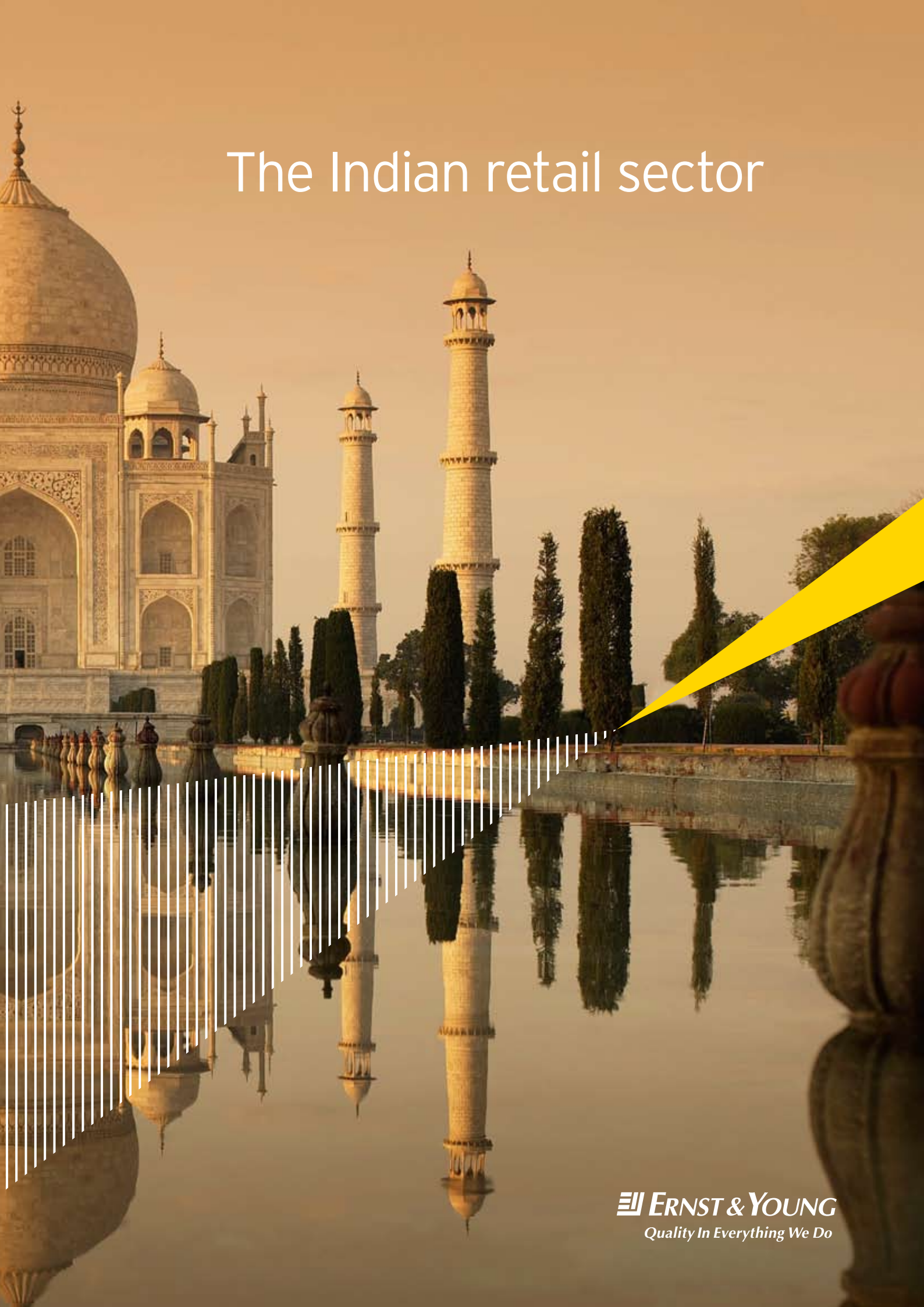


The Indian retail sector





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Introduction to the Indian market

Retail is one of the largest sectors in the Indian economy and accounts for approximately 8% of the country's employment. It is also considered as one of the most dynamic and fast paced sectors, and has propelled several domestic and international companies to invest in India's growth story.

