

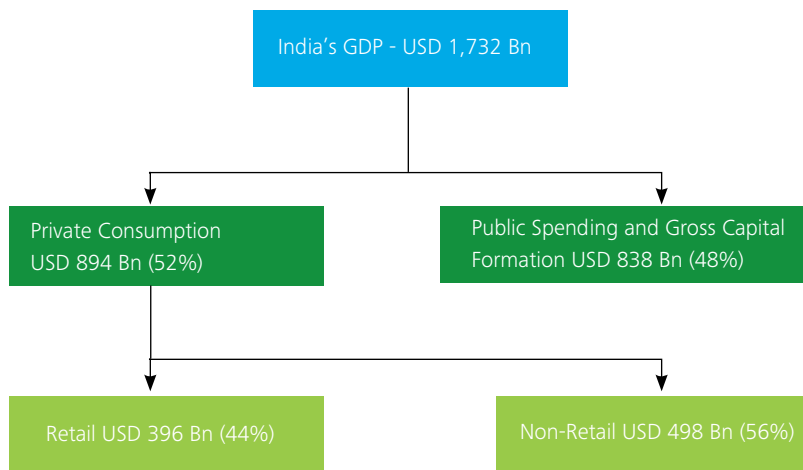
Indian Retail Market
Embracing a new trajectory



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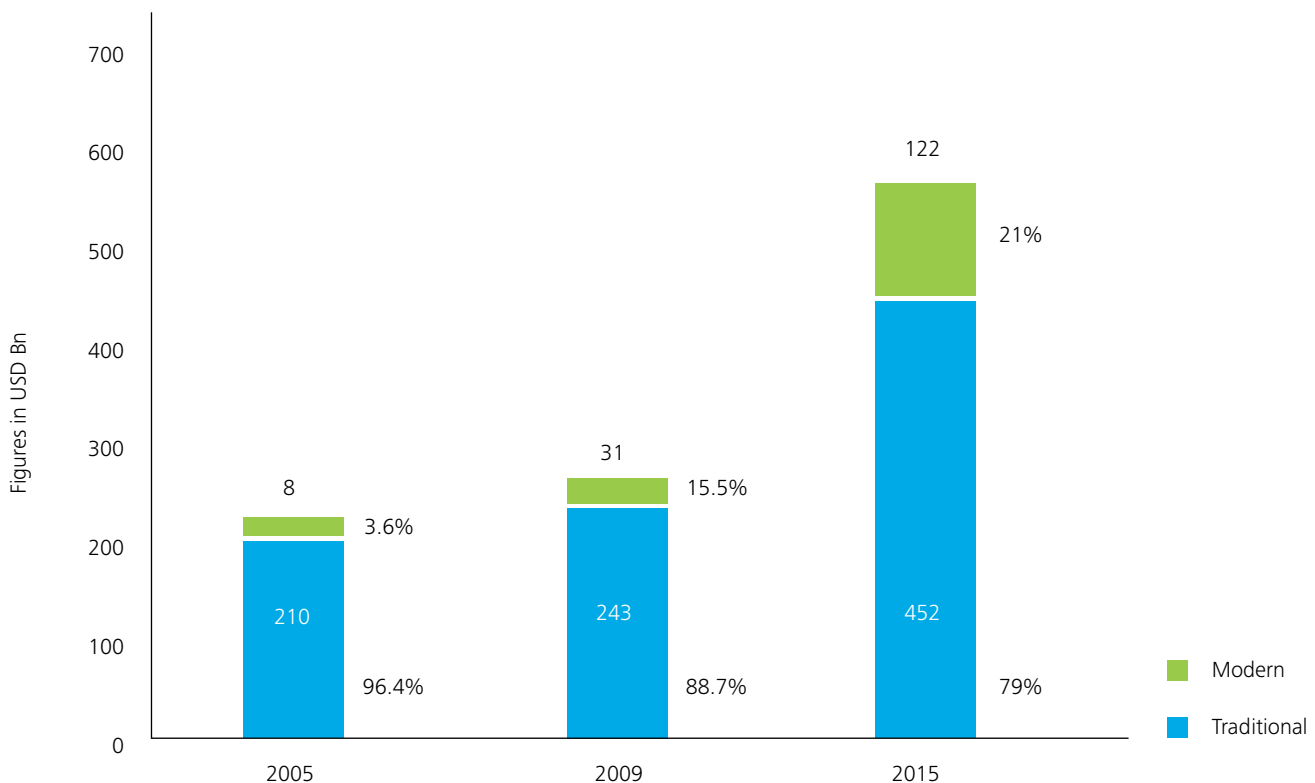
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The Retail Landscape



The Indian retail market currently stands at USD 396 billion and is likely to grow further at 12% to increase to USD 574 billion by 2015. This sector is the second largest employer after agriculture, employing more than 35 million people with wholesale trade generating an additional employment to 5.50 million more. The growing disposable income in the country is resulting in increasing consumer spending habits.

