

Beyond the Nakumatt Generation: Distribution Services in East Africa

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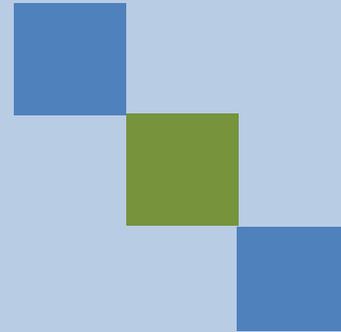
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Distribution services¹ are an important driver of growth in East Africa. With contributions to GDP ranging from about 11 percent in Kenya, Rwanda and Tanzania to more than 14 percent in Uganda in 2008/09 distribution services are a significant part of all East African economies. The sector also employs an important part of

¹ Providers of distribution services generally fall into four categories: retailers, wholesalers, franchisers, and commission agents. Retailers in both the formal and informal sectors sell goods for personal or household consumption; wholesalers sell merchandise to retailers or to other businesses. Franchisers sell specific rights and privileges related to operating a branded business, for example, the right to use a particular retail format or trademark. Finally, commission agents trade on behalf of others, i.e. they sell products that are supplied and usually owned by others to retailers and wholesalers. The main focus of this note is on the retail and wholesale given that they dominate the distribution sector in East Africa.



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the population (in many East African countries over 10% of the active population) and includes a high proportion of informal, unskilled, female and part-time workers. Distribution services are among the most rapidly expanding sectors in East Africa. Over the period 2001-08 (2004-08 for Uganda), distribution services have grown on average at 8 percent a year in Rwanda, 12 percent in Kenya and Tanzania and 20 percent in Uganda.

There is an emerging recognition amongst the East African countries regarding the importance of this sector. For example, distribution is a strategic sector in Kenya's "Vision 2030" – the country's new development blueprint. In addition, distribution services were identified as a priority sector in the context of the East African Community Common Market Protocol and the negotiations with the EU on services in European Partnership Agreements by Kenya, Rwanda and Tanzania.

Distribution services represent a crucial link between suppliers and producers. With improved efficiency and higher productivity due to the emergence of large supermarket chains and the increased internationalization of the distribution sector across East Africa, the sector has great potential to benefit both producers and consumers and contribute to increased food security and alleviation of rural poverty. Modern distribution channels and procurement systems that reduce transaction costs and facilitate market exchanges can increase the access of small farmers to high value markets and accelerate the transition from subsistence farming to market participation. For consumers, organized markets can provide substantial benefits that include better quality products at affordable prices.

So far, however, modern distribution channels have failed to capture a large portion of the retail market in East Africa. Across the region informality still prevails, small-scale farmers have found themselves marginalized by the distribution sector and its new practices, and very poor households (for example, slum dwellers) are often paying more per unit for basic products than wealthier households.

This policy note documents the current state of distribution services in East Africa, including the patterns and the determinants of the diffusion of modern distribution channels and the increased internationalization in the region. It shows why, despite major transformations during the last decade, the distribution sector remains underdeveloped and the impact of reforms is uncertain. To strengthen the contribution of the sector to poverty reduction, policy action that addresses the concerns of the households and producers at the bottom of the income pyramid, especially in the informal

sector, should be a priority in all East African countries. Policy action that enables a gradual transition of informal firms to formality as well as measures that encourage regulatory reform need to complement the liberalization of the distribution sector in East Africa.

Developing the Distribution Services Sector in East Africa to Reach Poor Consumers

Informality prevails despite the rapid diffusion of modern retail stores. Increasing population, continued urbanization, higher incomes, and political stability have propelled the growth of distribution services in East Africa during the last decade. The proliferation of supermarkets and large retail stores are among the most significant developments regarding the evolution of distribution services in the region. Supermarkets in East Africa have sustained impressive growth rates over the period 2006-10: the compound annual growth rates of retail sales reached more than 15 percent in Rwanda, about 13 percent in Uganda, almost 12 percent in Tanzania and about 7 percent in Kenya and Burundi, and retail sales in East Africa are expected to grow around 10 to 11 percent per annum over the next five years (Figure 1). Total retail sales in East Africa are expected to increase from around 43 million USD in 2010 to more than 70 million USD in 2015 (Figure 2).

Formal distributors in East Africa tend to be large supermarkets and large to medium sized retailers and franchisees. Retail outlets, including supermarkets, tend to grow by first focusing on urban areas and large cities, then branch out to medium size urban areas, and finally out to rural areas. In this way, although supermarkets generally begin by catering to higher income urban consumers, the growth path of retailers in East Africa has the effect of eventually bringing lower income rural

consumers into the retail outlets as well, driving up retail growth rates significantly. For example, the Uchumi supermarket expanded in Kenya by first opening stores in Nairobi then shifted its focus by opening smaller stores located near bus stations used by lower income consumers.

Figure 1: Compound annual growth rate (CAGR) of retail sales in East Africa, 2006-2010 and forecasted CAGR of retail sales, 2010-2015

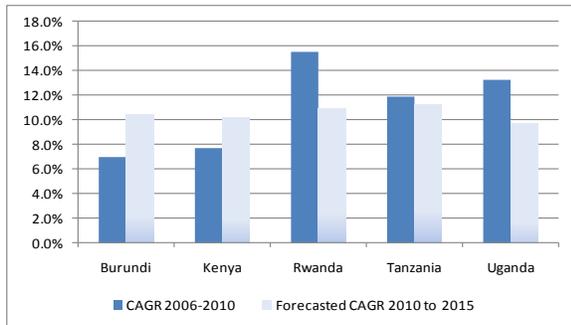
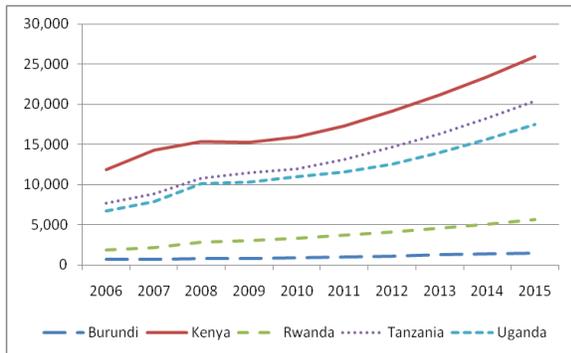


Figure 2: Retail sales in East Africa, millions of usd



Source: Planet Retail, retail sales data, 2011

Despite the growth of the higher end supermarket segment, including in rural areas, the number of traditional small stores that sell local produce remains high in East Africa’s retail market. In general, the distribution sector includes a small number of large supermarkets, a slightly greater amount of large to medium sized wholesalers and retailers, and a much larger number of independent and often informal small retail shops and street vendors. Such informal retailers can be found in both

urban and rural areas and are often the primary enterprises engaging in distribution services outside larger cities. Most businesses in the East African informal sector are engaged in the retail of food and basic retail household appliances, and are single shop sole proprietorships.

In the wholesale segment, we observe a high degree of duality between traditional and specialized wholesalers. Traditional chains are still widely prevalent in all East African economies. Farmers and traders supply traditional wholesalers, who then sell to individual retailers and processors. But most modern retail stores have their own direct procurement systems and buying centers. Several supermarkets – for example, Nakumatt – have also developed regional distribution centers to perform the wholesale function for their outlets.

The franchising segment is small and mostly limited to foreign firms. This is partly due to the lack of intellectual property enforcement in African countries, which hampers the process of branding that is required for successful franchising. For example, the weak enforcement of Intellectual Property (IP) and lengthy resolution of IP disputes² in Kenya prevents the establishment of international franchises. Some Kenyan firms, however, have been successful in establishing franchises in East Africa, such as Kenchic in the poultry segment and Deacons in the apparel segment.