The experience of shopping in India is undergoing a revolutionary change. The transition from street retailing to modern formats (organised retailing), especially in major Indian cities has led to the emergence of 'mall culture', offering shopping, entertainment and food under one roof.

Several new customer segments (middle class, youth, double income no children families, etc.) with significant spending power and affinity for quality products have also emerged in the past three to four years.

This shift and growth of consumption is expected to follow an upward trajectory, thus contributing to increasing potential for organised retailers.

In addition, Government policies are becoming increasingly favourable towards retail and the use of new technologies is further facilitating retailing operations.

Outlook and opportunities

In this publication we address some top of the mind questions that foreign retailers may have around a footprint in India's retail sector.

- ▶ What is the size and potential of the retail market in India?
- ▶ What are some of the key opportunities in this market?
- ▶ How favourable is India's regulatory framework for investments by foreign retailers?
- ▶ What are the potential options (business models) available for foreign retailers to adopt in the Indian market?
- ▶ What are the key challenges faced by retailers in India and how are these being addressed?
- ▶ What are some of the key success mantras for operating in India's retail market?

1. Organised retailing refers to a form of retailing whereby consumers can buy goods in a similar purchase environment across more than one physical location.

India's retail landscape

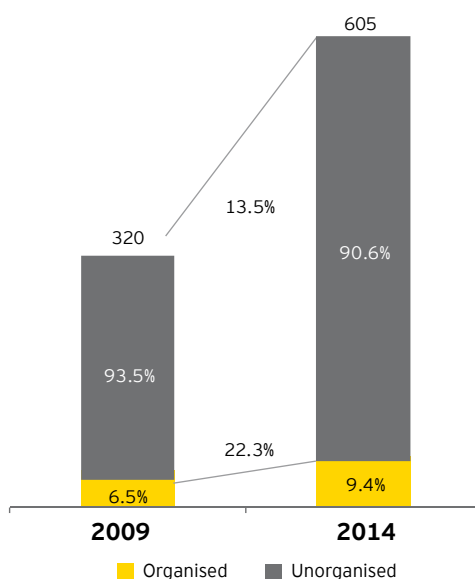
Historically, retail in India has seen robust growth of over 10%

- ▶ India's retail market has grown at a robust rate of over 10%-14% between 2004-2009. This growth trajectory has transformed the markets for many product categories and has reached tens of millions of customers across the country. The share of discretionary categories has been growing at 1.5 to 2 times of the total retail market.

Going forward, it is poised to grow at 13.5% per annum

- ▶ With rising aspirations and disposable income, Indian consumer spending is increasingly shifting from traditional necessity based items such as food to more discretionary spending on items such as lifestyle, personal care and consumer durables. Post the economic slowdown, which led to significant rationalisation in the industry, the Indian retail sector is regaining momentum and is poised to grow at 13.5% per annum to reach US\$ 605 billion by 2014.

Retail market in India (USD billion)



Source: Crisil Research

However, the organised market is growing faster at a CAGR of 22%

- ▶ Historically an unorganised market, retail in India still lags behind other countries in terms of the penetration of organised retail, which is approximately 6.5%, owing to the proliferation of smaller unorganised convenience stores spread across areas. The share of the organised segment in Indian retail, which is the relevant market for foreign retailers, is one of the lowest amongst BRIC countries. For example, the share of the organised segment in China forms 20% of the total retail market. The penetration of organised retail in other Asian economies such as Taiwan and Malaysia is more than 50%.
- ▶ However, driven by the entry of foreign and larger domestic brands across segments and a newly found consumer focus on product quality, the organised retail segment is expected to grow at 22% (1.7 times the growth of the overall retail sector) with the penetration expected to reach 9.4% of the overall market by 2014.
- ▶ This growth will be contributed by two factors i.e., shift towards organised retail and increase in discretionary consumption spending of target customer groups

Key opportunities in India's retail sector

Lifestyle², CDIT³ and personal care are expected to drive future growth

- ▶ Segments such as lifestyle, entertainment, CDIT and health and beauty services are among the fastest growing segments in the Indian retail market. These segments cumulatively contributed US\$ 84 billion to overall market in 2009, and are expected to contribute US\$ 202 billion by 2014.

