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SECTOR:
RETAIL, LIFESTYLE & LOGISTICS

SECTOR OVERVIEW: OCTOBER 2012

Foreign Direct Investment in Indian Retail

The groundbreaking events of the last fortnight saw FDI in retail take centre stage and play a catalytic role in the gripping political drama that erupted in its wake.

On 14th September, the Indian Government made the landmark decision of permitting up to 51% Foreign Direct Investment (FDI) in Multi-Brand Retail (MBR) in India. The Cabinet also further liberalized FDI in Single-Brand Retail (SBR) by approving amendments to the existing policy relating to brand ownership and mandatory sourcing requirements.

While these radical reforms were applauded by the international business community, they were met with outrage by the leading opposition parties who lashed out at the government for reinstating this policy which they claim will result in job losses of local retailers and traders, and exacerbate the plight of farmers and other underprivileged sections of society. They then proceeded to protest by calling a nation-wide strike while Mamata Banerjee, West Bengal Chief Minister yanked her party, the Trinomial Congress (TMC) from the ruling coalition.

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However, unlike the last time when resistance from allies such as the TMC and opposition parties led to a suspension of multi-brand retail reforms in November , this time the UPA remained firm in its resolve to allow global retailers to invest in the Indian market. The main difference on this occasion is that it has left the implementation of the move to open up retail to individual state governments.

So far 9 states and 2 Union Territories (Delhi, Assam, Maharashtra, Andhra Pradesh, Rajasthan, Uttarakhand, Haryana, Manipur, Jammu and Kashmir and the Union Territories of Daman and Diu and Dadra and Nagar Haveli) have pledged their support while others such as Bihar, Karnataka, Kerela, Madhya Pradesh, Tripura and Orissa have expressed their reservations.

A variety of conditions have been built into the reform to ensure that the Indian consumer and market benefit from foreign investment. Including provisions stipulating that at least 50% of the investment must be in back-end infrastructure such as cold storage and packaging, and that investments must total at least $100 million, investors will also be required to source at least 30% of their requirements from small industries. Additionally, investors will be restricted to states which wish to implement the reforms and will be required to invest in cities with populations of at least one million, of which India currently has 53.

The immediate response by UK and Indian business leaders to these restrictions is that they are not deal breakers. Instead, there is a definite sense of cautious optimism and growing interest from major retailers who perceive these reforms to be an encouraging next step in the gradual opening up of the Indian retail market.
In order to properly measure the impact of FDI on the dynamic Indian retail sector, it is worth revisiting this subject to get a better understanding of its intrinsic characteristics and the new developments that have earned it the title of the' fifth most desirable destination' for international retailers.

RETAIL SECTOR OVERVIEW

Driven by twin engines of economic growth and favourable demographics, the Indian retail sector continues to evolve rapidly and is predicted to expand by 15-20 % over the next 5 years to reach US$1.3 trillion by 2020.

At US$ 23 billion, organised retail currently makes up just 5% of current sales. Industry experts such as Technopak Chairman Arvind Singhal believe that the new FDI policy could boost this figure to reach 25% (US$ 80 billion) over the same period. The unorganized sector on the other hand, comprises approximately 12 million mom-and-pop stores scattered all over the country which can easily co-exist with modern trade players.

The Indian consumer: A powerful new phenomenon

An aspiring middle-class of 300 million people, 572 million young consumers and a relatively untapped rural population of 700 million constitute India's vibrant growth story. According to Standard Chartered Bank 2011 report, there will be:

- A five-fold increase in per-capita income by 2030 which will give rise to a much larger middle class (from 5-10% of the population today to approximately 90% by 2030)
- The breach of important income thresholds is likely to unleash huge consumer spending - approximately USD 15 trillion
- Domestic demand is expected to grow by a compound rate of 9.2% per year between 2010 and 2030.

In addition, the number of high net worth individuals (HNIs) in India, with assets of $1 million or more, would more than double to 403,000 by 2015, 50% of whom are located in Tier 2 and Tier 3 cities.

