Circle K at a Crossroads

Richard Yeung, CEO of Convenience Retail Asia (CRA)[1] is facing a tough decision these days. The first six months of 2003 had been a tough period in Hong Kong, where, on top of the sluggish market and rising unemployment, Severe Acute Respiratory Syndrome (SARS) had suddenly changed the way everyone was doing and thinking about business. The company and its Circle K convenience shops had survived the SARS crisis though the rebound from the worst of it had been slow. Only by July of 2003 were things getting back on track. And the fear among everyone in Hong Kong was that SARS would come back again as soon as the weather turned cold. How would the company weather yet another SARS storm? Would it be worse this time? How should the company make plans when the threat was something unforeseen like a lethal virus?

Prior to the SARS crisis in April, the company had been on track with its expansion plans in China. To be sure, some things were taking longer than expected - like building the relationships necessary to open a lot of stores - but there were two stores now in Guangzhou that were expected to turn profits soon. With SARS, all plans for had growth stalled.

Then, at the end of June 2003, the Closer Economic Partnership Arrangement (CEPA) was signed by the governments of Hong Kong and China and there seemed to be light at the end of the tunnel for Yeung and CRA. The CEPA agreement had given special preference to Hong Kong companies to grow their businesses in China. With fewer restrictions on wholly owning subsidiaries in China and also preferential treatment in terms of equity ownership, market entry to second- and third-tier cities and tariff reductions, the green light to move into a far less-regulated China was beckoning to Yeung.

With the green light so bright, Yeung knew that the moment to act was now. The advantages of the CEPA agreement would last only a short while. Hong Kong companies would have two or three years during which they would enjoy special privileges before the service-oriented markets would be totally deregulated by China's new membership in the World Trade Organization and companies from across the globe would be able to enter China easily. Should Circle K seize the moment and expand rapidly in China? This would mean abandoning the expansion plan that had been long conceived and carefully initiated. What were the risks to rapid expansion?

How would Yeung balance the growth of Circle K with the risk? Yeung sighed, *"We have been doing a balancing act between realizing growth opportunities and restricting ourselves from being exposed to too much risk."*

The balancing act made Yeung ponder many questions. Should the company shift to a rapid expansion plan in China? How large is the actual market in China? What would the expansion plan be and what geographic area would be covered? How would rapid expansion in China affect logistics, the IT infrastructure, financing and store operations back in Hong Kong? Should CRA run the China operation more or less the same as in

[1] *Corporate website of Convenience Retail Asia is http://www.cr-asia.com*

Hong Kong or should the company explore a different approach? How should CRA balance business development in Hong Kong and China when the two offer different opportunities and challenges? How should CRA handle relationships with existing joint venture partners since CEPA would allows CRA to own 100% equity of a mainland company? If the company abandoned its current expansion plan for a more aggressive plan, would it survive threats like SARS? Yeung thought back on the history of his company and his experience in Hong Kong as he looked for answers to these pressing questions.

Circle K in Hong Kong

Circle K in Hong Kong is operated by Circle K Convenience Stores (HK) Limited, which is a wholly owned subsidiary of Convenience Retail Asia Limited (CRA). In turn, CRA is a publicly listed company controlled by Li & Fung Retailing Ltd. (LFR), one of the Li & Fung Group companies with two retailing chains: Circle K and Toys"R"Us. Li & Fung Retailing Group is a privately held and wholly owned subsidiary of Li & Fung (1937) Ltd. which is also the holding company of the Hong Kong listed Li & Fung Limited (494).



The Circle K brand name was first established by Tosco Corporation in the US. Circle K (US) owns the licensing rights to franchise Circle K convenience stores. Circle K stores are located in 19 states in the US. There are over 2200 Circle K stores in the US.

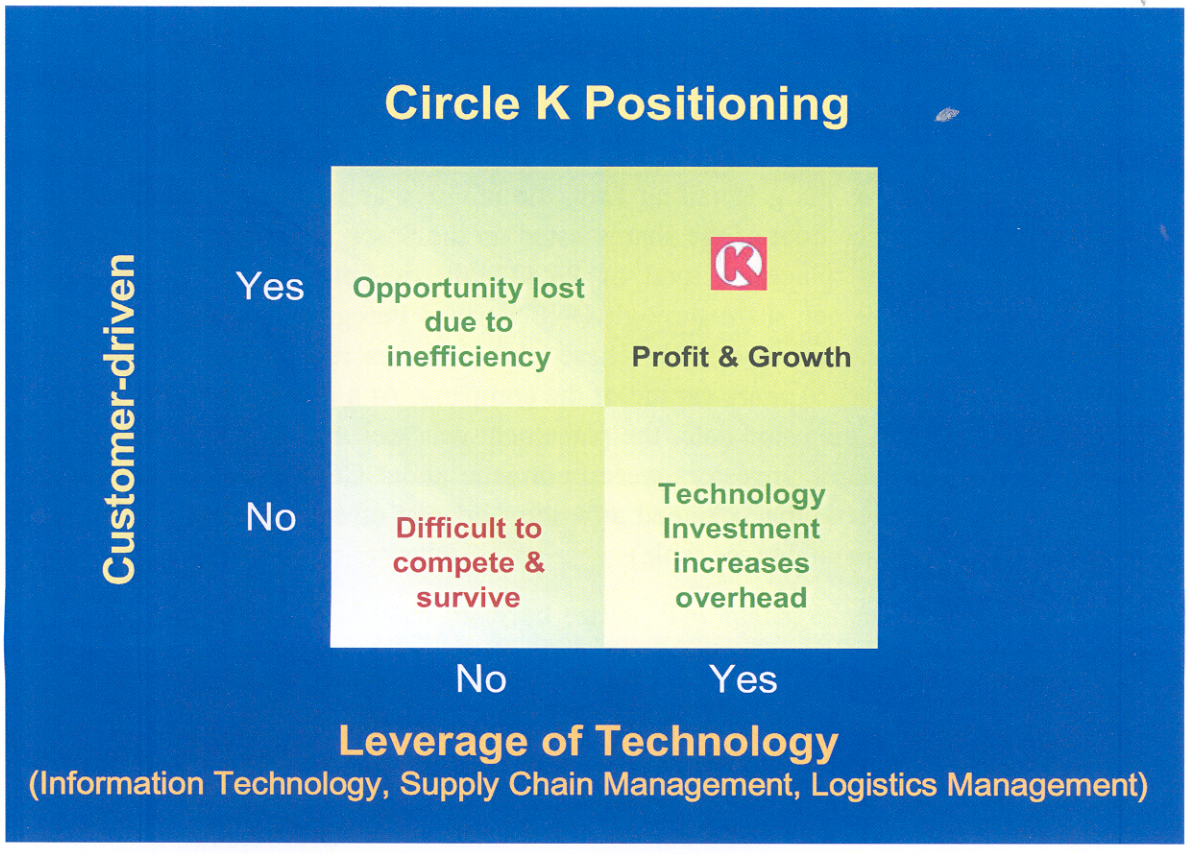
In 1985, Circle K (HK) was established as a joint venture between LFR (50%), Uny Co. Limited (25%) and Circle K International Limited (25%). Under a license agreement signed by Circle K (US) and CRA in March 1985, the CRA Group was given the exclusive right to use the Circle K trade name in Hong Kong, Macau and the southern region of the People's Republic of China (PRC) until July 2000. The terms of the agreement were later extended to 31 March 2025 and the geographic scope was extended to include Eastern and Northern PRC. After a series of corporate reorganizations, Circle K (HK) became a wholly owned subsidiary of LFR in February 1997.