The government is considering in allowing foreign direct investment (FDI) in multi-brand retailing as a measure to make India more attractive to overseas investors. The proposal, piloted by the Department of Industrial Policy and Promotion (DIPP), is currently at the discussion stage and is awaiting government clearance.



Source: Deloitte Retail POV "Indian Retail Report Changing with the changing times"; IBEF report;

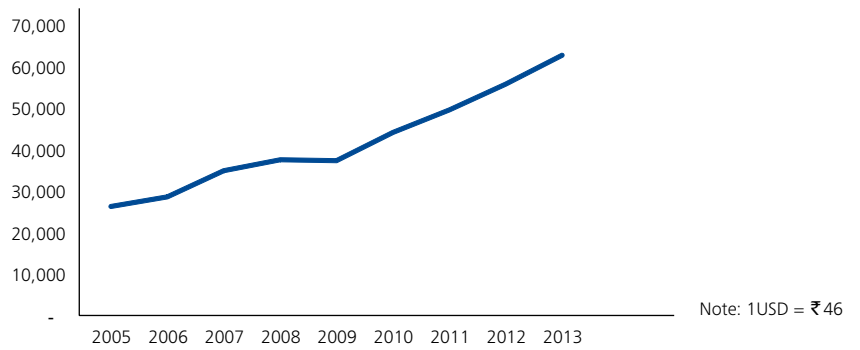
Consumption patterns of the industry

The total retail spending is estimated to double in the next five years. Of this, organized retail--currently growing at a CAGR of 22%--is estimated to be 21% of total retail expenditure. The food and grocery segment is the highest contributor to the retail sector with maximum contribution coming from traditional retailing, while penetration of modern retail is highest in the clothing and fashion segment, at 23% of the growth.