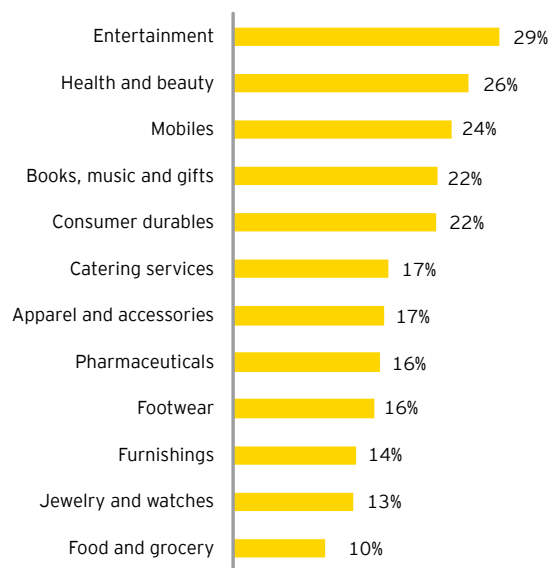
2. Lifestyle – apparel and accessories, footwear, jewelry and watches
3. CDIT – consumer durables and information technology

- ▶ The share of food and grocery which has historically dominated the retail market is expected to reduce owing to increase in discretionary spending. However, its share in organised retail is expected to increase more than five times.
- ▶ Similarly, the organised market potential for most discretionary segments is expected to double by 2014. Overall, the organised retail market in India is expected to contribute new opportunities of US\$ 36 billion by 2014.

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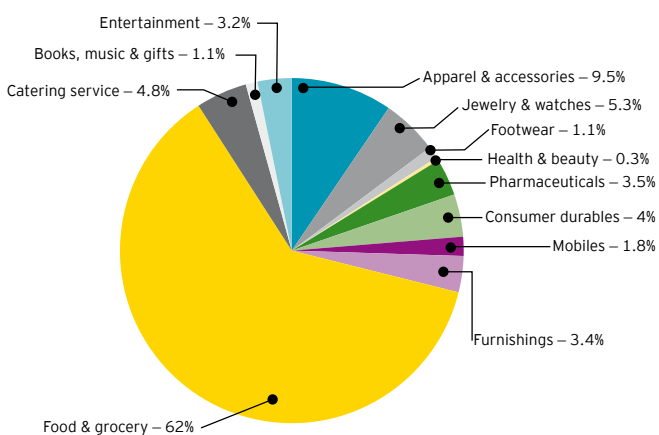
Similarly, the organised market potential for most discretionary segments is expected to double by 2014. Overall, the organised retail market in India is expected to contribute new opportunities of US\$ 36 billion by 2014.

CAGR by segment (2009-14)



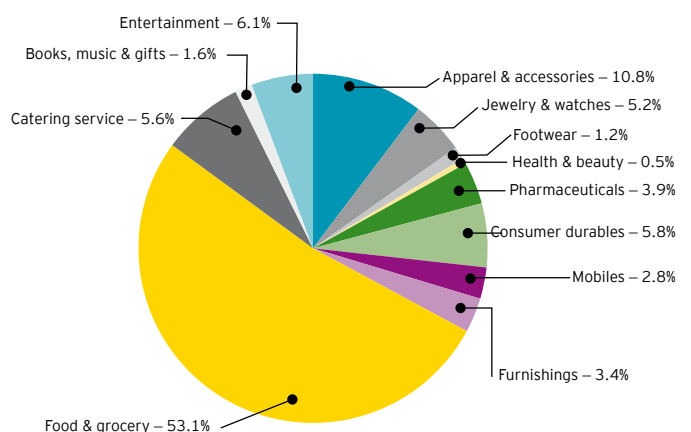
Source: Ernst & Young Research

Split of Indian retail (2009)



Source: Ernst & Young Research

Split of Indian retail (2014)