The license agreement with Circle K (US) requires that CRA pay a monthly royalty to Circle K (US) calculated as a percentage of the gross sales from all Circle K stores in operation in the licensed region. This royalty payment ranks well below other major expenditure items such as staff costs and rental and related property costs. The license agreement also requires that CRA uphold certain operational standards and maintain a

close relationship with Circle K (US). As a franchisee, CRA enjoys (1) a brand name that is well known worldwide, (2) a readily available comprehensive system for management, and (3) ready provision of technical support and training.

The Convenience Store market in Hong Kong is very competitive with two major brands, 7-Eleven and Circle K, dominating the market. Circle K has positioned itself as a customer-oriented business driven by technology and process excellence. All stores are company operated and are supported by a supply chain management infrastructure linking stores to a central distribution center and to suppliers. CRA has invested considerable resources in staff development as well as enhancing the physical flow and information flow of its operation. As Yeung comments

> *"We compete on service quality and process excellence. Any company can buy the latest hardware and equipment but it is the solid experience, management commitment and effective execution in these two dimensions that differentiates Circle K from other brands."*



Listing of Convenience Retail Asia

Convenience Retail Asia Limited (CRA), a member of the Li & Fung Retailing Group, was listed on the Growth Enterprise Market (GEM) Board of the Hong Kong Stock Exchange on 18 January 2001. Modeled after the Nasdaq, the GEM Board was established in 2000 for technology startups and high-growth companies that may not meet the capital and profitability requirements for listing on Hong Kong's Main Board. The listing of CRA was oversubscribed by both institutional and retail investors (see table).

	Number of shares available	Issue oversubscribed	Value per share (HK$)	Total proceeds (HK$)
Retail investors	32,780,000	6.5 times		
Institutional investors	131,120,000	14 times		
Total	163,900,000		1.15	188,485,000

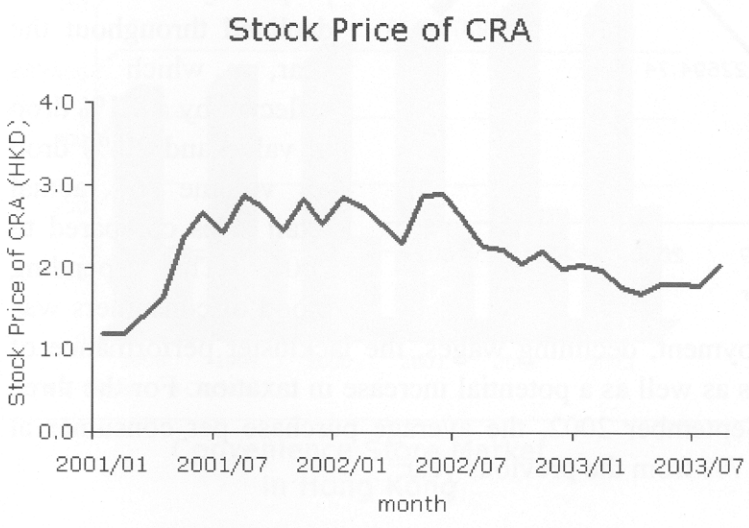
After deducting expenses related to the listing, the net proceeds from the listing were approximately HK$163 million. The money was raised mainly to fuel the expansion of the convenience store chain, Circle K, into the Chinese Mainland.

Two years later, Li & Fung Retailing Ltd., the major shareholder of CRA, sought to increase the public free float of the shares listed on the Stock Exchange of Hong Kong. Li & Fung Retailing placed a total of 93,422,000 existing shares to independent investors at HK$2.00 per share through BNP Paribas Peregrine Capital Limited and CLSA Limited on 22 January 2003. These placed shares represented approximately 14% of the existing issued share capital of the company. At a discount of less than 10% of the stock price on the same date, the placement was well received by analysts from an investment standpoint. Investors were optimistic about CRA's plan to expand into China. Li & Fung Retailing retained an equity interest of approximately 56% in the company after the placement (see table).

Shareholders	**Shareholding structure as of 22 January 2003**		**Immediately after the placement**	
	Shares	***%***	***Shares***	***%***
LFR	467,114,000	69.99	373,692,000	55.99
Designated Directors	25,586,000	3.83	25,586,000	3.83
Public	174,720,000	26.18	268,142,000	40.18
Total	667,420,000	100.00	667,420,000	100.00

Stock Price Performance

The stock price of CRA surged 226% to HK$2.675 within six months after the listing on the GEM board in January 2001. After hitting a peak of HK$3.1 in May 2002, the stock price dropped steadily over a period of six months until it settled at HK$2.00 in December 2002. The stock continued to dip further after the private placement by LFR of 14% of its shares in January 2003 and bottomed at HK$1.59 in May 2003. The outbreak of Severe Acute Respiratory Syndrome (SARS) took a toll of the already weakened Hong Kong economy, which had experienced over 48 months of continuous deflation since 1998 as reflected in the continuous drop of the Consumer Price Index. The CRA stock price started to move up as the economy picked up after the containment of SARS in June 2003 (see graph). The market sentiment turned positive after a series of joint initiatives between the Hong Kong and mainland governments to boost the local economy. Optimism grew as the mainland government relaxed restrictions on mainland residents traveling to Hong Kong. The policy relaxation served as a catalyst for a surge in stock prices in the retail sector, especially in companies perceived to benefit from a large increase in tourists from the mainland. The price rose to HK$2.4 in September 2003.



In terms of performance, the net profits of the company jumped from HK$48 million to HK$72 million with the gross margin and the net profit margin improving to 32.8% and 5.2%, respectively, in 2002. Despite posting a 10.2% increase in profits to HK$72 million for 2002, CRA was not yet eligible to pay out dividends as its books still showed a loss of HK$20 million, which had been incurred earlier. The management at CRA hoped that dividends would be offered by 2003 when the company would no longer bear this accumulated loss.

The Retail Industry in Hong Kong

The size and purchasing power of the local population and the general state of the economy are two factors that affect the consumer retail industry. From 1995 to 1997, retail sales in Hong Kong increased from HK$211 billion to HK$235 billion with the annual growth in GDP per capita increasing from 5.1% to 7.9% during the same period.

At the same time, the population in Hong Kong grew from 6.3 million in 1995 to 6.6 million in 1997.

At the end of 1997, the Asian financial crisis hit regional markets and most business sectors across the region experienced negative growth. In 1998, retail sales in Hong Kong totaled HK$196 billion and dropped to HK$180 billion in 1999, representing a decrease of 14.6% over the period 1995 through 1999.