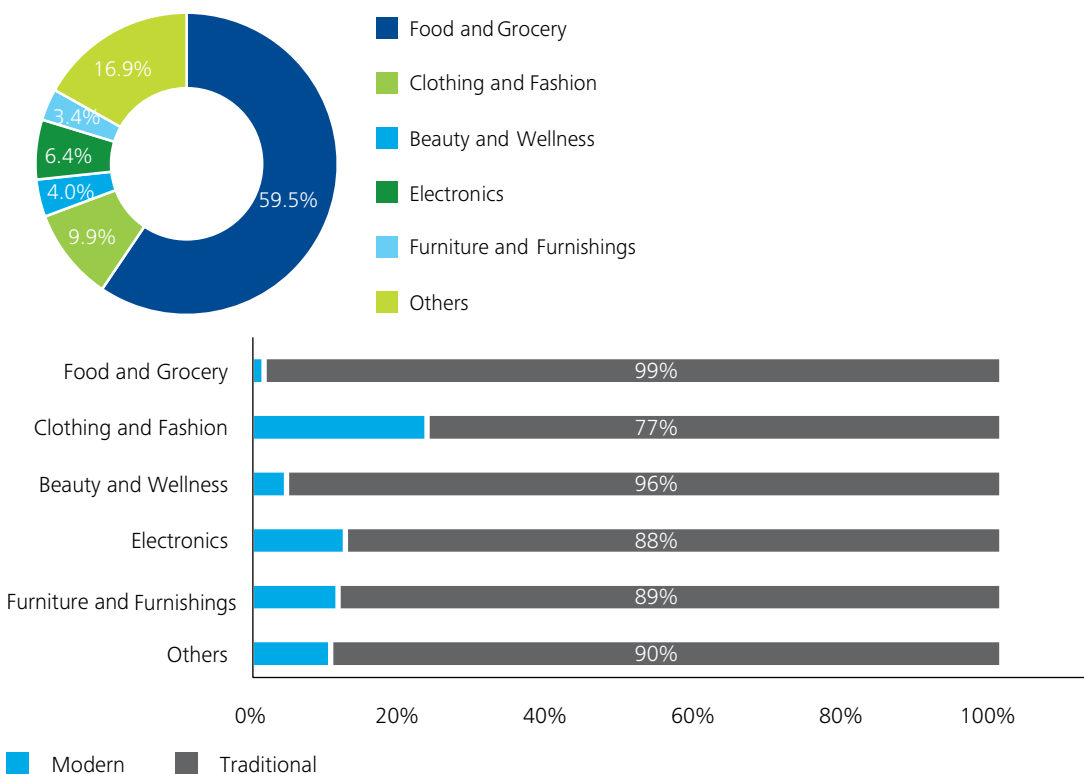
Trends in the Retail industry

- Emergence of organized retail: Real estate development in the country, for example, the construction of mega malls and shopping malls, is augmenting the growth of the organized retail business
- Spending capacity of youth of India: India has a large youth population, which is a conducive environment to growth of this sector
- Raising incomes and purchasing power: The per capita income in India has doubled between 2000-01 and 2009-10 resulting in improved purchasing power.
- Changing mindset of customers: The customer mind set is gradually shifting from low price to better convenience, high value and a better shopping experience
- Easy customer credit: Emergence of concepts such as quick and easy loans, EMIs, loan through credit cards, has made purchasing possible for Indian consumers, for products such as consumer durables
- Higher brand consciousness: There is high brand consciousness among the youth; 60% of India's population is below the age of 30 leading to popularization of brands and products

Personal disposable income per capita (₹)



Market Segments



Source: Deloitte Retail POV "Indian Retail Market: Changing with the changing times"

A Glimpse of FDI into Retail

Current FDI policy

Growing liberalization of the FDI policy in the past decade has been one of the key factors for transforming India from a closed economy into one of the favored destinations for foreign investments. The FDI policy governs and regulates the entire inflow of foreign investments into the country. The current FDI cap across various sectors in retail is as follows:

Immense liberalization of the FDI policy in the past decade has been one of the key factors for transforming India from a closed economy into one of the favored destinations for foreign investments

FDI policy in retail (August 2011)		
Sector/Activity	FDI Cap	Entry Route
Wholesale cash and carry trading	100%*	Automatic
Single brand product retailing	51%*	Foreign Investment Promotion Board (FIPB)
Multi-brand, front end retail	Currently Not Allowed	

*Subject to fulfillment of certain conditions

Proposed policy changes

In July 2010, DIPP released a discussion paper on opening the multi-brand retail sector for foreign investment in India. The government of India has thus proposed to allow 51% FDI in the sector; however, certain conditions still remain mandatory to such investments.

Some of the conditions currently being contemplated by the government for investment are:

- Permission from respective State governments would be necessary to open new stores
- Minimum limit of USD 100 million (about ₹450-460 Cr) for FDI in multi-brand retail
- Half of the total investment must be allotted for the back-end infrastructure like cold storage, soil testing labs and seed farming
- 30% manufactured products should be sourced from small and medium enterprises (SMEs).
- FDI is likely to be permitted only in the six big metros of Delhi, Mumbai, Kolkata, Chennai, Bengaluru and Hyderabad

Nevertheless, the Committee of Secretaries is yet to release a Cabinet note for the proposed policy; hence, there could be some additional changes to it.

Implications of proposed policy

The proposed FDI policy for multi-brand retail has many restrictions/conditions, which are likely to raise some concerns from the investors.

Some issues that investors need to consider are:

Requirement of State permission	<ul style="list-style-type: none"> • Identifying states for FDI investment • Any additional State conditions for allowing/approving FDI/s
Minimum FDI of ₹450Cr and maximum stake of 51%	<ul style="list-style-type: none"> • Availability of Indian partner/s to enter into joint ventures • Willingness of Indian partner/s to invest at least ₹432Cr
Half of the total investment must be in the back-end infrastructure	<ul style="list-style-type: none"> • Which area of back-end should be prioritized for investment first should be allotted for the back-end • Return on investment made in back-end infrastructure
30% manufactured products should be sourced from SME	<ul style="list-style-type: none"> • Margins and quality of products sourced from SMEs • Reactions of consumers for products from SMEs
FDI is likely to be permitted only in the six big metros	<ul style="list-style-type: none"> • Current competition landscape in the six metros • Availability and price/rentals of prime locations for multi-brand retail outlets in the six metros



Differences of opinion in the proposed policy

Some differences pertaining to the proposed FDI policy in multi-brand retail are:

- Consumer Affairs Ministry wants a larger share of 75% of FDI investment to be invested in back-end supply chains (Source: NDTV, 30 June 2011)
- Fear of small traders hindering large-scale retail vis-à-vis food inflation (Source: NDTV, 30 June 2011)
- Consensus is now emerging that at least all state capitals be covered, if not cities with over 1 million people (Source: Business Standard, 1 August 2011)
- Industry Ministry proposed that multi-brand retail giants may be allowed only in large cities, which have a population of over 1 million¹ (Source: NDTV, 30 June 2011)
- Consumer Affairs Ministry insisting on FDI cap of 49% in the sensitive sectors (Source: NDTV, 30 June 2011)

¹ As per 2011 census, 47 cities have population of more than 1 million

Market Opportunities

Top contributors across the segments

The food and grocery segment is the highest contributor to the retail sector (60%) with minimum penetration of organized retailing. Penetration of modern retail is maximum (23%) in the clothing and fashion segment, which is 10% of the total retail sector. Besides, organized retail in beauty, wellness and electronics through specialty stores is growing at a rapid pace.

Few highlights of the opportunities available under various segments are:

Food and Grocery Retail	<ul style="list-style-type: none">• Indian household spending on food is one of the highest in the world with 48% of income spent on food and grocery• With growing urbanization and consumerism and acceptance to modern retail this sector exhibit huge untapped potential
Apparel Retail	<ul style="list-style-type: none">• Demand for readymade and western outfits is growing at 40-45% annually• Critical success factors are to deliver affordable and accessible fashion, provide value-added services to sustain consumers
Beauty and Wellness	<ul style="list-style-type: none">• Pharmacy retailing in India is largely dominated by traditional/local chemists• Modern retailer is increasingly moving from pure-play pharma to health and beauty care
Consumer Durable	<ul style="list-style-type: none">• Current market size of consumer durables is USD 6.5 billion and is estimated to grow at a CAGR of 18%• Consumer durable market consist of consumer appliances and consumer electronic
Furniture and Furnishings	<ul style="list-style-type: none">• This category has recently witnessed modern retailers setting up home furnishing sections in hypermarkets or start-up specialty stores• This category faces stiff competition from small traditional retailers as well as individual carpenters/furnishers



Tax and Regulatory Structure

In the post liberalization scenario, India is considered a premium destination for foreign investment. It is hence essential to have a thorough understanding of the alternative funding options available in the market. At the same time, India poses some unique and interesting challenges to potential investors. Thus, navigating such risks not only requires being aware of the available options, but identifying all exogenous factors that can probably as well impact them.

Therefore, financing a business requires rigorous background evaluations, such as studying the type of business entity, nature of business, prevailing economic scenario, duration of financing requirement, etc. In addition, there are various structuring models for investments in India. To hedge investment risks and comply with various regulatory restrictions,

foreign investors may invest in the form of a joint venture company.

Foreign companies could also invest in India through a franchisee model. However, other investment structures could also be considered in order to enable compliance with the regulatory requirements. Typically, profits generated through investment are repatriated in the form of dividend/royalty payments to the foreign investors. Nonetheless, there are various tax and regulatory implications associated with such investment/repatriation models. To add, any investor would typically structure its investment in a tax efficient manner as this will enable easy repatriation of capital and profits. Therefore, capital structuring plays an important role while making any investment decision.

Capital structuring

Capital structuring could be done using a combination of the following instruments:

Equity Shares	<ul style="list-style-type: none"> • It is a permanent form of capital • It gives an ownership of the business i.e. equity investors become owners and partners in the business and are able to exercise some degree of control • Generally carries voting rights proportionate to the stake held by the shareholders • Equity financing does not involve a direct obligation to repay the funds • Return on investment is in the form of dividend • Dividend is not taxable in the hands of shareholder, however, the company declaring dividend is subject to Dividend Distribution Tax (DDT)²
Compulsorily Convertible Preference Shares (CCPS)	<ul style="list-style-type: none"> • This has a preferential treatment with respect to dividend and repayment of capital over equity shares • Bears a fixed coupon rate of return • For exchange control purposes, CCPS is considered at par with equity investment • Dividend is not taxable in the hands of shareholder, however, the company declaring dividend is subject to DDT² • Rate of dividend on CCPS cannot exceed 300 basis points over the prime lending rate of State Bank of India (SBI)
Compulsorily Convertible Debenture (CCD)	<ul style="list-style-type: none"> • Carries no voting rights • CCDs cannot be redeemed without conversion into equity shares • For exchange control purposes, CCD is considered at par with equity investment. However, for tax purpose, CCD is regarded as a debt instrument till conversion • While CCDs carry a specified coupon rate, currently no rate has been prescribed under the foreign exchange regulations. However, it has been generally observed that a maximum rate of 300 basis points over the prime lending rate of SBI is used • Prior to conversion, return on investment is in the form of fixed coupon rate of interest • Interest paid is a tax deductible expense in the hands of the company, subject to withholding of taxes at source³ • Post conversion, return on investment shall be in the form of dividend and shall be subject to DDT.