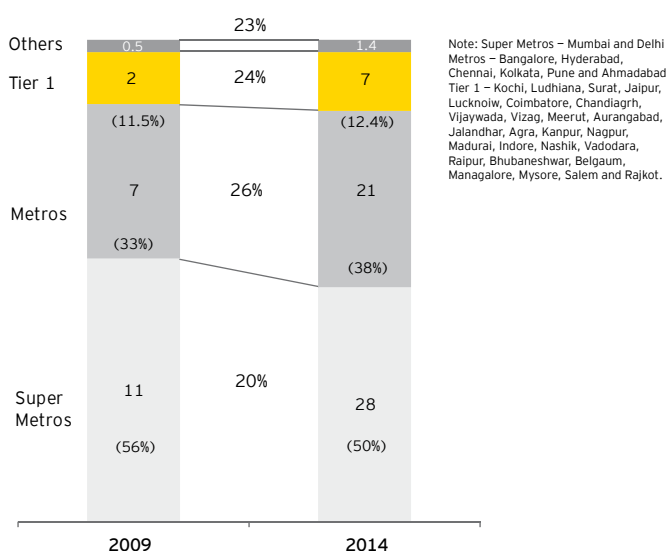


Source: Ernst & Young Research

Tapping the demand of Tier 1⁴ cities

- ▶ While the Super Metros⁵ have been the focus of retail growth to date, in the future, significant growth in penetration is expected in metros⁶ and Tier 1 cities. They are expected to contribute to new opportunities of US\$ 19 billion versus US\$ 16 billion of super metro cities. Moreover, their collective market share is projected to increase from 45% in 2009 to 51% in 2014.

Split of organised retail (USD billion)



Source: Crisil Research

4. Tier 1 – Kochi, Ludhiana, Surat, Jaipur, Lucknow, Coimbatore, Chandigarh, Vijaywada, Vizag, Meerut, Aurangabad, Jalandhar, Agra, Kanpur, Nagpur, Madurai, Indore, Nashik, Vadodara, Raipur, Bhubaneshwar, Belgaum, Managalore, Mysore, Salem and Rajkot
5. Super Metros – Mumbai and Delhi
6. Metros – Bangalore, Hyderabad, Chennai, Kolkata, Pune and Ahmadabad
7. Foreign Investment Promotion Board is a government body that offers a single window clearance for proposals on foreign direct investment in India that are not allowed access through the automatic route

Regulatory environment in India's retail sector

India welcomes foreign direct investment (FDI) in the consumer products sector without any restrictions. However, in the retail sector, there are certain restrictions/barriers to entry. India's regulatory framework offers selective options to international retailers for conducting business in India.

FDI framework in the retail sector

FDI in cash and carry/wholesale trading

- ▶ FDI up to 100% is permitted for cash and carry/wholesale trading in India under the automatic route, without any prior approvals, although certain prescribed guidelines need to be adhered to by the companies undertaking these activities.

FDI in single brand retail trading

- ▶ Currently, FDI in single brand retail trading is permitted up to 51%, with prior approval from the Foreign Investment Promotion Board⁷. However, FDI in single brand retailing is subject to conditions, which include that the products sold should be of a single brand only, the products should be sold under the same brand internationally and that the products should be branded during manufacturing.

FDI in multi brand retail trading

- ▶ While FDI in multi brand retail is currently not permitted, the Government has released a Discussion Paper on the subject of 'FDI in Multi-Brand Retail Trading' with the aim of generating an informed discussion on the subject and obtaining the views and comments from various stakeholders. The discussion paper is under active consideration of the Government.

Choice of business models in India

FDI restrictions in retailing have not deterred prominent international players from setting up shop in India and recent trends have only shown that a growing number of foreign retailers are establishing their presence in India. While the

entry of foreign retailers is possible through various channels, the optimal market entry strategy for an international retailer may be decided based on their choice of business model.

A foreign retailer may adopt a joint venture model (part ownership) for single brand retailing operations. Moreover, business models such as franchising or licensing are also permitted, whereby, an international retailer may not invest in front-end retail operations, which are typically managed by the Indian partner. A foreign retailer could also consider a simplistic distribution model for India entry in order to assess the demand potential of the product and depending on the experience, explore a joint venture or franchising model for establishing a stronger foothold.