Drivers

Factors such as urbanization, rising incomes, a growing number of nuclear families, and a greater exposure to international lifestyle products has led to increasing brand awareness, and changing tastes and preferences resulting in significant consumption growth.

India is thus treading the consumption pattern along the lines of developed economies and witnessing a shift in consumer spending from basic need-based goods to discretionary items such as personal care products, lifestyle goods, international travel and social events as well as education and leisure - all of which are experiencing a strong uptake in response to increasing prosperity levels.

Top three spend categories in 2020 will be

- Food, (consumers will graduate to branded, packaged, more expensive food of higher quality with a greater focus on nutrition and wellness)
- housing & consumer durables (modern gadgets and appliances for young people and greater demand for houses for nuclear families)
- transport & communication (mobile phone penetration will continue to increase and value added services are now in greater demand)

Changing Landscape : Domestic & International Retailers

Recognizing the long-term growth potential of India's burgeoning retail market, domestic players are taking major steps to capitalize on this emerging opportunity.

Some of the country's largest conglomerates such as Max Retail, Future Group, Spencer's Retail and Bharti Retail have allocated billions of dollars to expand their presence and strengthen their supply chains. These Indian giants have launched large-scale retail initiatives that span a range of categories and formats including cash-and-carry, food and grocery, books, music and leisure, gems and jewellery, footwear, apparel, and accessories to name a few.

Till date, foreign multi-brand retail was forbidden in India. However, this policy shift will irrevocably change the status quo as global retailers take steps to explore this high potential market. International retailers like Carrefour, Tesco, Metro and Walmart who have already established their back-end operations will now be able to set up store fronts and start trading under their own brand.

Challenges of the Indian Food Supply Chain

In the process, they will encounter the myriad challenges of operating along the Indian food supply chain which despite the country's economic progress, remains among the least developed in the world. A relatively one-dimensional system, the Indian food chain involves multiple intermediaries from farm to fork and is inherently defective because it victimises the farmer while placing all the power in the hands of the multitude of middle men who in many cases, act as a cartel of traders. Operational inefficiencies, fragmented distribution, poor infrastructure, high costs and long delays from point of manufacture to point of consumption are key obstacles crippling the Indian food supply chain. Legislative changes like permitting FDI in multi-brand retail will go a long way in resolving these problems and improving the lives of Indian farmers, SMEs and consumers.

Benefits of FDI in retail

The benefits of foreign direct investment to India will positively impact the entire spectrum of stakeholders and constituencies ranging from consumers, SMEs, farmers, to both the private sector and the government.

Consumers

- The increased competition will offer them a greater choice of products and rationalized prices that reflect their true market value
- Knowledge transfer and best practices in grading, sorting and processing techniques will allow them to access better quality food products

Government exchequer

- Modern trade players are tax-compliant and generate significant tax revenues through the building of sophisticated supply chains.
- In addition, the various individual elements of supply chains namely logistics, transportation, warehousing, and freight forwarding contribute indirect taxes such as service tax to the exchequer.

Farmers/producers

- Organised retail will improve India's chronically fragmented supply chain, cut out the middlemen and strengthen the links between farmers, small manufacturers and retailers.
- A robust supply chain will minimise wastage (especially of fresh foods and vegetables), enhance productivity, increase farmers' realisations, encourage best practices in crop management and improve food safety and hygiene.

CII Director General Chandrajit Banerjee states "The entire decision on multi-brand retail will go a long-way in capital infusion in the country and also leads to strengthening of linkages including benefits to farmers."This is an important reform for India for both growth and development", he added.

Small, independent retailers

Kiranas (i.e., mom-and-pop stores) will continue to thrive alongside modern trade players and will be able to explore new and potentially more profitable partnership models (e.g., sourcing, franchise partners) in a rapidly changing retail environment. To compete effectively with large footprint retailers, these independent stores might also be incentivized to join forces to form a cooperative that negotiates centrally and buys locally so they can then access the same pricing advantage that big retailers enjoy.

