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Indian Retail Market
Opening more doors

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Contents

The Indian scenario

The recent wave of reforms by the Government to incentivize Foreign Direct Investment (FDI) in various sectors is bringing a new zeal to the investment climate in India. One of the most debated reforms is the policy for allowing 51 per cent FDI in multi-brand retail.

Deloitte, in the past, has expressed its views on FDI in multi-brand retail, while the policy was still at the proposal stage. In August 2010, it published a paper "Changing with the changing times" in which the Indian retail landscape was analyzed along with the potential impact of FDI in the retail industry. The paper also predicted that given the then prevalent political landscape, there was a high likelihood of allowing FDI in multi-brand retail.

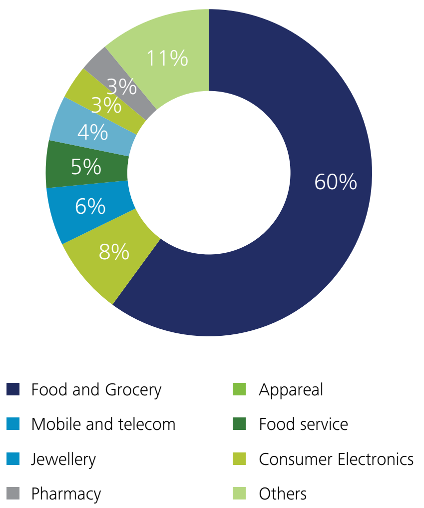
Deloitte's paper published in September 2011, "Embracing a new trajectory" analyzed various retail sub-segments in terms of their growth potential and penetration of organized retail. Food and Grocery retail and Apparel retail emerged as the most lucrative segments because of their large market size and high growth. The paper further cautioned that there will be no 'one-shot' or 'big-bang' kind of approach towards introducing FDI in retail. Instead, foreign retailers should expect a policy with number of conditions laid down, at least initially.

As predicted, the Government has now notified 51 per cent FDI in multi-brand retail. The current paper shall closely examine the implications of the policy across retail segments, business stakeholders, as well as, foreign retailers.

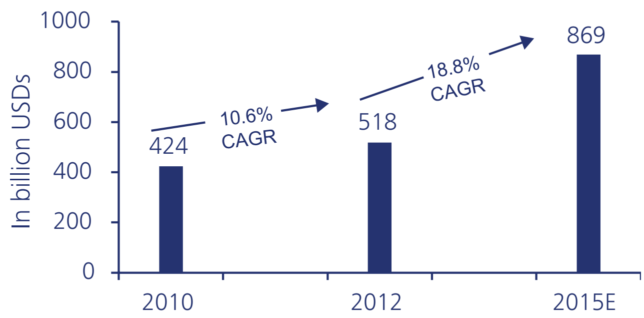
Organized retail, which constitutes 8 per cent of the total retail market, will grow much faster than traditional retail. It is expected to gain a higher share in the growing pie of the retail market in India. Various estimates put the share of organized retail as 20 per cent by 2020.

Retail market in India

The Indian retail industry has experienced growth of 10.6% between 2010 and 2012 and is expected to increase to USD 750-850 billion by 2015. Food and Grocery is the largest category within the retail sector with 60 per cent share followed by Apparel and Mobile segment.



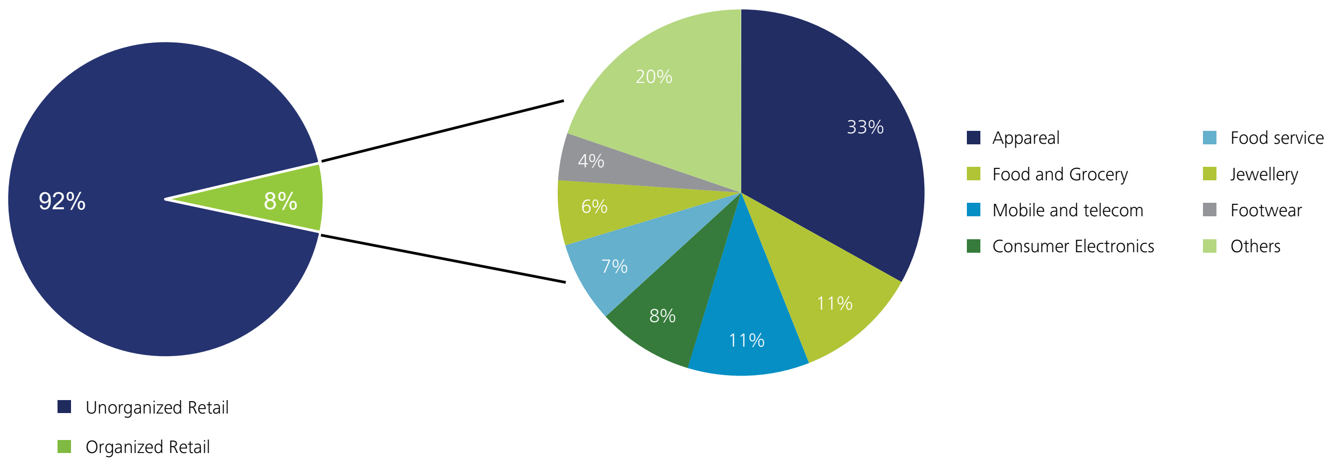
Source: India Retail Report 2013, Images Group