In 2000, economic indicators signaled that Hong Kong's economy was recovering. By early 2001, the retail market in Hong Kong was seeing signs of growth. In the first half of 2001, retail sales increased by 1.1% in value over the same period a year earlier. However, in the second half of the year, with the September 11 event and its effects on the global economy, retail sales in Hong Kong dropped by 1.2% over the whole year.



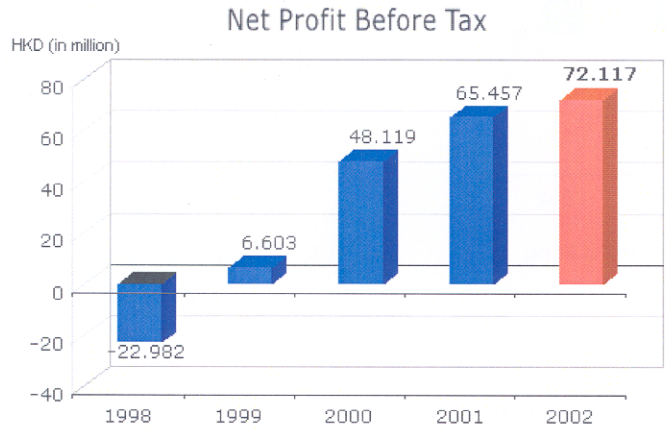
In 2002, the deflationary cycle that began in 1998 continued. Consumers became more price sensitive and the propensity to spend declined throughout the year, which was reflected by a 4.1% drop in value and 2.6% drop in volume of actual retail sales compared to 2001. The spending mood of consumers was affected by continued unemployment, declining wages, the lackluster performance of the equity and property markets as well as a potential increase in taxation. For the three quarters prior to the end of September 2002, the average purchase per consumer at Circle K was HK$10.62, down 7% from the previous year.

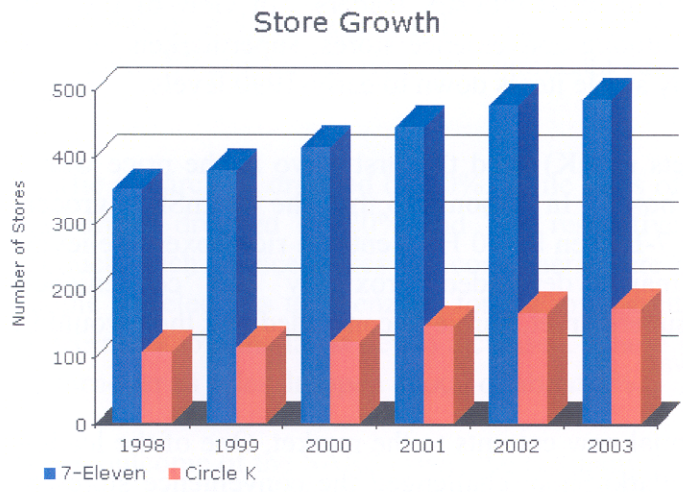
The Convenience Store Industry in Hong Kong

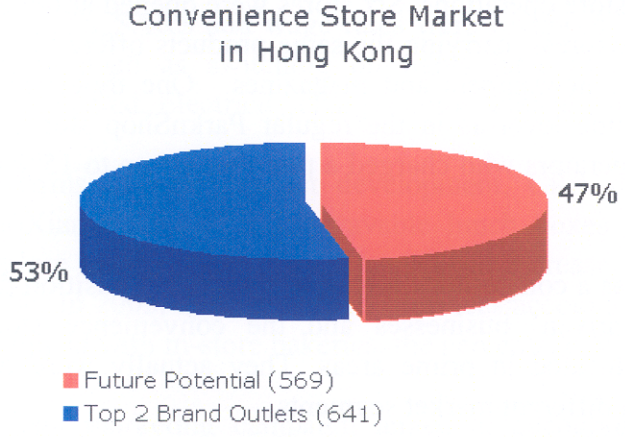
A "convenience" store is a small retail store that sells fast-moving consumer packaged goods and other services designed for daily convenience. In Hong Kong, convenience stores are virtually the only stores selling such items that are open 24 hours per day. In 1999, the convenience store density in Hong Kong was one to about 14,000 people. The convenience store density was one to 2,300 people in the US, one to 1,700 people in Japan and one to 3,800 people in Taiwan in the same year.

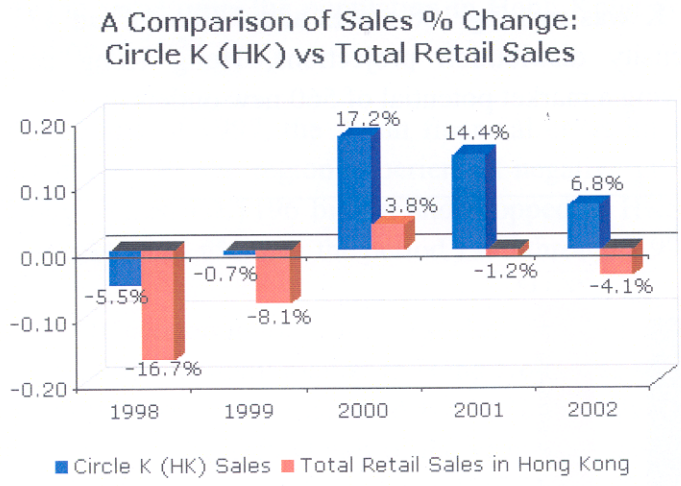
The two largest convenience store operators in Hong Kong are 7-Eleven and Circle K. In mid-2000, 7-Eleven operated 393 stores in Hong Kong while Circle K operated 114

stores. By the end of 2002, Circle K was running 166 stores and 7-Eleven had 475 stores in operation. Based on density distribution projections, Hong Kong can accommodate over 1200 stores, implying a market potential of 560 new outlets.









The Competitive Environment of the Convenience Store Market in HK

Overall consumer goods prices plunged about 30% since 1999 while the cost of living receded to the 1990 level, according to retail industry leaders. In view of the poor economy, a fierce price war raging among convenience stores, supermarkets and fast food chains pushed the prices of many staple items down to early-1990 levels.

7-Eleven (with more than 400 outlets in HK) fired the first salvo in the price war in October 2002, offering HK$10 rice boxes. In response to this, the ParknShop grocery chain joined the battle, undercutting 7-Eleven by 10 HK cents on rice boxes. Believing that convenience store customers mainly demanded 'proximity' and 'convenience' rather than bulk purchases like in a supermarket, Circle K concluded that they would be only slightly impacted by the price war.

Apart from pricing, there were potential new entrants to the market. One of the leading supermarket chains in Hong Kong, ParknShop, challenged the convenience stores by expanding into 24-hour convenience store operations. Six stores were opened at the end of 2002 under the name ParknShop Express, carrying the same products offered by its rivals including cooked food, drinks, newspapers and magazines. One thousand of these products were priced at the same level as in the regular ParknShop stores, in contrast to other convenience store operators who charged a premium of up to 15% for the same items.

Yet, Circle K did not see ParknShop as a competitor because of Circle K's position that convenience stores were 'location-driven' businesses and the convenience stores attached to supermarkets were not located in prime areas. They actually were two different store formats catering to two different market segments.

Circle K's expansion plan in HK

Though the environment was tough, CRA still saw room for more convenience stores in Hong Kong. The expansion plan for 2003 was originally set at a total of 200 stores. However, the outbreak of SARS made the group put a hold on the plan in April 2003 and the new target was revised down to a total of 190 stores.

The expansion of Circle K stores in Hong Kong is summarized below:

1998 107 stores
1999 114 stores
2000 123 stores
2001 146 stores
2002 166 stores
2003 200 stores (original forecast, revised down to 190 stores after SARS)

SARS and its impact on CRA

The outbreak of SARS weakened consumer sentiment and traffic flow was significantly decreased. Most retailers reported significant drops in sales of 20% to 60% in April 2003.

Traffic at Circle K dropped by 10%, while sales of impulse products such as ice cream and drinks dropped by 20% and 7%, respectively. However, sales of convenience products such as rice boxes (as consumers were reluctant to dine out), cigarettes (as people traveled less to Shenzhen for cheap cigarettes) and newspapers (as people were concerned about the latest news) increased. These increases helped to lessen the impact on turnover as sales dropped a total of about 5%.

As an outcome of the SARS crisis, the company explored new means of income as well as reduced costs in order to survive. Firstly, rent on store space was reduced by 20% to 30% after SARS and wage rates were reviewed to identify room for reduction. Other tactics, such as switching on lights later to save on electricity costs, were also implemented. Electricity charges constituted about 2% of sales.

In terms of new product development, CRA cooperated with Café De Coral and BaoXian to market microwavable lunch boxes in May 2003, with the intention to explore new product lines as well as to increase overall gross profits from the current 33%. In 2003, the sales of food services accounted for 3-4%. However for those stores equipped with in-store bakeries, the percentage of food services rose to around 10%.

A new marketing campaign aimed at encouraging consumers to spend more was launched in July and August 2003. The campaign was designed to increase consumer awareness of Circle K, to draw more traffic into the stores as well as to rebuild consumer loyalty.

Marketing

To face the keen competition from 7-Eleven and potential new entrants, Circle K formulated its own marketing mix to retain its business as summarized below:

Target consumers:	working class and students
Service:	reinforced 'speed, tidiness and friendliness'
New products:	SIM cards, IDD calling cards and online game cards
Pricing:	slashed prices by 6%, leading to a 1% increase in consumers
Promotion:	innovative to create 'fun' & 'in' to retain young consumers

To deliver quality service, investments were made in technology to streamline processes. Training was conducted for front-line staff in order to achieve 'speed, tidiness and friendliness'





Since the target consumers were mostly students and members of the working class, items related to mobile phones and the Internet were very popular. As a consequence, SIM cards and online game products were well received and their sales in 2002 tripled as compared to the year before.

Innovative programs such as the Gundam Crown Top joint promotion with Coca-Cola, the Eason & Friend Pop Concert, the 'Qoo in a Can' collectable soft toy promotion and the Coca-Cola Christmas Tree Projection Carousel Redemption plan were launched to create desirable image attributes targeting teenagers with 'fun' & 'in'.

Promotions focusing on value offers were also effective at Circle K, including the 'Weekend Super Value' offers and 'Counter Deals' – sales of special-priced impulse items displayed at the cashier's counter. The collectable 'stored value card' inserted in the Lucky Star tissue pack (which was given away free with every newspaper or magazine purchased) also generated incremental sales volume.

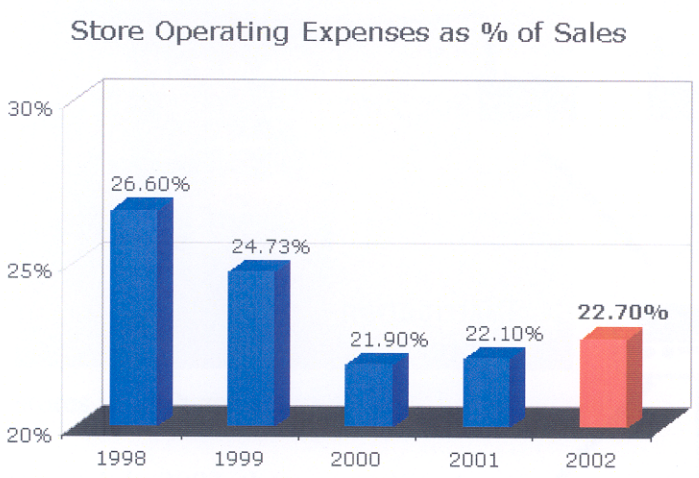
Logistics and Distribution

The company believed that they had to invest in technology and re-engineered business processes to increase efficiency in both the inventory and transaction processes. Major projects are summarized below:

1999	Electronic Point-Of-Sales system
2000	Logistics process re-engineering
2002	Category Management
	Fair Share Allocation System
	Vendor Managed Inventory
2003	Centralized delivery service for Chilled products

In 1999, the company invested HK$20 million to set up an integrated electronic point of sales (EPOS). With this system, purchase transaction times were reduced from 10-12 seconds to 5-6 seconds, enabling staff to serve more consumers. Average daily sales per store increased from $23,654 in 1998 to $26,915 in 2000. In addition, Chinese text and icons were used in the system, making the training of employees easy and at minimal expense. In a sector with high employee turnover, this helped to save costs.

As a result, store operating expenses as a percentage of sales dropped from 24.3% in 1999 to 21.9% in 2000, representing a substantial savings of 2.4% of sales. Gross margin and other income as a percentage of sales also increased by 0.8% of sales to 31.2% of sales in 2000 with a net profit of HK$48 million, which represented about a 629% increase over 1999's net profit (see chart).



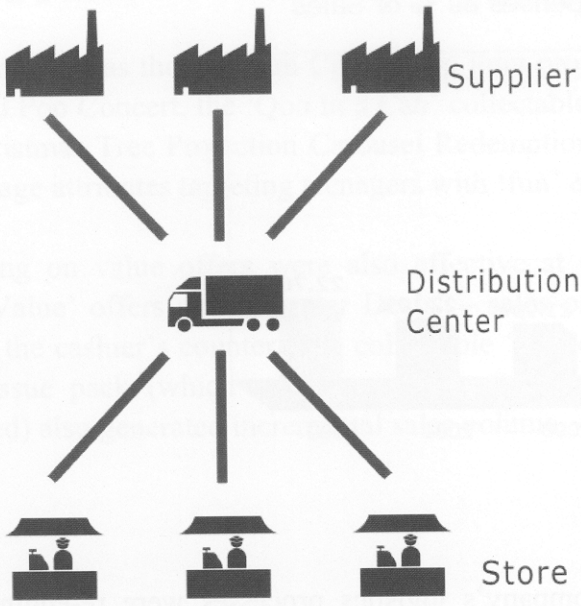
In 2001, most of the company's logistics processes were re-engineered to achieve delivery efficiency. As a result, seven-days-a-week delivery to stores was achieved.

Just-in-time delivery was utilized for fast moving product categories, with express delivery for comic magazines and Breakfast Express bread products. The Group's overall inventory holding days were reduced from 14.1 days in 2000 to 13.6 days in 2001.

In addition, a 'Fair Share Allocation System' was introduced. The mechanism was used to allocate any merchandise with limited stock to all stores requesting stock replenishment based on previous sales performance. Stores were classified into grades, relating to their sales volume, and were entitled to an appropriate order quantity allocation during the stock replenishment process. This ensured that no store would be overlooked, which can occur with a 'first come first served' allocation mechanism. Implementation of the 'Fair Share Allocation System' effectively minimized stock out situations.

Another initiative was Vendor Managed Inventory (VMI). British American Tobacco (BAT)–representing the cigarette category that accounts for a significant percentage of sales at Circle K stores–was the first partner. Reduction from 2.4% to 0.31% out-of-stock incidences was recorded. Stock turnover days were reduced from 14 days to 9.7 days in the tobacco category.

At the center of the supply chain at Circle K is the distribution center. The center serves as the warehouse and transportation hub of Circle K's logistics operations. Almost all suppliers ship their products to the distribution center. The products are then redistributed to the stores. While many suppliers are able to deliver items directly to Circle K stores in Hong Kong, the advantage of setting up a dedicated distribution center is to increase the delivery frequency to stores.



The Inventory Planning (IP) unit was established to coordinate with suppliers on inventory planning and management issues. The IP unit is supported by a computerized inventory management system. The IP unit serves two clients: the Category Management Department and suppliers of Circle K. A sub-unit of Inventory Planning is Store Service (SS), which operates a call center to respond to inquiries regarding quality and orders of product items from store managers.

To achieve optimal delivery efficiency, store orders are generated based on sales volume, inventory level and the in-store storage space of each store. The order size is determined by a number of factors, including average sales of the item, whether the item is on promotion, the backroom size of each store, and seasonal factors. Normally, store delivery is conducted once every day. For some stores, two deliveries are required to meet customer demand. While most of the items are stored at and delivered from the distribution center, there are items that are outsourced to third-party logistics companies. These include delivery of media, promotion items, and chilled items.

The reason for not outsourcing all the logistics operations to a third party is because of the need to coordinate with vendors to meet the volatile demand of product items under promotion. At any one time, there could be more than 100 product items under promotion. It is not uncommon to see a 10-fold surge in demand during promotions. These promotion campaigns create very volatile demands that are difficult to meet if the logistics operations are totally outsourced.

Store Operations

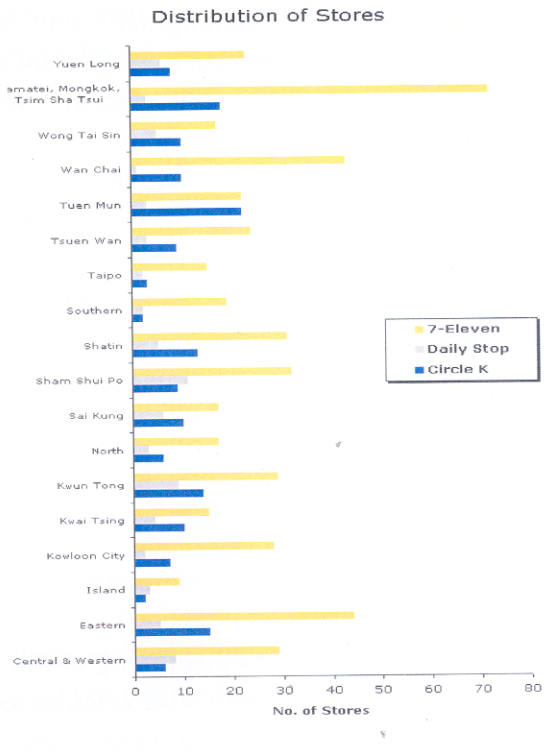




Circle K stores are organized in a three-layer hierarchy. The first layer is the store. The second layer is the zone and the third layer is the district. Each district has around 60 stores. There are 3 districts covering 13 zones, with about 14 stores in each zone.

As of July 2003, there were 176 stores operating 24 hours in three shifts. Depending on the size of a store, a typical staffing arrangement per shift consists of one store manager assisted by two or three staff members.

Although operation efficiency is essential, Circle K has selected service as the most important core competency for benchmarking. The company has developed a Service Excellence Program, which gathers all employees at the store level, from middle management to front-line staff members, to decide how to provide service and improve service quality. Service excellence refers to three areas called STF – "S" stands for speed, "T" for tidiness and "F" for friendliness. These three service components form the core of service benchmarking.



Each store carries about 2000 to 3000 products, with mini stores in MTR subway stations carrying 700-800 products. Given the very limited space at the store level, effective inventory management is critical. The inventory of each item at the store, zone, and district levels is monitored by a Decision Support System (DSS), which provides information to upper management and store managers on a timely basis. Managers at the zone level regularly review inventory levels with colleagues at the store level. The inventory level is affected by promotion programs in different periods of the year, but the inventory turnover rate is around 14 to 15 days for the whole chain.

At the end of each month, each store receives a copy of the profit and loss (P/L) account statement. Managers at the zone level and district level discuss the P/L with each store manager. At the store level, if the profit of a particular quarter shows an increase over that of the corresponding quarter in the previous year and is a positive figure, the store will be eligible for rewards under the company's profit bonus scheme. Every store has incentives to improve its own bottom-line.



Circle K is not operating on a franchise mode at the current moment. All stores are owned and managed by CRA. As of December 2002, the company had a total of 1,620 employees, 1,500 in Hong Kong and 120 in Guangzhou. Regular part-time staff accounted for 43% of total headcount. In addition to regular training programs, all employees attend an annual training program on a chosen theme. Even part-time employees are required to attend this training program. This theme-based training program is offered under "service standard

of the year". The themes were "A Step Further" in 2002 and "Diversified Service Techniques" in 2003.

At this annual event, the results of the Mystery Shopper Program (MSP), which provides incentives to store employees to excel in a number of areas, are announced. If an individual store has performed well (in a month) on all the 20 items of the MSP checklist, every employee of that store receives an attractive award.

Also, quarterly and annual in-house competitions are held at the zone level and district level. These competitions are used to foster a culture that views service as what must be provided and enhanced on a continuous basis.

Category Management

Category management is a new concept in Hong Kong's retail industry. Only a few retail chains have experimented with the concept. Category management relies on transparent communications and trust between the retailer and its suppliers. Circle K has defined 13 main categories for category management with beverages, tobacco, and media as the main categories. The three categories account for more than 60% of the total turnover at Circle K.





Circle K initiated category management with major suppliers in these categories. The retail chain has joined forces with Swire Coca-Cola in the beverage category and BAT in the tobacco category. Typical category management consists of six phases as follows:

1) Define the category
2) Conduct analyses on category turnover, profit, and brands based on internal sales data and overall market data
3) Define the category role (traffic builder and cash cow for beverages)
4) Create a category plan to maximize market share, sales opportunities and market demand
5) Implement the category plan
6) Review and evaluate the category plan

A typical category management project at Circle K lasts four months. To execute a category plan successfully, strong coordination between the category management team and store managers is essential. Circle K involves store operation personnel in the planning stage.

