete with their business rivals on the national market. In a unified international procurement market the number of competitors also increases with the number of countries involved, but only very few of them - if at all - are considered as direct substitutes because they have rather similar products. In the event that the product differentiation is narrowly adjusted to the national consumer habits and preferences, there is no reason to assume that fundamental and abrupt displacements in demand arise from changing procurement. Studies show that consumers in CEEC prefer local products as long as they meet their quality requirements.

Small and medium-sized food processors that produce retail brands by contract with a retailer (*category four*) are usually among the winners of internationalization of the retail firm. Every time the retail firm invades a new country or enlarges its engagement in one of the countries, additional quantities of the retail branded product are needed and the necessary products are purchased from the primary supplier. For example, when Lidl entered the Swedish market in 2003 they were importing milk from Germany. Hanf and Maurer (1994) argue that this advantage is particularly important when the retailer enters economically and politically unstable regions. This allows the respective food processors to be able to follow the growth path of the retailer without making investments in market development. However due to their small structure they face the risk of losing control over their firm's growth.[1]

Finally, the small firms that are subsumed in *category five* really will not be concerned by the mode of procurement. Regardless of whether the retail procurement is internationally bundled or predominately organized nationally, a certain share of retail supply has to be of local origin and therefore locally purchased. The same is true for regional and national niche products. However, in some cases, a niche may become larger by the internationalization of retail, and the small processor may use this larger niche in a piggyback process with the retail firm. For example, Real (the hypermarket subsidiary of Metro Group) carries a “Russian category” in Germany. It consists mainly of major Russian brands, and still provides some shelf space for niche products and Russian specialties. In other cases a foreign competitor is introduced into a niche by the same piggyback process.

As Dries et al (2004) have shown, another major consequence of retail internationalization is the forced introduction of *supply management tools*. This development trend absolutely favors large, globalized firms that are ordered in our first and second categories. The installation of the necessary coordination instruments are expensive and require high organizational expenditure. Food processors of category 3 cannot afford the additional financial obligations, and they do not provide a large enough labour force that is sufficiently trained. Food processors that produce retail brands under contract (category 4) are more or less obliged to introduce such a supply management system if it is required by the retailer. The investment costs thereby incurred are relatively small because most of these firms exclusively produce a very limited range of products for one single retailer. However, many of the smaller contracting producers of retail brands will have considerable difficulties fulfilling the increasing logistic demands that result from the implementation of the supply management system and the regional enlargement of the delivery duties in several countries. Small und medium-sized firms (category 5) are usually not willing and perhaps also not able to raise the necessary money (Hanf and Kuehl, 2002), especially because most of the arising costs are fixed and the investment in human capital is indivisible and has sunk cost character.

Retailers have often taken their suppliers into new markets, however when local supplier can meet the same quality, quantity and delivery requirements they compete. For example, when Metro entered Russia, Hochland AG followed and has built a dairy planet near Moscow. In the first years they were protected; however, over time local producers have reached quality and process management standards that are equal to those of Hochland AG, so they now compete with the company. Thus, every supplier has to meet the same process and product standards. German suppliers are changed for foreign ones, and visa versa. However, in the medium term we expect that processors from "second" and "third wave" countries will begin to compete with processors in "first wave" countries because production costs will increase in

[1] In Germany the bottled water supplier of a well known south German discounter grew enormously due to the vast German and global expansion of the discounter. However, because of the high investments, the supplier eventually ran out of equity

these countries, while the quality standards will remain a bit lower than in western European countries. Nevertheless, in the long term, the quest for global cost leadership is on its way.

The agricultural sector in CEEC is still a mixture of small-scale – even household – production and large-scale farming. Retailers and processors favour large scale production to lower the complexity of their supply chains. However, the findings of Dries and Swinnen (2004) show that small-scale farmer can find their place in vertically coordinated chains. Nevertheless, we have been told by some international retailers that they require small-scale farmers to build horizontal cooperation to provide products that meet the qualitative and quantitative demands of the retailers. If these demands are not met, the farmers are excluded from the procurement systems.

Conclusions

The retail industry has been undergoing an immense structural change for about two decades. The former nationally orientated players have suddenly become global players. There are remarkable differences in Central and Eastern European Countries in the market share of modern retail formats. In Hungary, most of the general implications can be found; however, in the other two Bulgaria and Russia, modern retail has not yet made such inroads, particularly in rural areas.

This process will have important impact on the agri food business of CEEC. The major consequences are the increased quality requirements, vertical integration and growing international competition. But this process offers outstanding opportunities for firms to supply globally. These changes will have different effects on food processing firms. The large international companies and worldwide premium food processors will be just marginally touched. The national cost leaders will face a serious competition as they will

and cash so that the discounter had to overtake the supplier to secure its supply.

compete on an international level. However this offers the opportunity of an increased market share. Firms who are able increase their efficiency, through organisational and technological innovation will survive. Medium sized firms, who produce retail brand in contract with retailers can be the winners retail globalisation. Finally, small producers that deliver to local or niche markets are not directly affected by the internationalization of retail. There is a given demand for local and niche products that have to be offered regardless of whether retail is nationally or internationally positioned.

We want to highlight two particular findings: First, we particularly think that national cost leaders will face much stronger (global competition) due to the retail internationalization. Second, farmers all over the world have to form horizontal collaborations to satisfy the qualitative and quantitative demands of the international retailers.

Making business with giants is today the major driver of structural change in the agri food business of Central and Eastern Europe.

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