Source: India Retail Report 2013, Images Group

Note: For the purpose of above graph currency value for $1 is taken as INR 50 in 2010 and INR 55 in 2012 and 2015

Within the organized retail sector, Apparel is the largest segment. “Food and Grocery” and “Mobile and telecom” are the other major contributors to this segment.



Source: & Bradstreet retail sector overview, India Retail Report 2013, Images Group

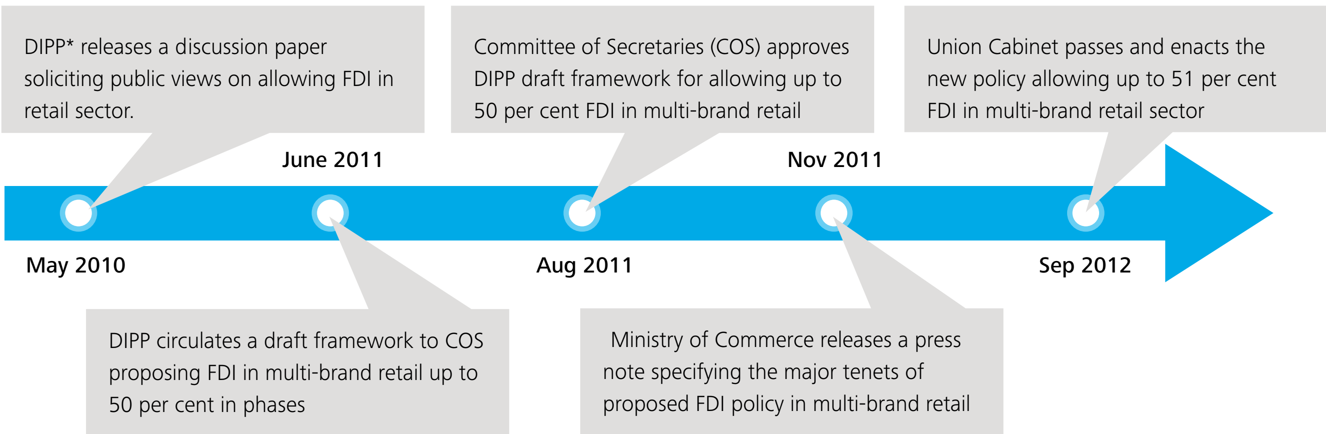
Evolution of the FDI policy in Multi-Brand Retail Trade (MBRT)

The Government of India had been considering opening up the MBRT sector to FDI for some time. They had released a discussion paper in 2010 on the topic and had extensively gathered public, academic and industry views on the issue. In November 2011, the Government came out with its proposal for the new FDI policy. However, unable to achieve political consensus on the issue, they had to shelve their plans for the enactment of the policy. Finally the Government decided to pass the new FDI policy on MBRT in September 2012.

The FEMA notification issued by the Reserve Bank of India permitting FDI in the retail sector was laid before the Houses of Parliament and the same have been cleared without any modification.

The changes in some of the policy conditions indicates government intention to provide a window to foreign retailers to cultivate/grow the SME segment

Timeline for evolution of Indian FDI policy in Multi-brand retail



*Department Of Industrial Policy & Promotion

The new policy contained a few key changes to the November 2011 policy draft released by the Government.