² Currently, the rate of DDT is 16.223% (inclusive of surcharge and education cess)

³ Taxes to be withheld at the rate of 42.024% (inclusive of surcharge and education cess), subject to lower withholding under the relevant treaty with India

External Commercial Borrowings (ECB)	<ul style="list-style-type: none"> • It is a debt investment and is governed by specific guidelines issued by Reserve Bank of India (RBI) • Any instrument other than equity, CCPS or CCD as mentioned earlier is regarded as ECB for exchange control purposes, irrespective whether they are convertible or not • Typically, ECBs have end-use restrictions. It cannot be used for working capital requirements, on-lending investment in capital market, real estate sector, etc. • ECBs upto USD 500 million during a financial year can be raised for rupee as well as foreign currency expenditure under the automatic route and an additional amount of USD 250 million can be raised with the prior approval from RBI, with an average maturity of more than 10 years • The maximum amount that can be borrowed vis-à-vis the maturity period is as under: <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="background-color: #92d050;">Amount of permissible borrowing</th> <th style="background-color: #92d050;">Minimum Maturity Period</th> </tr> </thead> <tbody> <tr> <td>Up to USD 20 million</td> <td>3 years</td> </tr> <tr> <td>Above USD 20 million up to 500 million</td> <td>5 years</td> </tr> </tbody> </table> <ul style="list-style-type: none"> • The all-in-cost ceiling on ECBs are as under: <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="background-color: #92d050;">Average Maturity Period</th> <th style="background-color: #92d050;">Ceiling over 6 month LIBOR</th> </tr> </thead> <tbody> <tr> <td>3 years and upto 5 years</td> <td>300 basis points</td> </tr> <tr> <td>More than 5 years</td> <td>500 basis points</td> </tr> </tbody> </table> <ul style="list-style-type: none"> • Return on investment is in the form of fixed coupon rate of interest • Interest paid is a tax deductible expense in the hands of the company, subject to withholding of taxes at source⁴ 	Amount of permissible borrowing	Minimum Maturity Period	Up to USD 20 million	3 years	Above USD 20 million up to 500 million	5 years	Average Maturity Period	Ceiling over 6 month LIBOR	3 years and upto 5 years	300 basis points	More than 5 years	500 basis points
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Exchange control regulations and tax provisions are enacted to achieve different objectives of the government. The key challenge is, thus, to decide on the funding option that is not only permitted as per the exchange control regulations but is 'tax efficient' at the same time. There have been numerous instances of conflicting provisions within such regulations; hence synchronization of these regulations becomes vital and crucial.

Repatriation strategy

Foreign capital invested in India is generally allowed to be repatriated along with capital appreciation, if any, after payment of taxes due on them, subject to other tax and regulatory conditions. Hence, in formalizing a strategy to achieve a tax efficient repatriation, the following aspects/options could be examined in detail:

Review of Financial Model	<ul style="list-style-type: none"> • Review of financial model from a tax perspective to eliminate any tax inefficiencies
Review of Royalty agreements	<ul style="list-style-type: none"> • In the case of Joint Venture (JV) arrangement for investing in India, review of royalty agreements, if any, from a tax perspective • Suggesting effective tax planning opportunities so as to minimize tax exposures, if any • Analyzing the transactions from tax perspective and complying with the Transfer Pricing (TP) requirements
Jurisdiction Analysis	<ul style="list-style-type: none"> • Jurisdiction Analysis for tax efficient investing • Analyzing/following alternatives for structuring investments in India: <ul style="list-style-type: none"> – Direct investment in India; or – Investment through an Intermediate Holding Company • Analyzing mechanism for up-streaming income and alternative exit strategies for repatriation of capital and profits in tax efficient manner
Transfer Pricing Planning & Analysis	<ul style="list-style-type: none"> • Transfer Pricing planning and analysis for facilitating arm's length transactions and proper documentation




⁴ Taxes to be withheld at the rate of 21.012% (inclusive of surcharge and education cess), subject to lower withholding under the relevant treaty with India

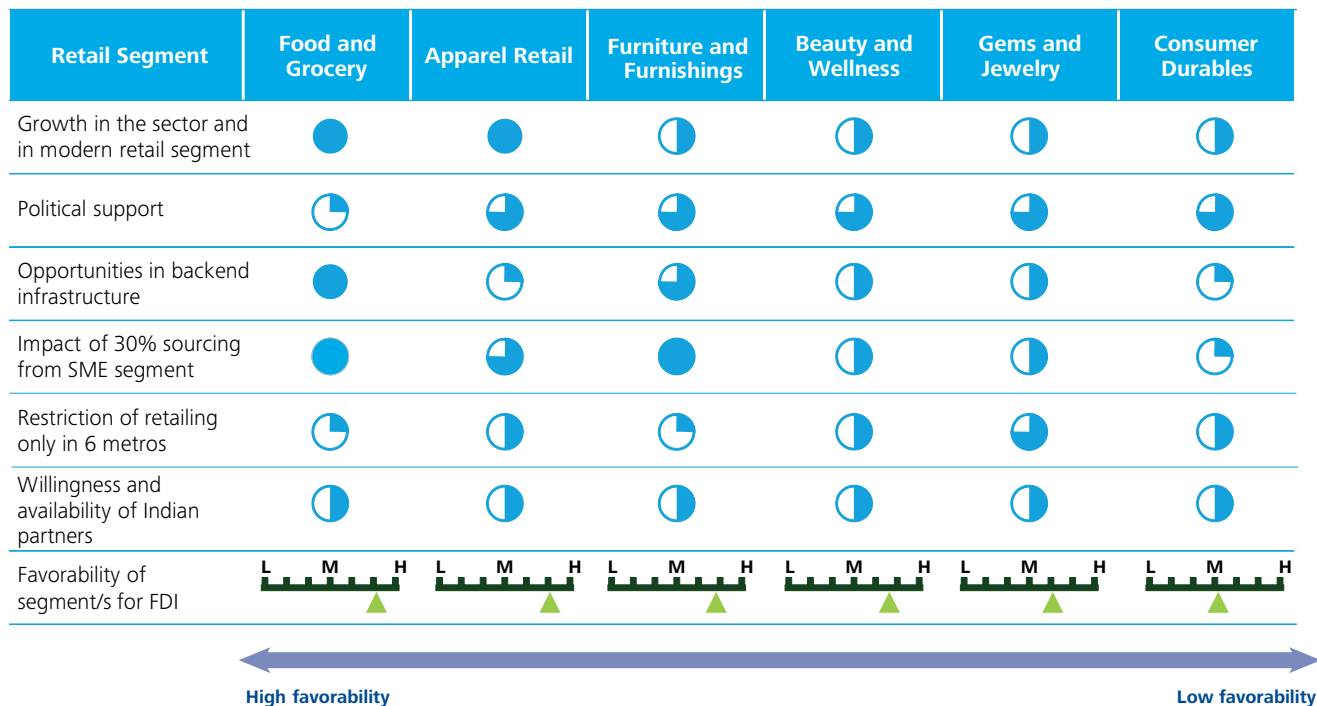
Sector Analysis

Food and Grocery Retail	<ul style="list-style-type: none"> • Business Monitor International (BMI) forecast that sales through Mass Grocery Retail outlets to reach to USD 27.67 billion by 2015 • According to industry estimates, lack of supply chain infrastructure results in 40% loss of farm produce; investment in back-end infrastructure should help reducing this • Sourcing of processed food from SMEs could result in higher margins • Political support for FDI in food and grocery may face challenges and many state may not allow FDI or else allow with more restriction • Hypermarkets and supermarkets are the best suited retail structure for this segment
Apparel Retail	<ul style="list-style-type: none"> • Readymade and western outfits are growing at 40-45% annually • Opening of multi-brand apparel retail for FDI is not expected to face major political deliberations • For apparel retail, investment in back-end infrastructure lies in creation of warehouses • Manufacturing facilities (for private label brand) and logistics is most likely to be outsourced • International retailer could have private label brand sourced from SME segment • Departmental store is the best suited retail structure for this segment
Furniture and Furnishings	<ul style="list-style-type: none"> • Category faces stiff competition from small time traditional retailers as well as individual carpenters • For furniture retail, options for investment in back-end infrastructure lies in creation of manufacturing facilities/warehouses • Some of the furniture products could be sourced from the SME segment • FDI in furniture retail is not expected to face major political deliberations • Specialty retail outlet is best suited structure for this segment
Beauty and Wellness	<ul style="list-style-type: none"> • Penetration level of modern retail is just 4% and there is a huge untapped potential in this segment • Private label brands in some of the product categories can be sourced from the SME segment • FDI in multi-brand beauty and wellness stores is not expected to face major political deliberations • Specialty retail outlet is the best suited structure for this segment
Gems and Jewelry	<ul style="list-style-type: none"> • Branded jewelry has rapidly acquired a niche over the past few years. Increasing purchasing power and disposable income of India's middle class has resulted in growth of this industry • Opening of multi-brand gems and jewelry stores is not expected to face major political deliberations • Special design products could be sourced from the SME segment • Target segment for retailers are largely in the metros and tier-1 cities
Consumer Durables	<ul style="list-style-type: none"> • Traditionally market is largely dominated by branded store, penetration of modern retail is 12% in consumer electronics segment • Consumers are brand conscious for consumer durables hence sourcing of products from SME the segment is not favorable • Target segment for retailers would not just be restricted in the metros and tier-1 cities, it would also include tier-2 cities • FDI in consumer durables sector too is not expected to face any major political deliberation

Although all the retail segments offer growth opportunities for foreign retailers, the largest opportunity in terms of potential market size and scalability is in grocery retailing, particularly for the supermarket and hypermarket formats. However, the large population of 'mom-n-pop'/'kirana' grocery stores is likely to be a force to reckon with for new foreign entrants.

Legend Description

	Highly Favorable		Moderately Favorable		Less Favorable
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The Road Ahead

Liberalization of FDI in multi-brand retail is getting closer to reality. After almost a year of deliberations post the White Paper published by the DIPP/ Ministry of Commerce and Industry, a Retail FDI Draft document has been submitted to the Union Cabinet for approval. This is the final hurdle that needs to be surpassed. However, there are all indications that the Cabinet is likely to endorse this liberalization since the government is committed to advance this sector. Accordingly, we could expect the final policy to be announced within the next six months to a year.

One aspect seems to be clear that will be no 'one-shot, big-bang' kind of approach toward introducing FDI in multi-brand retail. Instead, we could expect a phased liberalization approach with a number of conditions laid down, at least initially, for foreign retailers to enter India. These conditions would be intended to assure the opposition parties, the local retailer lobbies, the farmer and trade unions, etc. that the government has adopted a 'balanced/mid-way' kind of approach after due consideration of the views of all stakeholders involved.

Of the various conditions that are being discussed for entry, the most significant, from a foreign retailer perspective, are likely to be:- the minimum investment threshold (say USD 100 Million) for entry, and the permissions/support required from local State governments to enable foreign retailers to set up business in their respective states. Thus, we are likely to witness a second round of 'political uproars and debates' from the state level authorities and politicians, once the policy is actually announced. Amongst the larger and important states (from a retail market perspective), Maharashtra, New Delhi, Punjab, Andhra Pradesh, Tamil Nadu, West Bengal and Gujarat are likely to support the policy faster than the other states. While the opposition-ruled states such as Karnataka and Uttar Pradesh are likely to stage a round of political 'posturing' before the policy translates into stores on the ground.



Nevertheless, it is a clear signal to the foreign retailers who have been patiently waiting in the wings to begin their groundwork for their India entry. They will have some gainful time now, as the liberalization is likely to be more phased and calibrated. With their competitors eyeing for the same cities and probing for the best locations, potential entrants should start developing their plans, strategize their store locations and initiate discussions with their local partners. Also, India being a large and complex market with under-developed logistics and back-end infrastructure, adequate time and attention needs to be given on this specific area since the back-end retail infrastructure that has been taken for granted in developed countries (even in China for that matter) is still at a nascent stage in India.

To summarize, it is time for potential foreign entrants to make an earnest start as a major retail market in the world is finally poised for liberalization. The picture may be unfolding slower than foreign retailers would have liked, but those with a long term view on the growth potential of India's retail sector need to get ready now.

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