Logistics and supply chain companies

Logistics and supply chain companies are also expected to benefit as they will be the link between small manufacturers, producers and farmers and the organized retail chains, which will enable them to get higher returns for their supplies. This close integration with organised retail chains will also help small-time producers gain access to the latest technologies, systems and processes and maximize their profits in the long run.

Employment

According to the Indian Staffing Federation (ISF), FDI in the retail sector is expected to create as many as 10 million jobs in a span of 10 years, making it the largest sector in organised employment. To be more precise, FDI in retail has the potential to create around 4 million direct jobs and almost 5 to 6 million indirect jobs including contractual employment within a span of 10 years.

FDI in retail will generate employment since new entrants will need to hire staff. Once individuals become absorbed in retailer operations, they can access more equitable wages and benefits. Current employees of unorganised retail players do not receive healthcare or other benefits. Modern trade's effect will be most apparent at the bottom of the population pyramid, as it will provide new and better careers for rural youth and a better quality of life for the existing agricultural society. There will now be an even higher demand for quality training, both from employers and young people looking to secure their future in the industry.

"It is expected that the impact of the FDI in retail will have a much wider impact on organized employment than what happened in IT 12 years back as it shall open doors for less skilled and less educated people as well. The impact shall be far and wide and all across country," ISF said.

Decoding conditions on FDI

There is no doubt that FDI in retail is a progressive step for the Indian economy however, it is imperative to understand the various conditions built into this reform and the implications for international players:

Multi-brand retail

The notification issued by the Department of Industrial Policy & Promotion (DIPP) says that FDI in multi-brand retail will be permitted subject to the following conditions:

- 51% FDI permitted in MBR with approval from the Foreign Investment Promotion Board (FIPB)
- Minimum amount to be brought in as investment by the foreign investor would be $100 million. At least 50 % of this amount should be invested in 'back-end' infrastructure. This will include investments in processing, manufacturing, distribution, design improvement, warehouse, logistics, storage, etc. Investment in rentals and land cost will not be

counted nor can these funds be used to relieve local partners of existing debt. Thus these funds have to be deployed purely for new asset creation and capacity enhancement.

- At least 30 per cent of the procurement of manufactured/processed products purchased shall be sourced from small industries with investment in plant and machinery not exceeding $1 million. The compliance with this regulation can be initially averaged over 5 years since these are formative years for this policy. The main reason for including this clause is to allow economic benefits from retail trading by foreign companies to boost the MSME and cottage industry sector.
- The policy is an enabling policy only and state governments would be free to take their own decision.
- Retail sales outlets may be set up in cities with populations greater than 10 lakh (1 million) as per 2011 Census. The limit of a population of 10 lakh (1 million) restricts the entry to around 53 cities in the country. But as the government has given the choice of implementing this policy to individual state governments, the number falls down to around 19 cities in the country, with 10 cities being in Maharashtra alone. There will be a logistical issue for the players as they would require contiguous states in order to be operationally effective. The policy however, does allow for setting up of retail shops in the largest city in case the state does not have a city with a population greater than 1 million.
- Retail trading by means of e-commerce will not be permissible for companies with FDI. This will be a dampener to companies like Amazon, which were looking at investing in the country. However, there is a strong possibility that this is a temporary restriction and could change in the near future given that is it driven mainly by technical considerations as opposed to political reasons.
- A high-level group maybe constituted to examine the issues concerning internal trade.

Single Brand Retail

100% FDI in SBR has been effective since January 2012 but it has been further liberalised so the amended policy contains previous conditions as well as notified changes which are described below.