Policy draft in November 2011	Policy notified in September 2012
No mention of any time lines for meeting 30% sourcing from small segment	5 year window was allowed to investors to achieve the 30% sourcing for the first time
No mention of e-commerce	Retail trading through e-commerce channel has been prohibited for companies with FDI in MBRT
Only cities with population more than one million	In States / Union Territories not having cities with population exceeding 1 million, retail stores are allowed in large cities of the State’s choice

Policy implications

Multi-brand specialty retail segment such as Beauty & Wellness and Consumer Electronics are still in their nascent stage. Their current market size may not hold a big potential for foreign retailers.

Implication of FDI policy on different sub-sectors of retail

The FDI policy conditions will have a different impact on the various sub-segments of the retail industry in India. A policy condition might have a low impact in one segment but could be a major stumbling block for another segment. In this section we have delved on the implications of each FDI policy condition in Mass Grocery, Apparel and specialty stores such as Beauty & Wellness and Consumer Electronics.

Minimum FDI of USD 100 million

Minimum FDI of USD 100 million and a constraint of maximum 51 per cent stake of the foreign entity imply that the minimum investment required by both, the foreign and the Indian partner together, is more than INR 1000cr.

Mass Grocery and Apparel are two of the fastest growing organized retail segments. In both these segments there are large domestic retailers who could be potential joint venture partners for foreign retailers.

Segment	Existing player	Revenue (In INR cr)	# stores
Apparel	Pantaloons	4097[1]	>65
	Shoppers Stop	1927	>50
	Westside	821[2]	>60
Mass Grocery	Big Bazaar	6914[3]	>210
	Reliance Fresh	7,599[4]	>400
	More	NA	>575
Beauty & Wellness	Apollo	860[5]	>1350
	Medplus	NA	>980
	Titan Eye+	328[6]	>200
Consumer Electronics	Croma	NA	>54
	Ezone	NA	>44
	Reliance Digital	NA	>75

Note: [1]Revenue figure is of Pantaloons Retail India Ltd for 2010-11
[2]Revenue figures of Trent India Ltd for 2010-11
[3]Revenue figures of Future Value Retail Ltd for 2010-11
[4]Revenue figures of Reliance Retail (all formats), 2010-11
[5]Revenue from only pharmacy business in FY12
[6]Revenue from the eyewear and precision engineering division

50 per cent of FDI in backend infrastructure in three years

Minimum investment of INR 250-220cr is to be invested in backend infrastructure in the first three years. However, different retail segments have dynamic requirements of backend infrastructure.

	Manufacturing	Warehousing	IT infra	Logistics
Apparel	Do not have their own manufacturing units	Own warehouses in different regions of India	Possess IT infrastructure for inventory management	Outsourced to third parties
Mass Grocery	Many existing retail chains; own processing centers for private label brands	Own distribution centers with cross dock facility & cold chains etc.	Possess IT infrastructure for inventory management	Own subsidiaries for their logistics (For example Future Supply Chain & Reliance Supply)
Beauty & Wellness	Do not own manufacturing units, except few stores such as eyewear	Own warehouses in different regions of India	Companies have centralized database management	Outsourced to third parties by retailers
Consumer Electronics	Source products of other manufacturers	Own warehouses in different regions of India	Possess IT infrastructure for inventory management	Either outsourced or company owned

Mass Grocery needs significant investment in the backend. (For example food processing unit, cold chains, etc.). However, other segments such as Apparel, Beauty & Wellness and Consumer Electronics have limited requirements in the backend. Further, as per the policy, land cost and rentals that might be incurred for warehousing are not included in the definition of backend infrastructure. Hence, meeting this policy constraint would be a challenge for any player in the retail segment other than Mass Grocery.

30 per cent of sourcing from "small" industries

This policy constraint implies that retailers should have at least 30 per cent sales from private label brands or unbranded products sourced from small industries.

Segment	Current sourcing practices
Apparel	• Private label apparels: Retailers source fabric and supply them to contract manufacturers or purchase finished garments from low cost suppliers • Other accessories: Non-apparel accessories like wallets, handbags etc. are becoming a significant part of total sales for apparel retailers.
Mass Grocery	• Increasingly, companies are stressing on a private label portfolio in both grocery and non-grocery retailing because of the high margins (for example, private label constitute approx. 25 per cent of total products for Spencer's) • Companies are sourcing directly from producers to economize on the price and increase margins (for example, Pantaloons' retail subsidiary - Future Fresh Foods Limited sources directly from producers)
Beauty & Wellness	• Retail chains such as Apollo and Guardian have private label brands (Guardian has more than 220 SKUs), which offer higher margins • For most OTC medicines, prescription-based medicines and beauty products, retailers source from large pharmaceutical companies
Consumer Electronics	• Retailers source electronic products directly from the manufacturers and distributors appointed by manufacturers or wholesalers • Even in case of private label brands, majority sourcing happens through foreign shores

Existing Mass Grocery retailers in India source many products directly from producers and "small" food processing units. However, suppliers of Consumer Electronic and other specialty stores such as Beauty & Wellness are large size companies.