A common characteristic across the distribution sub-sectors of all East African countries is the large proportion of the informal sector. An

² On average it takes about 8 to 9 years to resolve IP cases in Kenya.

estimated 70-80 percent of sales in East Africa still go through informal enterprises, with only about 20 percent of sales going through formal outlets. In Kenya, for example, an estimated 88 percent of businesses in the distribution services sector are considered informal, employing 80 percent of the total labor force in the sector. Low entry barriers and the relative ease of operations are among the factors that could explain the high level of activity in the informal distribution sector. However, informality can be also a byproduct of low productivity. World Bank (2010) shows that as Zambian firms became increasingly productive, they became more formal.

Although informal enterprises handle the large majority of sales, turnover is low for most individual informal enterprises and businesses tend to be very small. Enterprises in the informal sector are more limited in their operational capacities than businesses in the formal sector. Furthermore, the lack of access to finance, uneven cash flows, the absence of management knowledge, highly fragmented and inefficient supply chains, and poor infrastructure are key constraints faced by enterprises in the informal sector that discourage their transition to formal activities.

The prevalence of the informal market can sometimes discourage large formal business from entering this market segment. Informal retailers are also suboptimal from a governance perspective, since it is difficult or impossible to collect taxes (VAT, excise tax, import duties, etc) from unregistered businesses without licenses.

Regulatory barriers limit the benefits of internationalization in the distribution sector. Foreign direct investment (FDI) is starting to play an important role in the distribution sector of most East African economies. The largest

businesses operating in the formal sector of all countries except Kenya tend to be companies with substantial foreign equity. For example, the supermarket segments in Uganda and Tanzania are dominated by South African and Kenyan chains. Kenyan supermarkets are also present in Rwanda, and Nakumatt is preparing its entry into Burundi in 2012. The Burundian distribution sector has already several foreign operators from Belgium, China, India, the Netherlands and Pakistan. By contrast, the Kenyan market has been challenging to foreign investors in distribution services. Foreign retailers such as the South African Metro Cash & Carry and Lucky 7 exited Kenya's market in 2005 after brief operations. The limited success of foreign companies in Kenya's retail segment has been attributed to strong competition, insufficient and expensive suitable locations and inadequate market entry strategies among others.

Kenyan supermarkets began establishing foreign operations in the EAC from about 2002 and have since stepped up their efforts to penetrate the regional market. Currently, the three largest Kenyan supermarkets have a combined total of seven branches in Uganda and one in Rwanda. The main market entry strategy employed by these supermarkets is acquisition of existing supermarket chains. In 2011 Tuskys acquired the Ugandan supermarket chains Good Price and Half Price and has now four stores in Uganda.

The estimated Kenyan FDI in the East African supermarket segment amounts to USD22 - 28 million (table 1). Total Kenyan FDI outflow in distribution services is estimated to be around USD 26 – 32 million over the period 2002-2009. Expected investment in the EAC distribution services sector over the next five years is

projected to be USD 30-503 million. Major drivers of investment in East Africa include the adoption of the EAC Common Market Protocol and the harmonization of tax regimes and customs import regulations.

Table 1: Kenyan Supermarkets with EAC Presence⁴

| Kenyan Supermarket | No. of Branches in EAC Countries | | Estimated FDI Investment Flows* (\$ millions) |
|--------------------|----------------------------------|----------|---|
| | Uganda | Rwanda | |
| Nakumatt | 2 | 1 | 8.25 |
| Tuskys | 4 | | 11 |
| Uchumi | 1 | | 2.75 |
| Total | 7 | 1 | 22 |

Source: Consultant Interviews 2010/11.

The foreign presence in the distribution sector of the East African economies has been made possible by extensive trade liberalization measures adopted by these countries. Burundi, Kenya and Rwanda are largely free of any major impediments to foreign presence in retail services. Tanzania imposes a few explicit policy

³ Nakumatt plans to invest \$20 million in its EAC expansion over the next 5 years, Deacons \$10 million. Nakumatt is looking at opening 2 new stores in Kigali, Rwanda by the end of 2011. Uchumi is looking to commence its Tanzania operations in 2011.

⁴ Average investment required for establishing a supermarket in EAC is \$2.75 million. This figure was calculated using past investment spend of Kenyan supermarkets in EAC. Nakumatt invested about \$3 million for each of its Uganda branches, \$2.5 million of their Rwanda branch. Uchumi invested about \$2 million for its branch in Uganda, and are poised to spend \$2.5 million for their planned branch in Tanzania.

restrictions: there is a 50 percent limit on foreign ownership if the foreign firm is acquiring a state-owned retailer, and the licensing criteria tend to favor and promote domestic retailers. (data from Borchert, Gootiiz and Mattoo, 2011).

With a population of more than 140 million people, the East Africa region provides a vast retail market for formal retail traders with important benefits for consumers and producers. According to Nakumatt Holdings Research the current regional population has an opportunity to sustain at least 10 major retail stores in each town. In the next ten years, Nakumatt Holdings is forecasting that close to 25million customers across the region will have access to formal retail trade facilities with monthly sales reaching the US 700 million mark and selling space reaching close to 40Million square feet up from 15 million square feet today (Nakumat CBC, 2011).

Several regulatory measures obstruct the entry of formal distribution firms and limit their operations in East African markets. Most East African countries have some form of regulation on market access (World Bank, 2011). In Kenya, Rwanda, Tanzania and Uganda new businesses must register with the commercial registry and must notify authorities. These countries also require that a new business obtain licenses and permits in order to engage in commercial activity, with fees depending on the type of business permit required. Multiple licenses are a significant challenge in distribution services. For example, a Kenyan distributor who covers a territory spanning several local authorities will be required to have licenses from each local authority to drop off goods at particular customers and receive payment. A similar problem occurs in the case of exporting. A distributor is required to have documentation

for each product regardless of whether it is in the same product category. For instance, if the distributor is exporting yogurt in different flavors export documentation for each flavor is required.

In Kenya and Rwanda businesses selling certain types of goods must also comply with outlet site regulations, in addition to compliance with local urban planning provisions. Large outlets have an additional set of regulations. In Uganda, foreign retailers are required to establish their outlets in the city area - establishment anywhere outside the city is prohibited. This decelerates the expansion of retailers from urban to rural areas. Rwanda has regulations on tax registration for micro-retail businesses and franchising. By contrast, Burundi has very little regulation in place with regards to distribution services. With the exception of pharmacies, which have to follow zoning and location rules, regulations or registration requirements are absent for most businesses. This lack of regulation has created a legal vacuum that actually constrains business growth and allows many opportunities for unfair competition and corruption.

The main restrictions affecting operations in the distribution sector are related to price regulation. The justification for such regulations is consumer protection, but price restrictions have a negative effect on competition. Price controls exist in most East African countries for essential goods. In Burundi gas and sugar are price controlled; in Rwanda there are price controls on gas, gasoline, and pharmaceuticals. Tanzania has price controls on a large number of goods and services, with fuel, water, electricity, transport fares, and telecommunications all being regulated. More recently, Kenya has introduced price controls on

numerous food products to address food security concerns despite a strong opposition from the private sector. Across the region particularly problematic are the cartels that control the prices and the flow of certain goods such as sugar or maize.

Several countries have regulations on the quality and the standards of sourced products. But often such standards do not take into account the technological or economic constraint in the region, producers – especially small-scale producers - are unable to implement the standards and remain informal (see Jensen et al (2010) for an example in the dairy sector).

Finally, it is worth noting that regional imports by modern retail chains face a number of non-tariff barriers related to standards and rules of origin as well as delays due to bureaucracy and congestions at the ports. This has an impact on the cost of importation and stocking of appropriate inventory levels, and limits the role of foreign distribution companies as regional integrators.

The distribution sector in East Africa has undergone major transformations in the last decade but the impact on poverty reduction remains uncertain. The emergence of large supermarket chains across East Africa and the increased internationalization of the distribution sector have transformed the retail environment in the region. Numerous middle class consumers benefit from a greater variety of goods at affordable prices in modern retail outlets. The modern procurement systems and buying centers established by supermarkets have also improved the lives of many participating farmers. Several procurement and marketing studies focusing on fresh fruits and vegetables, dairy products and crops in Kenya, Tanzania and Uganda document the positive

implications of the reorganization of supply chains and transformation of food systems for farmers, food security and rural poverty (Hooton and Omoro, 2007 and Ngugi, Gitau and Nyoro 2007).

However, very poor households at the bottom of the income pyramid pay higher prices for

basic goods and services than do wealthier consumers—either in cash or in the effort they must spend to obtain them—and they often receive lower quality as well. Box 1 illustrates the price penalty for cooking fat, sugar and maize affecting poor consumers in Nairobi’s Mathare and Kibera slums.

Box 1: The bottom of the pyramid penalty

Within informal settlements retailers buy normal goods from wholesalers or retail outlets and break them down into smaller affordable quantities. For instance, consumers living in slum areas cannot afford to buy the 2kg packet of sugar that retails at about KES 200 (or USD 2.5) in most shops; however, they can afford to buy a pack of 50 grams at KES 10 (or USD 0.12). This makes goods affordable for slum dwellers many of whom live on less than USD 1 a day.

Though the smaller quantities are more affordable to consumers in slum areas, they are paying a considerably higher price for these products. Table 1 illustrates this point where a 10 grams pack of cooking fat retails at 300 percent premium, and a 50 gram pack of sugar at 141 percent. The poorest members of the society pay more for their essential goods than ordinary Kenyans.

Table 1: Price Comparison of Selected Products in Informal Settlements

| Commodity | Kiosk: Price for Units under 250 grams (Kes/grams) | Supermarket: Price (Kes/grams) | Price Differential for Units under 250gms (%) |
|-------------|--|--------------------------------|---|
| Cooking Fat | 0.50 | 0.125 | 300% |
| Sugar | 0.20 | 0.083 | 141% |
| Maize Flour | 0.05 | 0.030 | 67% |

* Some retailers in informal settlements, such as Mathare, have weight scales. But by and large the portions are meted out without the use of weighing scale. Thus the packs found in these retail kiosks weigh sometimes more, sometimes less.

Source: Interviews in the Mathare and Kibera slums of Nairobi, 2011.

Moreover, in all these countries where the majority of the population depends on agriculture, small-scale farmers have sometimes found themselves marginalized by the distribution sector and its new practices. Given the high fixed costs associated with participation in modern chains, many small farmers and traders are not able to participate

in modern procurement systems and continue to supply traditional wholesalers, who then sell to individual retailers and processors. As the supermarkets in the highest tier tighten their demands in terms of consistency in volume and quality, small producers and under-capitalized brokers face tougher competition from larger

producers and risk being squeezed out of the system altogether.

Talent shortages impede the development of the distribution sector. The availability of adequate skills remains an issue across the distribution sectors in East Africa. Despite the economic importance of the sectors, targeted training programs remain largely unavailable across East Africa. Only Kenya's Jomo Kenyatta University of Agriculture and Technology (JKUAT) offers a diploma level retail management training course in East Africa. Consequently, most formal distribution businesses rely on training on the job. Also, there is limited influx of knowledge with regard to best or good practice in the sector. Lack of access to specialized training has led to slow growth and late adoption of modern retailing techniques. For example, many large supermarkets are only beginning to understand the value of and adopt modern retailing techniques such as merchandising, category management and just-in-time inventory management.

Poor infrastructure, insecurity, cumbersome import processes and lack of market data further constrain the development of the distribution sector. Business representatives in East Africa identified the following additional issues as important constraints to the development of the sector:

High transportation costs due to poor road networks conditions, especially in rural areas, and traffic congestion in main cities.

Insecurity is a recurrent concern. The frequent hijacking of goods during transport leads to increased insurance, storage and transport costs. A hidden cost associated with insecurity is the growth of organized crime filtering into

the distribution services sector. Criminal groups such as the 'mungiki' control certain regions and extort money from formal and informal distributors on their territories.

Cumbersome importation processes due to overly burdensome bureaucracy and congestion at the ports increases the price of imported goods and complicates stocking and inventory planning.

The limited availability of market data affects particularly distributors at the bottom end where business is highly fragmented. It is extremely difficult to measure the value of goods that move through this channel. Even in the modern distribution segment information is difficult to obtain. Distributors are unable to gather information on their market shares or performance indicators with negative implications for the development of marketing strategies, new product development, and forecasting and strategic planning.

Policy recommendations

Raising awareness about the importance of distribution services is an important first step in designing a comprehensive reform strategy that is linked with national development plans. The sector urgently requires a broad development strategy and recognition as a key economic driver to facilitate its growth to the next level. The importance of the formal distribution sector that is heavily contributing to economic growth and is currently the second leading (formal) employer has been acknowledged by several East African countries. Steps must be taken to raise awareness about the importance of the sector in a consistent way on the basis of detailed economic performance analyses and benchmarking exercises, and incorporate the informal sector into the landscape of

distribution services. The large size of the informal sectors in all East African countries underscores the importance of distribution strategies that can efficiently reach households at the bottom of the income pyramid and integrate small-scale farmers into the distribution system.

Addressing the concerns of the poorest households and facilitating the inclusion of smallholders in modern distribution chains should be a priority in all East African countries. The majority of the population, who account for a significant percent of overall income, remain at the base of the pyramid and are excluded from the benefits that large distributors have brought to middle class families in terms of wider availability and lower unit prices for basic products. Possible policy actions to address the constraints that prevent informal forms from formalizing, meet the needs of the poorest households and expand their access to basic products at affordable prices include:

- Facilitate access to financial services in the informal sector. Several case studies show that increased access to credit by micro and small enterprises has contributed to the growth in the distribution sector particularly in the informal segment.
- Provide support to traditional and informal operators to acquire relevant skills. For example, training courses focusing on basic hygiene standards, merchandising, sampling or promotion techniques offered in the slums could improve the skills of retailers in wet markets, kiosk sellers or hawkers. There are several examples of innovative solutions to localized conditions that rely on consumer behavior and private public partnerships with commercial potential (see Box 2 for an example).

Box 2: Pharmacy Accreditation Programs for Informal Retail Operators – Tanzania

Because they allow access to treatment in areas and conditions where no formal commercial entity could operate at a profit, distribution models that leverage existing physical infrastructures and consumer habits to distribute drugs in remote areas have an enormous development potential. An accreditation and training program and access to microfinance services enabling small rural shops (duka la dawa baridi) to sell essential drugs is a business model that has significant development impact that can also be financially sustainable. Given high retail margins, charging fees for a 40-day training program that allows regular shop owners to sell essential medicines is a viable business model. This has been implemented in Tanzania through the Accredited Drug Dispensing Outlets (ADDO) scheme on a pro-bono basis. However, regular retail shop owners have demonstrated a willingness to pay for this training that includes marketing support in order to enter the lucrative retail drug market. These business models dramatically increase access to drugs for remote populations by increasing the number of medical outlets available. In addition, training programs for small retailers can improve their awareness of counterfeit and substandard products, thus enlisting them as key agents in improving product quality.

Source: IFC 2007

- Encourage firms to design and apply business models that deliver the right products at the right price point. For example, to meet the needs of consumers at the bottom of the pyramid, companies must re-design

products and use smaller pack sizes to increase trial purchases and volumes, build strong distribution partnerships and adapt marketing strategies (see Box 3 for an example)

Box 3: Reaching the Bottom of the Pyramid – Innovations in Distribution in India
Business strategy enabling access.

Some of the higher prices paid by consumers at the bottom of the pyramid can be ascribed to the difficulties and added costs of distribution in low income communities. Many companies are finding innovative ways to reach poor consumers. For example, Hindustan Lever Limited (HLL) requires new managers to spend six to eight weeks in a rural area and learn from these consumers as part of their training. HLL uses non-conventional marketing to reach this consumer segment: fairs, festivals and travelling cinemas have become part of the company's consumer outreach combining entertainment with hygiene education.

HLL has reached deeper and deeper into rural areas and has set up networks that carry its products to the most remote villages by whatever means required – motorbike, bicycle, oxcart – and has also employed direct sales agents. The approach builds brand loyalty and creates employment.

Source: World resource Institute and IFC 2007.

Steps should be taken to ensure a gradual transition of informal firms to formality. The transformation of distribution and procurement systems may offer participants higher returns but they also introduce new risks and costs. With fewer and more powerful buyers, small farmers are confronted with reduced negotiating power in addition to important transaction costs. Policy actions to facilitate the access and participation of smallholders in modern distribution chains include:

- Encourage horizontal coordination – such as farmer associations and cooperatives – to increase the bargaining power of small farmers, allow for economies of scale and lower marketing and negotiation costs. Given the mixed experience with such associations, a case by case approach is

warranted that puts emphasis on soft skills and contextualized management structures;

- Coordination between farmers that focuses on subcontracting arrangements, different forms of tenant farming (e.g. exchange of labor for a portion of harvest) or reverse tenancy (e.g. leasing of land management to a larger operator in exchange for rent) could be alternatives to associations and cooperatives;
- The widespread duality between traditional distribution chains and modern procurement systems in East Africa could be exploited to increase the participation of small farmers in modern chains. Rather than bypassing

traditional wholesale systems and increase the gap between traditional domestic markets and the formal processing sector, encourage the upgrading of traditional wholesale systems to support the interaction between the modern and traditional systems. The main focus should be on improving basic safety standards, increasing the traceability of products and reducing spoilage rates in the traditional markets. This can improve the structure of wholesale markets and enable upstream linkages with producers and downstream linkages with retailers and processors.

Steps should be taken to eliminate the regulatory barriers that limit investment in the sector. Although all East African countries have made progress in removing explicit restrictions to trade, the lack of regulation in critical areas, onerous regulation elsewhere or an unequal enforcement of regulation pose serious problems to competition and affect formal, including foreign operators, in the distribution sector.

Reforms should focus on developing the necessary regulatory frameworks for modern distribution services including rules and regulations affecting the business environment. The lack of licensing and operation rules for distribution companies, inadequate codes on investment, commerce, labor, and taxation, as well as the lack of bankruptcy procedures create significant uncertainty and burden for firms that are trying to conduct business

operations in the formal distribution sectors of East African countries.

Improvements to existing regulatory frameworks should eliminate disproportionate entry requirements such as lengthy registration procedures, multiple licenses, or inadequate zoning regulations. Price controls imposed across the region and the cartels in place in several East African countries represent a serious impediment to competition and should be removed.

Address skills issues in the distribution sector. A strong distribution sector will require local know-how and talent. At first, companies will need to bridge the gap by using a mix of local and international employees. In parallel, investments in developing and retaining local talent are required. Developing local training programs and putting in place apprenticeship opportunities will be critical to achieving long-term success.

Address the other constraints identified by the business community. Steps must be taken to address the infrastructure and insecurity concerns raised by the business community. The removal of non-tariff barriers that hamper the imports of distributors should be on the policy agenda of all East African governments. Finally, all governments in the region as well as business associations can play a constructive role in collecting and disseminating relevant market information for distribution operators in the formal and informal segments.

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