Existing policy:

- Up to 100% FDI with government approval for single brand products only
- The products should be sold under the same brand internationally
- Products to be branded during manufacturing process

i) The previous condition of 30% mandatory sourcing from small enterprises of the value of goods sold for FDI over 51% was difficult to comply with especially in the case of high technology items, and niche products with specialized features which were difficult to source from MSMEs, village and cottage industries, artisans and craftsmen. Thus the main change was easing this clause by making it 'optional' and 'preferable' instead of being 'mandatory'. Accordingly the new amendments to the sourcing requirement are as follows:

Sourcing:

- From anywhere in India (but preferably from small industries*)
- Based on purchase cost (not turnover)
- Result in enhancement of production capacity

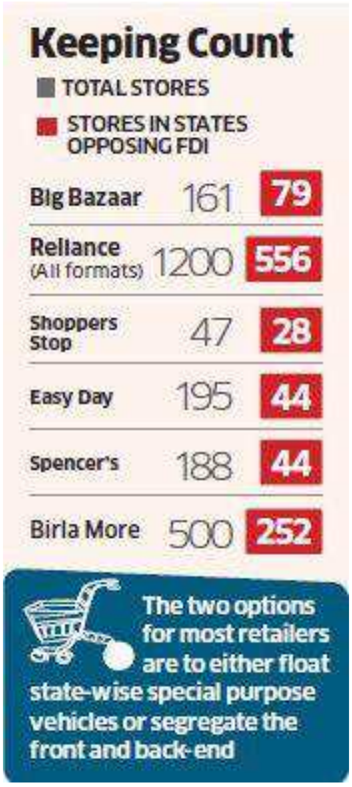
ii) The previous condition mandating that the investor should be the brand owner has been revised to state that only one non-resident entity, whether owner of the brand or otherwise (including franchisee or exclusive license holder), shall be permitted to undertake SBR trading for the specific brand, through a legally tenable agreement, with the brand owner for the specific brand for which approval is being sought. The onus for ensuring compliance with this condition shall rest with the Indian entity carrying out SBR trading in India.

While this will help Swedish retail giant Ikea, which has applied to set up shops in India with an investment of €1.5 billion (Rs.10,600 crore), it may also lead to the revival of a proposal by Spanish apparel retailer Zara that was rejected by the Foreign Investment Promotion Board (FIPB) for not abiding by the ownership clause.

And finally, overseas investors will have to seek no-objection certificates, or NOCs, from individual states before approaching the FIPB, the nodal body that clears foreign investments. In case a state opposed to foreign investment changes its mind and an MNC-funded retailer decides to invest there, the company will have to furnish a fresh no-objection certificate from that state.

To comply with these proposed guidelines, leading retail chains including the Future Group, Bharti Retail, Spencer's Retail, Videocon's Next Retail and Gitanjali Group, will have to modify operational structures before selling stakes to foreign players since many of their stores are in states opposed to foreign investment in supermarkets.

(*Small industry – gross investment in plant and machinery (ie. without depreciation) < USD mill)



Keeping Count

TOTAL STORES

STORES IN STATES OPPOSING FDI

	Total stores	Stores in states opposing FDI
Big Bazaar	161	79
Reliance (All formats)	1200	556
Shoppers Stop	47	28
Easy Day	195	44
Spencer's	188	44
Birla More	500	252

The two options for most retailers are to either float state-wise special purpose vehicles or segregate the front and back-end

INVESTMENT UPDATE

This policy change has been welcomed by big ticket names like Walmart, Tesco and Carrefour who are better placed to take advantages of this reform because they already have a strong local presence. Other companies who are starting from scratch will first need to find an Indian partner with the financial clout to handle the 49%, study and comply with the sourcing conditions and then navigate the federal environment.

Walmart

At present, Walmart, the world's largest retailer has a 50:50 cash and carry joint venture with Bharti Enterprises, which it entered into in 2008 to manage their wholesale and back-end supply chain operations. The recent FDI liberalization will now enable Walmart to invest in its Indian partner's front-end retail business that operates 217 'Easy Day' supermarket stores in the country. Consequently, Walmart is looking to open its first retail outlets in India within the next 12 to 18 months in partnership with Bharti Enterprises.