Only cities with population more than one million
Only 53 cities in India qualify under this policy condition. This policy constraint restricts the access to retail market in all sub-one million populated cities and towns.

More than 80 per cent of stores of various multi-brand retail chains (such as Spencer, Spar, Shoppers Stop, Croma, Titan Eye+ etc.) are in cities with more than one million population. Hence, the policy condition may not significantly affect operations in most of the retail segments.

Segment	Existing player	Percentage store in cities with population >1mn
Apparel	Shoppers Stop	81.5%,
	Lifestyle	85.7%
	Reliance Trends	69.4%
Mass Grocery	More	60.2%
	Spencer	87.4%
	Spar	84.6%
Beauty & Wellness	Apollo Pharmacies	55.0%
	Titan Eye+	89.3%
	Guardian	66.5%
Consumer Electronics	Croma	96.0%
	Ezone	90.6%
	Reliance Digital	80.0%

Approval from State Government required
There are only 18 cities in India with population more than one million and the corresponding State Government supporting FDI in multi-brand.

More than 50 per cent of the existing retailer stores (such as Spencer, Shoppers Stop, Lifestyle, Apollo etc.) are in states not supporting FDI in multi-brand. This policy condition impacts the access to a significant market. Further, limited cities means limited stores and reduces economy of scale.

Segment	Existing player	% stores in cities with pop >1mn & states supporting
Apparel	Shoppers Stop	46.3%
	Lifestyle	51.4%
	Reliance Trends	26.5%
Mass Grocery	More	27.5%
	Spencer	30.5%
	Spar	46.2%
Beauty & Wellness	Apollo Pharmacies	25.0%
	Titan Eye+	42.0%
	Guardian	40.6%
Consumer Electronics	Croma	68.5%
	Ezone	67.4%
	Reliance Digital	40.0%

E-commerce not permissible

Multi-brand retailers with FDI will not be able to use e-commerce, whereas, Indian retailers can use e-commerce as another channel for sales.

Most of the existing retailers in Mass Grocery and multi-brand Apparel do not use e-commerce to sell their products. Even in specialty retailers such as Beauty & Wellness, e-commerce does not form a significant part of their sales. Hence, this policy constraint should not materially impact operations.

Segment	Existing player	Using E- Commerce
Apparel	Shoppers Stop	✓
	Lifestyle	✗
	Reliance Trends	✗
Mass Grocery	More	✗
	Spencer	✗
	Spar	✗
Beauty & Wellness	Apollo Pharmacies	✓
	Titan Eye+	✗
	Guardian	✓
Consumer Electronics	Croma	✓
	Ezone	✓
	Reliance Digital	✓

Summary

Policy conditions of 50 per cent investment in backend and 30 per cent sourcing from small industries are the two most difficult conditions to be met for FDI in multi-brand specialty retail such as Consumer Electronics, Beauty & Wellness etc.

Various policy conditions for FDI in Multi-Brand Retail makes Mass Grocery and Apparel the two most favorable segments

Implication of FDI policy on different stakeholders

Farmers

Higher penetration of organized retail would reduce the role of the middleman and enable better realization of price to farmers. Farmers will gain support from the retailers with whom they will share a common interest. This is expected to enhance productivity of farming activity.

Farmers could access large markets through the organized retail chains. With improved supply chain, retailers will pick up the produce right from the fields. This will save transport costs incurred to take the produce to the local *mandis*.

SME segment

The policy condition of 30 per cent sourcing from the small enterprises will enable the SME segment to work with the large retailers and have access to a much larger region in India and potential access to world markets.

Traditional retail

In the last three years, both, modern retail and unorganized retail, have continued to grow. Due to real estate space constraint in prime locations within cities, traditional trade will continue to be a convenience store next door, whereas, organized retail is more likely to grow in the suburbs and outskirts of large cities.

Both organized and unorganized retailers will coexist as both offer different value propositions to customers. