Oil Retail
What It Takes to Win in the BRIC Countries

THE BOSTON CONSULTING GROUP
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High oil prices in recent years have pressured profits for oil retailers around the world. Traditional players in mature markets are finding that new business models and rising factor costs are encroaching on their margins and diminishing growth. In response, many of these companies have begun looking at developing markets—and especially at the BRIC countries of Brazil, Russia, India, and China—for the next wave of growth and higher profitability.

The potential for growth in these countries dwarfs that of other emerging markets and even outpaces projected growth in the mature markets after 2015. (See Exhibit 1.) However, there are serious questions about profit potential. A recent analysis by The Boston Consulting Group of oil retail markets in the BRIC countries revealed sobering findings for traditional players. Although developing markets are undoubtedly the growth engines of the future, incumbents and new entrants face both the challenge of building a winning position and the risk that these countries will make a rapid transition to less profitable, highly competitive markets.

To win in the developing markets, all oil retailers, whether international oil companies (IOCs) or national oil companies (NOCs), incumbents or new entrants—as well as nontraditional players such as international hypermarkets—will have to be ruthless in their strategic focus, excellent in their on-the-ground execution, and aggressive and nimble in recalibrating their business model and capabilities. In this report, we identify the opportunities for building successful strategies in the developing markets of the BRIC countries.

Market Potential Varies by Development Stage

Oil retail markets typically evolve from developing to developed through three stages: early, transitional, and late. (See Exhibit 2.) Early-stage markets represent a large portion of the world’s incremental fuel demand and offer attractive growth potential. But access to fuel supply is often limited and pricing control is often strict. Transitional markets offer the greatest potential for profits as deregulation takes hold, prices begin to float, and competition remains limited to traditional retail formats. Late-stage markets are characterized by intense competition, lower margins, and the rise of new business models and players, including such nontraditional competitors as hypermarkets, large and efficient gas stations with competitive prices, convenience retail formats in key urban locations, and easy-access highway formats with fast food and other tailored offerings. Traditional oil retailers, including incumbents, struggle against these new competitors and must reduce their networks or withdraw if they are unable to adapt their offering successfully.

When evaluating the potential for entering a new market, oil retailers must determine its stage of development and estimate how quickly it will move from the early stage through the transitional stage and on to the late stage, when competition intensifies and profits are likely to shrink. The speed and nature of a market’s development depend on a number of factors:

- the role of dealers, independent retailers, and large national players
- the extent of access to supply and infrastructure
- the degree of regulatory influence
Exhibit 1. The BRIC Countries Will Provide Compelling Oil-Retail Opportunities in the Coming Decades

Projected Increase in Annual Demand for Retail Oil

From 2005 to 2015

From 2016 to 2030

Emerging markets

Mature markets

BRIC

Middle East

Asia

Africa

Latin America

Other

Million metric tons of oil equivalent

0

50

100

150

200

250

300

Emerging markets

Brazil

Russia

India

China


Note: Retail oil does not include biofuels. Mature markets consist of the United States, Canada, Western Europe, Poland, Hungary, the Czech Republic, and the Slovak Republic. Asia does not include India and China.

Exhibit 2. Oil Retail Markets Evolve Through Three Stages

Early-stage markets

Transition markets

Late-stage markets

Overall profitability

Strict

Limited

Low

Share

Pricing control

Access to fuel supply

Breadth of competition

Basis of advantage

None

Flexible

High

Efficiency

Source: BCG analysis.
the sophistication of retail formats combining food, fuel, and other products and services

Oil retail players need to understand how these factors will affect their entry into the BRIC markets. To maximize the probability of success, they must consider a number of issues.

Rapid transition to the late stage carries significant risk. Some countries are likely to move more rapidly than others to the late stage of the oil retail market. The big hypermarket players, which are increasingly international, are seeking to expand their markets and offerings to include fuel. This hypermarket growth erodes distribution and retail prices in their areas of influence. These players understand both the importance of fuel retailing to their business model and the potential of the BRIC markets—although their penetration may be less than in denser, more mature markets such as Europe partly because of regulatory constraints. At least one of the major hypermarkets has already introduced a fuel offering in Brazil and has announced its intention to do the same in China as soon as regulation permits. Traditional oil retailers will find it hard to compete in urban segments once hypermarkets are established.

The sophistication of existing oil retail in the BRIC countries should not be underestimated. A variety of formats and consumer propositions are already present in many developing markets. India’s NOCs have launched a broad mix of convenience fuel-retail outlets. In Russia, a big traditional player has made powerful inroads in the branded-fuel sector, and premium-fuel penetration in the Moscow region is among the highest of any developing market worldwide. Many of these retail concepts are almost indistinguishable from their counterparts in the developed world. Successful market entry will require a deep understanding of existing oil-retail structures.