"We are Walmart's natural partner and we will begin discussions on their buying into our front-end stores," Rajan Mittal, vice-chairman and MD of Bharti Enterprises and chairman of Bharti Walmart, said. "It is not necessary that we will rebrand Easy Day stores Walmart," he added.

At the same time, Bharti Walmart Pvt. Ltd will continue to open additional wholesale stores which will expand alongside their new retail outlets. Currently there are 18 Walmart Best Price Modern wholesales stores across the country with six more planned over the next few months.

Raj Jain, President of Bharti Walmart shared his view on the UPA Government's move and commented that Walmart were happy with this calibrated and cautious approach to opening FDI. Given the huge potential benefits Walmart's investment will bring to states, they are confident that it will only be a matter of time before states opposing this reform will also open their doors to the global retailer.

(A Bharti Walmart store in Amritsar. The government's recent announcement allowing FDI in multi-brand retail will not hamper the growth of wholesale stores, according to Bharti Walmart president Raj Jain. Photo: Ramesh Pathania/Mint)

<u>Tesco</u>

UK retailer Tesco, which currently has a successful franchise arrangement with the Tata's Star Bazaar stores, have adopted a 'wait and watch' attitude. Lucy Neville Rolfe, board member of

Tesco, Britain's biggest retailer, shared their view: "We're glad about the progress that has been made in India... But there are conditions. We have to study the impact of the conditions."

However, they are hopeful that this positive development will allow more Indian consumers, businesses and communities to benefit from world-class retail investment. As mentioned above, domestic retailers may now split their businesses to induct foreign partners in states that allow FDI, while expanding on their own in other states.

Future Group

Future Group, the country's largest retailer, intends to modify its structure to induct foreign investors starting with Pantaloon Retail, their flagship store as well as their home and electronics businesses.

Videocon

Videocon plan to restructure the operations of Next Retail by splitting the existing company into two - one part will operate in FDI-friendly states along with a foreign partner (who will pick up a 51% stake), and the second will be wholly owned by Videocon that will operate in other states. Although they expect the restructuring process to be a lengthy one lasting 6-9 months, Videocon's Chairman Venugopal Dhoot is confident it will yield results and expects states opposing FDI in retail to relent gradually. His foreign partner will have the right of first refusal to pick up stake in stores located in states that decide to allow foreign investment at a later date.

Dune Group

The latest entrant into the single brand space is none other than London-based luxury footwear and accessories brand Dune which has recently announced that it will enter India in partnership with the retail arm of India's largest private firm Reliance Industries and plan to launch their first flagship store by the year-end or early next year,. "India has been a key territory targeted for development," Dune International chief executive Mohamediqbal Yacoobali, said in a statement. Reliance Brands, a unit of billionaire Mukesh Ambani-controlled Reliance Industries, operates stores for brands such as Ermenegildo Zegna, Paul and Shark, Diesel, Quiksilver and Steve Madden and others, through joint ventures and long-term licensing deals.

CONCLUSION

India is already one of the most desirable retail destinations in the world. This revolutionary development is a historic milestone in the long journey of India's liberalisation and will pave the way for both global as well as Indian retailers to explore joint ventures or strategic partnerships with each other or even, as is the case with single brand players, 100% owned businesses.

The reforms are of major interest to UK Plc as they will allow UK retailers, food & drink exporters, and logistics experts to enter into the Indian market on an unprecedented scale and inject fresh capital into India's highly fragmented agri-food supply chain, an area where the UK has world class know-how and technology. The advent of modern trade will also encourage UK skills and education providers to share their knowledge to enhance management and vocational skills in the Indian agribusiness and retail industries.

There is a still a long way to go in this sector and much for businesses to consider but it is clear that India is increasingly open to foreign retailers and it is reassuring to see forward-thinking UK companies looking to make the most of this exciting new opportunity.

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