Selection of the category partner is very important. Selection criteria include top management support, availability of resources, and if the vendor has demonstrated true commitment and willingness to share data. It is important to avoid suppliers who have private agendas and do not commit data and resources on their part.

To be successful, a category management project must be win-win for Circle K and the vendor selected as a partner in the category. The main incentive for the vendor is channel development. Vendors know the market share of their brands, but they have little information at the channel level. Participating in a category management project will help a vendor to understand consumption patterns in terms of demographics, package size and flavor preference in a specific distribution channel so that the vendor can spend their advertising and promotion budget more effectively. On the other hand, Circle K acquires industry-wide data from the partner in the project. These data can be used to formulate strategies to grow category sales and revise the mix of items in a category to improve sales and profitability.



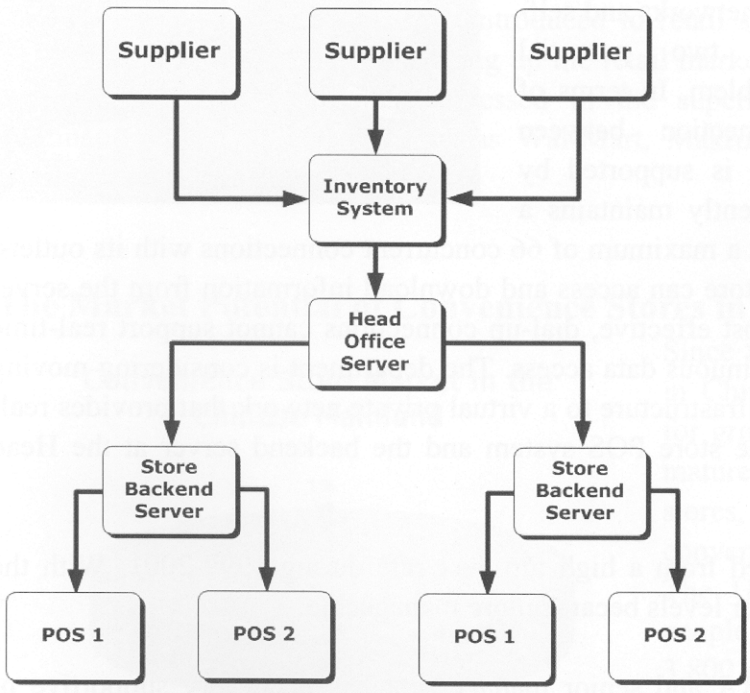
In 2002, under the Category Management Excellence Program, management resources were reallocated and category responsibilities were redefined, resulting in a sharper focus for all the major product categories and better support for categories with high growth potential. An overall margin improvement of 1.2% was achieved by year end.

Although the overall retail market in Hong Kong suffered since the onset of the Asian financial crisis, the market for food, alcoholic drinks and tobacco products remained relatively stable during the period. The elasticity in demand for these products was relatively lower than for luxury products. The value of sales of food, alcoholic drinks and tobacco increased by 4.7% in the non-supermarket sector and by 21% in the supermarket sector during the period 1995 through 1999.

IT Infrastructure

The Business System Development (BSD) department is an internal support service unit of Li & Fung Retailing Group, serving the two retailing businesses of the group: Circle K and Toys"R"Us Asia (including Hong Kong, Taiwan, Singapore and Malaysia). Services are delivered through in-house development and outsourcing to third parties. Development time, quality and cost-effectiveness are the criteria in determining whether an internal request should be fulfilled through in-house development or outsourcing. In the latter case, the department serves as a liaison between the internal customer and the vendor and assumes the role of project manager. Each project is assessed by the internal customer after the project is completed. This assessment takes the form of filling in a questionnaire with assessments on delivery schedule, achieving requirements, and other service quality.

Every project is evaluated for how it can contribute to efficiency gain in Circle K's operations or how it can enhance the decision-making of senior management.



During peak times, each store needs to handle over 500 transactions per hour. With an increasing number of stores open in Hong Kong and the mainland, the capacity of the system needs to be upgraded to keep pace with the business expansion plan.

Currently, the IT infrastructure of Circle K consists of four major applications. The core application is a third-party Radiant Point-of-Sales (POS) system. The system consists of three subsystems: (1) Store Front-end POS, (2) Store Backend system, and (3) Head Office Backend system. Transactions are supported by the Store Front-end POS, which consists of one to two terminals in each store. The Front-end POS is connected to the Store Backend system, which provides general system administrative services and dial-up connection to the Head Office Backend system.

The data collected are analyzed using a decision support system utilizing OLAP and data mining technology. The system performs analyses on sales, inventory turnover, and profitability and generates reports to support managerial decision-making. Because of

the unique requirements and context, the decision support system (DSS) was developed in-house. The general administration and warehouse services are supported by two third-party packages.

To connect to its suppliers, Circle K developed an interface system to accommodate the different stages of IT development of its suppliers. Suppliers that are IT ready can integrate with Circle K's system using electronic means such as EDI. Those that are not ready to integrate their systems with Circle K receive faxes or emails generated by the interface system.



Looking forward, the BSD department is looking at a number of emerging technologies. As store traffic increases during peak hours, the fixed cashier has become a bottle neck in transaction processing. Mobile cashiers connected via local wireless networks and self-serve cashiers represent two potential technologies to ease the problem. In terms of communications, the connection between stores and the Head Office is supported by dial-up links. Circle K currently maintains a modem pool that can support a maximum of 66 concurrent connections with its outlets. Through the dial-up link, a store can access and download information from the server at the Head Office. While cost effective, dial-up connections cannot support real-time applications that require continuous data access. The department is considering moving the dial-up communication infrastructure to a virtual private network that provides real-time connections between the store POS system and the backend server at the Head Office.

The BSD department suffered from a high turnover rate during 1999-2001. With the crash of the dot.coms, turnover levels became more manageable.

IT is a strategic asset of CRA and senior management has been very supportive of capital investment in developing the firm's IT infrastructure. Since the department serves the different business units of the group, applications developed for one unit can be modified to support other units. For example, an Intranet developed for one unit has been deployed to other units. Such an arrangement enables CRA to leverage its IT resources (infrastructure, human resources, and organization knowledge) and experience to benefit the entire group.

China Expansion

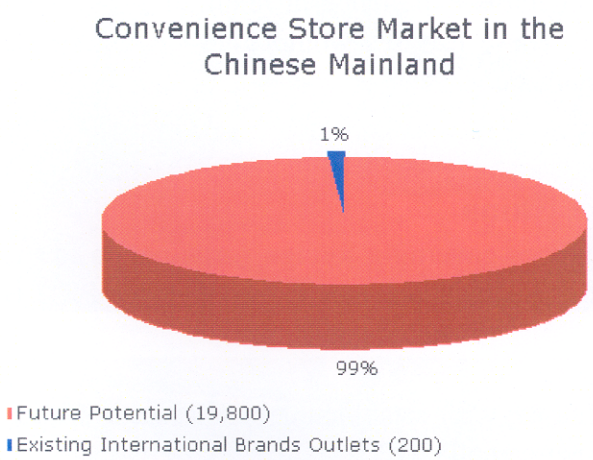
While Hong Kong's retail industry suffered since the onset of the Asian Financial crisis, the PRC's retail industry was less affected by the economic downturn. Retail sales of consumer goods grew by about 4.8% in 1998 and 6.8% in 1999.