There is no one-size-fits-all strategy. Developing markets are heterogeneous. Chinese oil retailers face a unique regulatory environment. Brazilian oil retailers have problems with fuel adulteration and powerful, informal dealer groups. In Russia, supply, competitors, and the business environment vary by region. In India, stiff government price controls and control of infrastructure and prime sites by NOCs pose a challenge to retailers. Oil retail remains a local business in the BRIC countries and, although there are overarching strategic themes, each market requires a highly tailored approach.

Brand is important. Most consumers in developing markets are brand conscious. For example, a 2007 BCG study of Chinese consumers showed that 59 percent of the affluent consumers surveyed intended to trade up to more expensive brands.1 Driving a car is a high-status activity in China and thus offers a big opportunity for branding. In a market such as Brazil, where the risk of fuel adulteration is high, brand is an important quality signal. Entrants in these markets should be prepared to invest in a brand.

Government relationships play a vital role. Typically, developing markets are either highly regulated or in the early stages of deregulation. Because supply generally resides in the hands of NOCs, entrants looking to gain access to supply and attractive locations must develop a comprehensive government-relations strategy. For IOCs, this requires a strategy integrated across their oil-and-gas value chain that addresses broad government agendas regarding technology transfer, industry development, and job creation.

The path to profitability may be long. In highly regulated markets, the profitability of retail businesses is often low. During periods of high oil prices, governments often intervene and restrict pump prices, arguing that integrated players are making plenty of money on the refining side. A market such as India typifies this structure: a nonintegrated player with only a retail business has to decide how long to trade at very low margins and how far to push expansion.

Opportunities in the BRIC Markets

To avoid the pitfalls and capitalize on growth opportunities in the BRIC countries, oil retailers must take into account the market stage of each country. Of the four, Brazil is the most advanced, having entered the transitional stage of traditional

competition. Russia is beginning to deregulate its oil-retail market but has not yet moved to the transitional stage. India and China are still in the early stage, with strict price controls and limited access to fuel supply.

**Brazil has high growth but poor returns.** Although Brazil’s oil-retail market is experiencing a growth in demand of approximately 3 percent per year, returns in the distribution market are currently unsatisfactory. A high level of informality in distribution contributes to tax evasion and to lax enforcement of standards for branding, sourcing, engineering, and safety. This is particularly the case in the market for ethanol, which is a growing substitute for gasoline.

By law, distribution and marketing of retail oil in Brazil must be kept separate: distributors cannot operate gas stations. Dealer-operated stations, whether company or dealer owned, are the only options available. Approximately 85 percent of Brazil’s 34,000 gas stations are dealer owned and operated by many small, independent players. About 40 percent of the sites are unbranded.

Brazil’s Petrobras has a powerful position in distribution and retail through dealers affiliated with its subsidiary, BR Distribuidora. Other IOCs have to compete not only against BR Distribuidora but also against many local, often informal, distributors. However, the market is changing. Regulatory pressure prompted by industry associations is reducing market informality, driving smaller, subscale players out of the business and improving distribution margins. Individual sites are becoming part of the large chains of the main players.

At the same time, food retailers have started to implement high-throughput formats such as hypermarkets. One of the largest supermarket chains in Brazil has a network of approximately 70 high-throughput sites that are company owned and dealer operated. Its success is prompting other hypermarket chains to follow suit in testing and rolling out these formats.

For traditional players seeking to develop a position in oil retail, there may be better locations to place bets on than Brazil. For incumbents already present there, the challenge will be to carefully manage their gas-station networks and operators, improve control over station operations, develop hypermarket partnerships where appropriate to address the threat of new entrants, and strengthen government relationships to level the playing field.

**Russia still offers a chance for successful entry.** Of all the BRIC countries, Russia has healthy retail margins, the highest penetration of cars per capita, and a large and growing demand for oil products, which has been met primarily by domestic companies. The country is therefore a market of great interest to most international players. There are a number of independent refiners, and infrastructure—access to supply, transportation, storage, and distribution—is available in most regions. Of the IOCs, only one has established a significant presence, through a joint venture and the development of a separate network in Moscow. Another IOC has a smaller presence in Moscow and St. Petersburg.

Building a meaningful retail position in Russia is not without its challenges, however. One Russian NOC has aggressively expanded by acquiring another company’s assets. Another NOC continues to build a strong national position in refining and marketing, with a large market share in some regions. Many of the smaller independent retailers play by different, “informal” rules. Because new retail sites are difficult to obtain in Russia, acquisition prices for existing sites have increased dramatically.

For traditional IOCs, entering Russia requires an integrated play and the government’s blessing. Growth opportunities exist beyond Moscow and St. Petersburg in the western part of Russia, but entrants need secure access to refined products and depot networks, which may necessitate partnerships with NOCs. New greenfield sites on major transit roads are still possible.

Russia’s incumbents should deepen their brand and quality differentiation, and upgrade and expand their national networks in order to raise barriers that new entrants will find difficult to replicate.

**India is best for players that can wait for deregulation.** India is perhaps the most challenging of the BRIC markets. NOCs control the infrastructure and most of the prime sites. The government controls prices and compensates the NOCs for their marketing losses through different mechanisms, leaving private companies to struggle with poor economics. What sets India apart is the degree to which NOCs have invested in retail to deliver a range of offerings well adapted for the local markets, as
well as strong branded products, innovative formats, and extensive nonfuel partnerships.

Like China, India’s sheer size, rate of urbanization, and car penetration make it structurally attractive. Eventually, the government will have to allow market forces to begin playing a role, especially if massive government subsidies to offset high crude prices continue. The trigger for such a policy shift is hard to identify, but signposts such as government policy announcements must be carefully monitored.

IOCs considering India should first develop an understanding of the oil retail market without investing a significant amount of capital, perhaps by establishing footholds in a few regional centers and extending onto the major highways by organic growth. They can then move quickly as regulations change. Given India’s need for crude supplies, any significant retail play will eventually require an integrated deal.

Incumbents need to plan network expansion that takes advantage of urbanization, and they must upgrade their sites overall to increase network resiliency once market forces take over.

**China offers potential for politically savvy entrants.** China, which is on everybody’s “must conquer” list, offers the largest single source of incremental growth in fuel demand. New pockets of wealth are emerging in multiple regions away from the traditionally oversupplied coastal regions. Most consumers in China, unlike those in India, are undersupplied in terms of fuel and nonfuel offerings. NOC sites typically provide little beyond a small basic shop, although one of the country’s three NOCs has begun experimenting with retail partnerships.

The challenges of fuel retailing in China are well known. Market entry for foreign players must be through a joint venture, and NOCs control supply, infrastructure, and prime sites. Prices are regulated, limiting the profitability of retailers. A few IOCs have entered through the mandatory joint-venture route, and others are beginning to follow their example.

China also poses the greatest risk of rapid market transition. International hypermarket players have been targeting China for a number of years and have built a significant presence there. They are on record as intending to build a fuel retail offering when regulation permits. Depending on how the market evolves, this could lead to a highly competitive urban fuel-retail market in a relatively short period—certainly shorter than the payback period assumed for most real-estate investments.

Given the risk of rapid market transition, IOCs considering China must decide how much capital to invest, where to invest, and with whom to partner. Choosing a partner is important given the number of joint ventures in widely separated geographic areas. New entrants also need to look at building regional footprints as the basis for longer-term growth.

Chinese incumbents likewise need to decide how much capital to invest. In addition, they need to determine whether joint-venture partnerships are necessary or whether they can independently develop the capabilities that a joint venture would bring to the table.

**Strategic Implications for IOCs, NOCs, and Hypermarkets**

To develop an oil retail business in the BRIC markets, all players—IOCs, NOCs, and hypermarkets—will need to develop successful strategies. These strategies must build on each player’s strengths and take into account each country’s unique characteristics.

**IOCs.** IOCs have to be realistic about what they bring to the game in the BRIC markets. Oil retail is a very local business, and NOCs are able to build relatively sophisticated offerings drawing on the example of developed markets. Nevertheless, IOCs have shown that they, too, can build successful businesses in emerging markets by using their experience in developed markets. For example, they have been able to build more resilient businesses in developing markets by focusing on network quality, larger format sites, and premium fuel offerings.

Most IOCs will be able to dedicate resources to only a small number of countries and regions. To be successful, they will need to answer the following questions:
Which markets and regions are the most attractive in terms of market structure?

How do those markets fit within the company’s broader upstream and downstream strategic objectives?

What are the challenges of building a position in these markets?

How much will the company need to invest and over what period?

What does this investment imply for the business model, such as a joint venture or a share of dealer-owned, dealer-operated facilities?

The Offering. Determining what to offer is critical. Questions such as the following must be answered accurately to ensure a successful offering:

While rapidly building a distribution network, can the company also build large, efficient sites with a high percentage of premium fuels and provide a platform for competitive pricing as the market develops?

Is there an opportunity to build a convenience retail brand, recognizing the inherent challenges of retail capability, site location, and brand perception that have translated into low profitability for many consumer retail businesses in developed markets?

Should the company partner with a local food retailer for urban convenience-retail locations?

What is the company’s strategy with regard to hypermarkets?

When does the company believe hypermarkets will become a threat?

Should the company seek to partner with hypermarkets in a joint-entry strategy? If partnering with a hypermarket does not make sense, should the company focus on network growth in high-traffic areas away from hypermarket locations?

The Business Model. It is equally important for IOCs to identify the optimal business model by addressing these critical questions:

How much operating freedom exists for sites that are company owned and operated, dealer owned and operated, or company owned and dealer operated?

How much capital and risk does the company want to tie up in company-owned operations?

If the company is forced to be heavily dealer owned and operated, how does it build a compelling dealer proposition and manage the inherent conflicts of interest?

Is it necessary or desirable to enter the market through a joint venture? In China, where this is a prerequisite, is a partnership with an NOC or with a local real-estate company more desirable?

How can the capabilities to manage a joint venture be built into the organization?

Government Relations. Most government authorities in developing markets expect an IOC to negotiate as an integrated entity, which gives the company more bargaining power. For example, an IOC could bring a developing market both upstream technologies and a retail offering. Companies negotiating with such an integrated offering need to ensure that their upstream and downstream agendas for market expansion are aligned.

NOCs. NOCs hold most of the cards but typically have the fewest capabilities for developing and managing retail offerings. While they control supply and existing locations and have the strongest government relationships, they often see retail as an outlet for their refinery production rather than as a business in its own right. Businesses are often dealer owned and operated, with little internal capability in convenience retail. The retail network is typically diverse, with many different site types of varying quality and retailer competence. Regional variation is also high.

NOCs can nonetheless be in the driver’s seat when it comes to how the market evolves, especially in terms of hypermarkets. Those that partner with international hypermarkets benefit from a winning business model while providing these retail sites with a secure supply of fuel. Depending on the existing dealer network, there are many challenges to be managed in such alliances, but they are almost certainly worth the effort for NOCs.

The Offering. To determine how far to go in standardizing the offering across the network, NOCs must answer the following questions:

Where in the value chain does the company wish to participate?
Is convenience retail an area in which to build?

Can the brand be upgraded through more consistent site quality?

How can competitive pricing be ensured across the network?

Does the company need to form partnerships—for example, with food retailers or hypermarkets—to build capability?

**The Business Model.** As NOCs review their business model, they need to explore the following key questions:

- How far is the company willing to go to develop company-owned sites? Such sites can provide the platform for delivering a more consistent brand and an offering that can be a part of the dealer’s value proposition, but they involve significant additional costs and capabilities.

- What are the risks and rewards of partnering with an international hypermarket?

**Hypermarkets.** The most successful outcome for hypermarkets is unlimited access to quality fuel under their own brand with unconstrained pricing. Hypermarkets have demonstrated worldwide that the power of their business model—to deliver massive traffic in fuel—builds a winning business. Their brands can easily absorb fuel as a private-label offering under the banner of good quality and value. The economics of their sites create a virtuous retail cycle of low price, higher volume, lower unit cost, and attractive economics that can be reinvested in further price reductions.

Hypermarkets should recognize the strength of their business model. To protect the core drivers of their success, they need to consider the following questions:

- If giving a local NOC access to hypermarket sites is a precondition for obtaining a reliable supply of fuel, is it worth granting such access for a limited period?

- Is the company ensuring that its government negotiations protect the ability to price fuel freely?

- Is the company sure that the source of supply will ensure consistent high-quality fuel to protect the brand?

The BRIC markets are a challenging environment for oil retailers. Whether the company is an IOC, an NOC, or an international hypermarket retailer, success depends on a detailed understanding of the market and the region, a tailored business model, and upgraded organizational capabilities.

While the lessons learned from mature markets are relevant in the developing BRIC markets, they need to be adapted to each unique situation. The journey may not be straightforward, but companies that succeed will find that they have established a platform for the next wave of growth and profitability in oil retail.
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Acknowledgments

The authors thank their many colleagues at The Boston Consulting Group who contributed to this report, especially Oxana Dankova, Karl Holmes, Jean Le Corre, Oliver Steen, and Brad VanTassel for their insights and helpful discussions. We would also like to thank Gary Callahan, Angela DiBattista, Gina Goldstein, Corry Leigh, Lynne Smith, and Janice Willett for their contributions to its editing, design, and production.

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7/08