China Restaurants Facing Big Challenges

I just came back to Hong Kong from a two week project in Shanghai & Beijing with a Chinese restaurant chain that has struggled the past three years. Visiting with headquarters staff as well as store managers and team members, it was clear that the market is in a state of massive flux and only those concepts which can adapt quickly to changing consumer behaviors will prosper going forward. It is a real minefield to navigate for all operators.

Economic Slowdown

The overall economy has clearly slowed but foodservice is still growing over 7% per year. However, consumers perceive there is a slowdown and are tightening their household budgets and spending less when eating out. Restaurants with average spending per person over 70 RMB are feeling the effects, while fast food concepts are less impacted given lower price points.

Mall Glut

Malls are overbuilt in Tier 1 cities like Shanghai, Beijing and Shenzhen. Older mall traffic suffers as soon as new malls open with the latest and greatest new retail concepts. Restaurants in older malls feel the impacts and struggle to get a decent financial return while rental costs keep rising. It is common to see multiple new malls open in the same trade areas creating a large "red ocean" for the entire restaurant industry.

Restaurant Over-Supply

E-commerce has negatively impacted all lifestyle retail in malls. Customers still go to malls to window shop for apparel and footwear but they look to buy the same item online for less money. Many lifestyle retailers

primarily pay the malls percentage rent on sales so the mall revenues suffer as well. Many lifestyle retailers are also closing many of their shops to focus on the online business. In many cases, malls then double the size of their F&B concepts which creates too many restaurants for the customer traffic. In other words, demand and supply are not in sync creating negative same store sales for the F&B segment which leads to cash flow declines while labor and rent are unchanged or increasing.

The Delivery Apps

All of the above is enough of a challenge for any restaurant group but now there is the added problem of dealing with online delivery ordering. Meituan-Dianping and Ele.me control more than 80% of the total foodservice delivery market in China and are locked in a price war. They are subsidizing every delivery by as much as 3 RMB to gain market share and this is part of the larger battle between their main investors Tencent & Alibaba. If restaurants want to capture a slice of the delivery market then they need to offer discounted meals that appeal to these price sensitive customers, which puts further pressure on restaurant margins. Most delivery is done from the restaurants themselves and it is very common to see delivery drivers in front of restaurants waiting to pick up the order. Customers who order delivery are more concerned with price and convenience than food quality so this tends to hurt full service restaurants with guest checks higher than 70 RMB compared to lower priced concepts.

Restaurant Chain Growth Fueled by Private Equity Cash

It is important to note that much of the growth in chain restaurants has been fueled by investments by Private Equity groups who have bet on rapid growth through store development. Overtime this has also created an over-supply of chain restaurants in the market.

How to Survive in This Environment?

Surviving in an environment like this is very tough and it is probably not prudent to enter at this stage as a newcomer until the market settles down to a new normal. Here are some tips if you are a Korean restaurant group already deep into the China market.

- Get a delivery strategy fast if you don't have one, and reorient the organization to putting delivery as a major sales driver.
- Look at your menu and cost of goods. Can you re-engineer your menu to create more value for your customers without sacrificing margin or food quality?
- If you are a full service brand, look at making a fast casual version or at least a "ghost kitchen" with a limited menu to take advantage of the growth in delivery.
- Finally, do not build new restaurants without rigorous analysis of the city and trade area. Tier 3-4 cities are less effected than Tier 1-2 cities with these volatile conditions, but you still may experience negative growth after the first year.