Update on the evolving indirect tax regime

The indirect tax regime in India is also undergoing considerable change. The introduction of goods and services tax (GST) which will replace various indirect taxes like value added tax (VAT), central sales tax (CST), service tax and excise duty, is expected to positively impact organised retail activity in India.

For example, current CST legislation is a prime driver to maintain a State (region) specific warehouse and distribution system. Abolishment of CST will simplify the supply chain for consumer product companies and warrant a re-evaluation of both procurement and distribution strategies, which may result in optimisation of tax cost in the supply chain.

Furthermore, the elimination of cascading tax and fungibility of credit for taxes paid on both goods and services (currently not fully available) is expected to lower business input costs and improve profitability.

Successful implementation of GST will require adequate time investment in initiatives such as employee training, compliances and vendor education.

GST was proposed to be introduced from April 2011; this has now been postponed. However, a new date of implementation is yet to be announced by the Government.



Business models adopted by international retailers/brand owners

Based on the analysis of business models adopted by key players in India's retail market, there are four key options available for international retailers/ brand owners:

1. Licensing
2. Franchising
3. Joint ventures
4. 100% owned operations

Apart from the regulatory impact, each of these models is differentiated from the other, primarily based on the extent to which the brand owner partners with other investor/operators. The interplay between both the parties is influenced by two key variables:

- a. Who controls the value chain (and to what extent)
- b. Investment and related financial risk committed in the value chain

While the retail model approach ensures availability and visibility of the brand, selection of the right model is of paramount importance to prevent erosion of the brand's value proposition. The selection of a retail model is influenced by some key factors mentioned below:

Regulations

- ▶ FDI restrictions are largely applicable in the case of foreign single brand and multi-brands retailers. For instance, multi-brand retailers are not allowed to own retailing operations, while single brand retailers can own up to 51% stake in retailing operations. Post FDI reform in 2006, many existing and new foreign brands capitalised on this opportunity and entered into joint ventures (part ownership) with Indian companies.

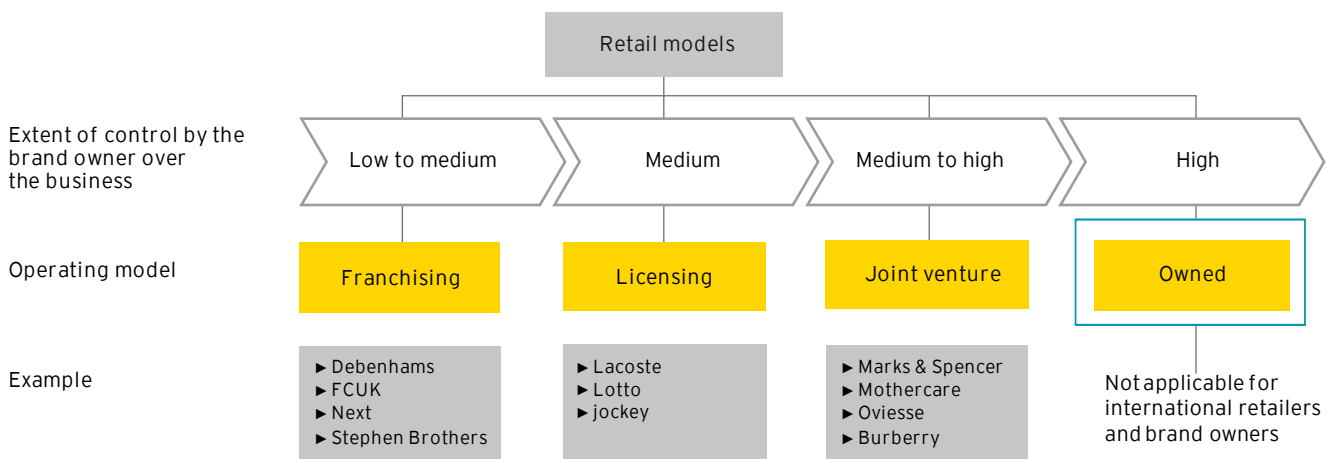
Costs associated with operations and expansion

- ▶ A retail business requires continuous capital infusion for store expansion. Moreover, the market is still developing and therefore, a new entrant may be required to invest capital in developing the channel and brand building activities. This may significantly impact the break-even and payback period. The choice of entry model is thus directly linked to the risk appetite and capital commitment by the foreign player.

Internal influencers

- ▶ Internal Influencers like the scale desired and brand image are impacted by a pivotal factor, 'product category' and 'brand positioning'. For instance, there may be some product categories/brands which may not have the spread to stock a store. In that case, a franchising model through shop-in-shops (SIS) and multi-brand outlets (MBOs) may be optimal.

Considering the above factors, the choice of the business model is critical for an international player, especially to achieve set goals for the market.



Key challenges gripping the sector:

While growth opportunities are in plenty, retailers face formidable challenges on multiple fronts.

Area	Challenges	Some examples of how these challenges are being addressed
Customer	▶ India's geo-cultural diversity results in different product requirements across customer segments. Consequently, buying and merchandising strategies need to be altered based on these requirements.	▶ Products are customised to suit customer needs and affordability. For example, apparel manufacturers vary the size and sleeve matrix depending on targeted regions. ▶ Levi's in India has introduced its Curve ID concept to cater to the varying sizes.
	▶ Customers are price sensitive which makes it difficult to convert footfalls to sales.	▶ With a view to tap the masses in India and drive revenue growth, Reebok has introduced shoes at an entry price point of Rs 990 (<GBP 15) in 2010; a few years back this was Rs 1390 (approx. GBP 20) .
Competition	▶ Intense competition owing to entry of leading Indian business houses in the retail sector. Their experience and networks pose a significant threat to incumbents.	▶ Leading international brands have partnered with strong domestic players who enjoy a good reputation in the Indian market (e.g., Zara with the Tata group's Trent).
	▶ Existing retailers in the unorganised segment provide store credit and higher levels of service making competition tougher.	▶ Levi's India introduced a scheme to purchase denims at a three-month EMI ⁸ option and a zero interest rate.
Regulations	▶ FDI is not allowed in front end retail except for single brands where foreign company holding is limited to 51%.	▶ Franchising and licensing agreements are used by international retailers, with joint ventures gaining popularity. ▶ Players like Walmart have entered with a cash and carry model and currently provide exclusive management services to a retail chain owned by their local partner, Bharti. Once FDI regulations on multi brand retail are relaxed, foreign players like Walmart (who would have already established their back end systems) will be able to roll out their front-end retail operations faster, thereby gaining first mover advantage.
Infrastructure	▶ Supply chain infrastructure in the country is poor, thereby limiting the ability to set up efficient back end processes to drive down costs.	▶ Players like Woolworths (Australia) have structured their partnerships to leverage their supply chain expertise by importing or procuring goods exclusively for the retail chain 'Infiniti – Croma' owned by their local partner, Tata group.
	▶ Quality retail space is expensive and not easily available, thus impacting profits and payback period.	▶ To counter the skyrocketing realty prices, BIBA entered zero rent revenue sharing agreements with mall operators with a view to reduce fixed costs and bringing down the risk-reward ratio.

8. Equated monthly instalments

Some of the key considerations for foreign retailers desirous of establishing an Indian presence are:

- ▶ **Adaptation of product mix** to cater to the geographic diversity in India. For example, the size and sleeve matrix and preference for fabric differs across regions.
- ▶ A **brand led approach**, considering the availability of a number of marginal domestic and international brands in this market.
- ▶ Focus on **low cost domestic sourcing** to counter high import duties and price sensitivity of Indian customers
- ▶ Commitment of initial investment in setting up a **robust supply chain network**.
- ▶ Introducing and **adapting established global processes** in the Indian context

Conclusion

The retail sector has played a significant role in the growth of developed economies around the globe. Organised retail in India is still at a nascent stage but there are significant business opportunities for the taking, given that the sector is so heavily under-penetrated. Recognising the potential, several international retailers have already forayed into the Indian market and have adopted tailored strategies to build their presence. There is a strong case for other players to follow suit by adopting a long term view and exploring alternative options for a presence in what is one of the most important developing consumer markets in the world.

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