In 2001, the retail market in the PRC saw double-digit growth of 11%. By 2002, this rate of growth had slowed to 10.3%, although retail sales were described as "healthy" in absolute terms and "robust" compared with retail sales in other countries around the world.

Upon China's WTO accession, it was anticipated that the lowering of import tariffs would in turn lower prices, provide more product choices and stimulate consumer spending. The market would also open up to foreign retailers with relaxation in the equity structure of joint ventures and relaxation of controls of geographical area and number of outlets.

During 2002, major changes were introduced to retail sales structures in accordance with a WTO timetable set for opening up the retail market to foreign investment. The most significant growth was witnessed in the supermarket sector, with leading multinational retail operators such as Wal-Mart, Makro, and Carrefour entering the retail market in China.

The Market Potential of Convenience Stores in the Chinese Mainland



Since the convenience store market in China is undeveloped, the room for growth is large. Japan, the most mature market for convenience stores, had on average one convenience store per 1,700 people. The US had one store per 2,300 people, Taiwan had one store per 3,800 people and HK had one store per 14,000 people. With a conservative assumption that 20,000 people could support one convenience store in China, the potential is for a 20,000-store market.

Joint Venture with the Mainland Partners and the Ownership Structure

	Beijing	Shanghai	Guangzhou
1997	16735	25750	24895
1998	18478	28240	27474
1999	19846	30805	30265
2000	22460	34547	34292
2001	25523	37382	38007

Per Capita GDP (RMB)

To facilitate the setting up of a Circle K store chain in Guangzhou in Southern China, CRA signed a joint venture agreement with Guangzhou Grain Group Limited in December 2001. The registered capital was RMB65 million; the total investment was RMB100 million; and the equity structure was as follows:

CRA	65%
Guangzhou Grain Group	25%
Shanghai Shenhong Corporation (a member of the Shanghai Friendship Group)	10%

Guangzhou Grain Group Limited has considerable experience in retailing and owns a network of retail premises in Guangzhou. These features would give CRA a strong foundation for expanding the chain into Guangzhou.

CRA's Expansion Plan in Mainland China

Until China's accession to the WTO, guidelines governing foreign participation in the retail sector were strict. Consequently, the convenience store industry in the PRC is undeveloped and in its infancy.

CRA originally adopted a phase expansion strategy for establishing businesses in China. The plan focused on major cities with high per capital GDP.

Phase One was to establish a business base with adequate store network coverage in Guangzhou and the Pearl River Delta in the period of 2001-2003. The entry strategy also included a distribution center as part of the integrated supply chain and a training center to cultivate the Company's 'speed, tidiness and friendliness' operating culture.

Phase Two would extend the expansion into Eastern China (Shanghai and the surrounding area). Phase Three would move to expansion into Northern China (Beijing and the surrounding area)

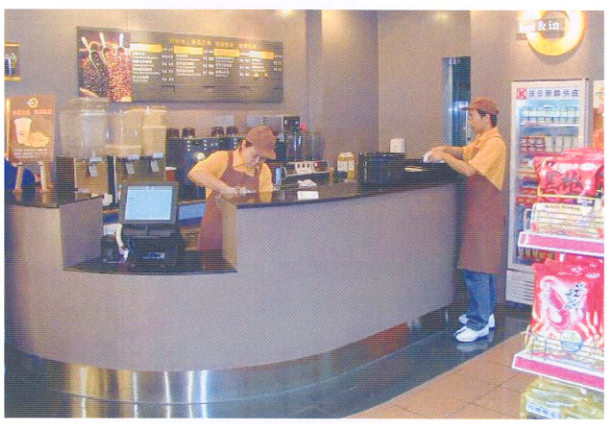
Initially, operation in Guangzhou was delayed by a year because of licensing issues. Yet, an aggressive expansion plan had been formulated for Guangzhou and the Pearl River Delta area such that targets for the number of stores were:

by 2003	30-50 stores
by 2006	100-150 stores
by 2008	400 stores

Guangzhou Operations

In developing the convenience store market in mainland China, the biggest challenge is to help consumers create the habit of visiting a convenience store. Chinese consumers have 'more time than money', permitting them to shop around for bargains even if it means they have to travel. CRA's strategy is to focus on the workers and students markets. These consumers purchase products for immediate consumption. The company planned to introduce new products to the market with premium brand images and trendy packaging in an attempt to offer new shopping experiences to customers.





In view of the lifestyle of Guangzhou consumers, a new business model was designed with two objectives: (1) to adapt the store format to meet the needs of PRC customers, and (2) to provide a differentiated and unique experience for brand building purposes. Five Circle-K stores were operating in Guangzhou by September 2003 with the first one opened in November 2002. The new stores in Guangzhou are bigger and more spacious than a typical store in Hong Kong. Also, prepared food items contribute a larger share (about one-third) of the sales volume to Guangzhou stores. As a result, special emphasis was placed on a new range of proprietary hot-served gourmet food and drinks, in-store bakery products, freshly brewed coffee and freshly ground soy milk. With more space

available, in-store consumption was made possible to provide consumers a new food consumption experience. In April 2003, lunch boxes priced at RMB8.50 per box were introduced as compared with RMB5 at hawker stores and over RMB10 at specialty stores. The number of lunch boxes sold monthly was around 1300 by May 2003 as compared with 2000-3000 for a Hong Kong outlet.

The stores in China also incorporated a host of other consumer benefits, including the world's leading dual-touch monitor electronic point-of-sales system and in-store lucky draw promotions. The objective was to offer a positive and unique experience to customers and to project Circle-K's brand image.



Investment per store is about RMB800K and monthly sales per store are estimated to be around RMB300K. The distribution and central kitchen overhead is estimated to be HK$12 million to support the Guangdong expansion. The business is expected to break even when 80 to 100 stores are in operation. While gross margin and other income of products average 35%, operating expenses are lower than in Hong Kong. Rental and salaries are 50% and 60% lower compared with Hong Kong. For working capital, because of the small volume so far, credit from suppliers averages around 30 days as compared with 72 days in Hong Kong.

In China, Circle K operates a distribution center in Panyu. Compared with Hong Kong, distribution in China is even more important because the delivery capacities of mainland suppliers are limited. Many are not able to cover all Circle K stores in Southern China. It is essential to consolidate inventory to a single distribution center and redistribute items to stores. The current distribution center at Panyu is expandable and can be developed into a main hub supporting all the retail outlets of Circle K in Southern China. It is envisioned that smaller distribution centers serving as hubs to serve smaller regions will be developed as the number of stores in China increases.

WTO and CEPA: Opportunities Ahead?

