A Deadly Chain, or New Retail Booster

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Future of Russian retail business depends on whether it agrees to follow Germany's Metro rules

The much talked about advent of Germany's retailing giant Metro, has happened. Two Metro Cash & Carry stores, each worth $25 million, opened in Moscow November 1. The both offer 15,000 foodstuffs and industrial goods – from freshly baked bread to table tennis tables, from chocolate to computer hardware. The two hold goods worth $7.5 million and expect $80 million turnovers per annum. The company intends to open another four stores next year. The gossip has it that the dreadful times have come and Russia will be following the Eastern European pattern: six years ago, the Czech Republic had five chain stores operating nationwide of which only two survived through to 1997 while the others went bankrupt. In 1999, Metro AG was the leader at the local retail market. Now retail trade in the Czech Republic is represented by small shops and regional supermarkets. In Poland, only the Land SA chain is capable of competing with foreign chain stores.

Fortunately, Russia is not the Czech Republic or Poland where Metro's scope is the only factor of its dominance in the market. Things are different in Russia. The market, full of vim and vigor, is benefiting retailers. Therefore, it's not about the scope of the business Metro launched in Russia, it's about the rules of running it; and Russian retailers' future depends on whether they learn to play under these rules.

Fight for suppliers

Shortly before Metro Cash & Carry opened in Moscow, the heads of the largest chain stores (Kopeika, Perekrestok, Sedmoy Kontinent) negotiated with their suppliers – producers and wholesalers. The retailers heard the gossip that some suppliers sold their products to Metro at bargain prices – sometimes at a third of the prices set by Moscow retailers. Furthermore, the discounts allegedly did not depend on shipment volumes. The chain stores delivered an ultimatum – they promised to detect violations and impose sanctions on the violators like exclusion of their goods from their stores' inventories.

How did the condemned party respond?

To many suppliers, negotiating with Metro was like arm-twisting. They were pressed to reduce the prices and forced into a bonus system common in Europe: additional discounts during sales months, big sales bonuses, advertising bonuses etc. Armstrade (distributor of SPInternational, primarily known for their San Pellegrino pantyhose) said that their sales were planned and did not stipulate any price cuts demanded by Metro. If Armstrade fulfilled Metro's demands, it would entail losses.

However, for many suppliers, cooperation with Metro turned more attractive than with Russian retail stores. At the meeting with the domestic retail business giants they focused on logistics. Wholesalers and manufacturers deliver their goods directly to retail stores because the latter do not have any distribution centers. Only Perekrestok has one, but it needs streamlining: it does not have facilities to store frozen foods because the required equipment is too expensive. With Metro, suppliers deliver large lots directly to the store, which is very cost-effective.

Belaya Dacha agricultural firm spokesman pointed to another serious drawback of the domestic retail trade. Russian retailers practice return of expired products to manufacturers. Stores' reasoning is clear: the limit for writing off losses to the prime cost set by the tax legislation for retail trade is

extremely low. It means extra expenses to suppliers. Therefore, Belaya Dacha found agreements with foreign retailers (Metro and Spar), stipulating no return of expired goods, very attractive. One of the EuroSpar managers has been fired recently for attempting to send withered cucumbers back to Belaya Dacha. The store management saw this move as a managerial mistake, as the volume of products ordered exceeded the sales capacity.

Sadly, such managerial mistakes are not uncommon in our retail stores. Oleg Yankelev of the Institute for Financial Studies tells us: "Our stores poorly monitor merchandise turnover. Products often do not sell, which is absolutely inadmissible for foreign companies as the selling space is very expensive. Russian retailers almost don't use any alternative methods of getting rid of inventory – like margin reduction".

Another common mistake of Russian managers is unscrupulousness in selecting goods for placing in the store on premium conditions. This classical chain trade technique is misused in Russia causing a contradiction with long-term business objectives. It's about generating maximum profit from the selling space based on smart product placement and optimal array fitting into the demand structure. But, according to an Expert interlocutor who didn't wish to be disclosed, 'our traders have learnt to gain profit from trading shelves but failed to master the art of benefiting from principal activities." Mr. Yankelev said that, tempted by opportunities to gain from placement of poorly selling goods, traders receive one-off profit but lose on their image and future proceeds.

Until recently, the largest retail players could afford setting longer payment tenor for shipped goods – around 70 days. With Metro coming on board, behavior like this is likely to be deemed unfair. Here the payment tenor does not exceed thirty days.

Partnering with Metro as a trans-national corporation is beneficial to some companies. Hans Kerber, chairman of the executive board of Metro AG, communicated to the public present at the solemn opening of the shopping center that new export opportunities were opening before Russian businesses – the German giant runs its business in 21 countries worldwide.

Six million to cut down prices!

Metro is accused of being unfair: Moscow chain stores are sure that the company will work not only with small businesses as it says but with retail buyers, too. To put it short, they imply that suppliers are deceived by Metro and are making a mistake agreeing to cut down the prices.

This accusation was brought about following the last summer's campaign when Metro customer cards were said to be given to private entrepreneurs. Now it's hard to say whether that was the distributors' mistake. Anyway, official information has it that today Metro has 200,000 customers in Moscow. But the number of HoReCa enterprises in Moscow doesn't exceed several thousand. Moscow has around 20,000 petty outlets and several dozens offices – so it appears that the corporation does have business with private customers. Knowing people say that in some countries Metro runs so-called club cards giving access to Cash & Carry to selected individuals who tend to make large purchases.

Metro representatives say however that their Russian-based Cash & Carry will not be a direct rival to retail stores. Walter Demetz, Metro's country manager for Russia, says that indirect competition might be in the field of mastering the methods of reaching the new price level. Those who learn how to cut prices faster have a chance to draw a part of the customers. He emphasized that in Moscow retail prices are high compared to Western Europe. This is strange for the market where overall customers' buying capacity is lower. It's hard not to admit the righteousness of the last statement. Consultants of Roland Berger and Partners GmbH state that 'leading an aggressive price making policy gives a big advantage to foreign companies in the market that is highly sensitive to price levels," and rightly so.

Saying that the local retail business is deaf to Metro reasoning would be wrong. Evgeny Kabalov, general director of the Mir shopping center (trading home appliances), says that practically all Russian chains seek ways to cut prices to reach the margin level of their foreign counterparts. Some have succeeded – and the solution does not appear too painful.

The Pyaterochka discounter and supermarket chain (fifty-eight stores in St. Petersburg and a dozen in Moscow) that has grown in Russia's northern capital where people are less wealthy the margin for certain merchandise is less than 5% - lower than at Metro. Sergey Lipkovich, the chain director, says that Pyaterochka's margin is one of the lowest in the industry.

The Pyaterochka leadership associate their pricing achievements with automated control system which enabled the company to avoid extra expenses. 17-20 persons work in each store per shift (against 60-70 in a regular store). The company expects to put into operation a distribution center that will help save on logistics. An automated warehousing facility is estimated to reduce manpower by a third, the warehouse area – 2.5 times and the logistics will be three times cheaper. Cargos will be processed twice as fast. The innovation will cost $6 million to the company.

Turkish Ramstore practices another approach to winning Russian customers. This year, it introduced private label goods that are priced 15−25% lower as they are provided for offer by regional producers little known on the Moscow market (for instance, Belgorod dairy factory milk is sold under the Ramstore brand).

Temporary difficulties

Some observers cherish a hope that Metro will face local hardships like Russian roads and traffic jams impeding commuting and telephone failures caused by throughput capacity. Besides, it's hard to predict how Russian small businesses – trade outlets, restaurants, cafes - will respond, perhaps, they are not ready to drop the established chain of uncivilized logistics and move up to Cash & Carry.

The Metro product array does not fully meets Russian customers' habits. Metro's confectioneries offer Udarnitsa, Orsk Factory, Korkunov, and Sladko brands but don't hold Krasny Oktyabr. The meat department does not sell much-loved Cherkizovsky and Mikoyan factories. Darya is the only trademark present in the fridges.

It's clear that overcoming hardships won't last infinitely. Therefore, the only advantage enjoyed by Russian chain retailers so far is the market size. In Moscow, the fast moving consumer goods market is worth $30 billion. A half of it is held by small wholesale markets and small specialized shops – the formats for which chains will fight.

Metro, with its six centers, will have a $480 million turnover per year – this is an aggregate turnover of Sedmoy Kontinent, Perekrestok, and Kopeika – Moscow's largest chains. Home appliance-focused chains have the same turnover. Russian chain stores have been growing 170−200% over the latest two years, some intend to yet increase their expansion.

So, the race promises to be an eye-opener. Evidently, domestic participants of this race can only expect good results if they fulfill two conditions. First, they need to consolidate. By now, the understanding of this necessity caused pools to be formed and joint actions involving even direct rivals. Mr. Yankelev believes that assets are likely to be consolidated in future, too. The other condition is making breakthroughs in technology and management. Technological streamlining will enable businesses to keep and speed up the growth rates. Pyaterochka, by the way, promises to grow nine times larger in three years.

Otherwise, analysts say, the Moscow chains will be ousted from the capital's market to the regions. In fact, the latter scenario will be just a repetition of the first one – only a bit later.

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