With the accession of China to WTO, China has promised gradual elimination of most restrictions on foreign entry and ownership that have been preventing foreign companies from major expansions in China. While many foreign companies have been setting up manufacturing operations in China in recent years to take advantage of the vast pool of inexpensive labor, developments in many sectors, such as retail, logistics,

professional services, and banking and finance, are still subject to tight government control through licensing requirements and equity ownership restrictions. To fulfill its accession commitment, China will eliminate many of the existing trade barriers and restrictions over a period of seven years starting in 2001. In addition to reducing import tariffs on a wide range of products, China will comply with a schedule to liberalize its services industries and open them to foreign companies. In the Appendix on China and the WTO, there is a summary of the schedule on China's specific service commitments in terms of market access and national treatment as they relate to the following modes:

No	Mode	Definition
1	Cross-Border Supply	Purchase of services from a supplier located outside of China (e.g., purchase insurance from a firm located in the US)
2	Consumption Abroad	The consumer travels to the territory of the supplier located outside of China (e.g., tourism)
3	Commercial Presence	Direct foreign investment of a foreign supplier in establishing a branch and subsidiary in China providing services (e.g., a foreign bank setting up branch banks in China)
4	Presence of Natural Persons	Movement of employees of a multinational supplier (e.g., temporary assignment of an overseas employee to work in China)

CEPA

Ever since China began to open its markets in 1979, Hong Kong has been the leading investor in China. Direct investment from Hong Kong tops investments from all foreign countries. It is estimated that Hong Kong companies employ over 10 million workers in China with the majority of them located in Southern China. After China regained sovereignty over Hong Kong in 1997, under the one country two systems arrangement, Hong Kong companies received no preferential treatment from the mainland government in terms of market access and ownership restrictions. A major breakthrough occurred with the signing of the Closer Economic Partnership Arrangement (CEPA) between Hong Kong SAR and China's central government on 29 June 2003. Under CEPA, Hong Kong companies in many industry sectors can accelerate their mainland expansion plans. CEPA allows Hong Kong companies to set up wholly owned subsidiaries and enjoy preferential treatment in terms of equity ownership, market entry to second- and third-tier cities, and tariff reductions. The agreement allows retailers such as Circle K to expand rapidly into China either through organic growth or merger and acquisition. CEPA creates a window of opportunity of two to three years over foreign competitors in terms of opening up a number of service markets. The Appendix on CEPA summarizes the CEPA arrangement and the advantages Hong Kong companies have over foreign companies in expanding their businesses in China.

As Yeung reviewed the CEPA agreement one more time, he again pondered the many questions he had to answer before deciding what to do next. Should Circle K take advantage of CEPA or stay its course as planned? What would the expansion plan be and what geographic area would be covered? How would rapid expansion in China affect logistics, the IT infrastructure, financing and store operations back in Hong Kong? Should CRA run the China operation more or less the same as in Hong Kong or should the company explore a different approach? How could CRA create a barrier to entry by its competitors? How should CRA balance business development in Hong Kong and China when they offer different opportunities and challenges? How should CRA handle relationships with existing joint venture partners since CEPA would allow CRA to own 100% equity of a mainland company? If the company abandoned its current expansion plan for a more aggressive plan, would it survive threats like SARS?

Business Initiatives and Implementation – An Overview

Hong Kong

Marketing and Brand Building

2001

- All Circle K front-line staff continued to improve STF service standards and customers commended excellent services.
- A total of nine promotional campaigns were successfully carried out: $10 Promotion; Summer Promotion; Scratch & Be a Millionaire; Mid Autumn; Octopus Promotion; Breakfast Express; Coke Classic Premiums; Media Promotion; Buy $15 Free $15.

2002

- Brand Imagery Campaign 2 was postponed to 2003 due to the unfavorable retail environment.
- A total of 9 promotional campaigns were successfully carried out: Jul – Octopus Promotion and Qoo Promotion; Aug – New Trendy & Fun Promotion; Sep – Lucky Star Loyalty Program Promotion & Snack Promotion; Oct – Phone Card Promotion; Nov – Bonus Scratch Card Promotion; Dec – Christmas Tree Promotion & Sharing Promotion.

Store Expansion

2001

- The number of stores increased to 146.

2002

- The number of stores increased to 166.

Service Excellence

2001

- The following training courses were successfully completed during the period: Service Seminar for Newly Joined Staff; Effective Leadership; Supervisory Skills Training; Store Management Program; Courtesy Award Training; Managerial Experience Sharing.

2002

- Five sessions of managerial and leadership skill training were successfully completed for store managers
- The company's senior store manager won the Hong Kong Retail Management Association's 2002 Service & Courtesy Award for the Supermarket/convenience store category

Category Excellence

2001

- A consulting firm from the UK, SRCG Group, was engaged and conducted an Advanced Category management workshop for all Category management Teams
- 2002 strategy plan was completed in November 2001 and the teams started deployment in December 2001

2002

- Category management teams started the "Mass Customization" initiative to match product offerings and pricing to the customer profile of each store

Supply Chain Management & Logistics

2001

- Enhancements to streamline the processes and making the system user-friendlier were completed during the period

2002

- The Vendor Managed Inventory (VMI) initiative with British American Tobacco was successfully rolled out to all stores, resulting in reduction of 0.31% in out-of-stock incidences. Stock turnover days reduced from 14 days to 9.7 days for the tobacco category. Category partnership programs with Heineken and Coca-Cola were also launched.

PRC

Business Model Adaptation

2001

- A refined model positioning Circle K as the "premium" convenience store chain in China was completed in December 2001

2002

- The review of the business model for Phase 2 expansion will be done in mid 2003 when the number of stores in Guangzhou reaches 10 – 15 stores.

Establishment of Joint Ventures

2002

- The initiative to establish a legal entity in Eastern PRC will be delayed due to the focus on building stores in the Pearl River Delta area. This will become an initiative for 2004.

Training Center

2001

- The training center was ready in late 2001. In-house training courses for store crews and store managers are being developed and will be completed in February 2002. An external consultant for STF training program will be contracted in the first quarter of 2002.

2002

- The initiative to develop and train management teams for Phase 2 expansion was postponed to 2004.

Category Management

2001

- Category management teams were formed and all members are still undergoing training. As most suppliers still are dealing in a traditional approach, we are adapting our strategy to become more flexible in working with local suppliers.

2002

- The Hong Kong and Southern China Category Management Teams worked closely together to set up the initial category classification and opened the first three stores. The team is now focusing on localizing the categories according to local consumer preferences.

Store Openings

2001

- Store opening was deferred due to delay in obtaining business license. Expect to open first batch of stores by mid year of 2002.

2002

- Due to delay in obtaining business license, we opened the first Circle K stores in November 2002 and finished 2002 with 2 stores. The revised plan is to have 30 stores in the Pearl River Delta by the end of 2003.

Supply Chain Management

2001

- This project was postponed due to the delay in store openings.

2002

- Existing distribution center in Pang Yu has capacity for supporting 50 – 70 stores.

Business System

2001

- The system services provider was chosen in December and programming for all local adaptations is scheduled to be completed in March 2002.

2002

- The system in Southern China was developed based on expertise gained in Hong Kong and most of the DSS features for data analysis and decision support are available to the Southern China management team.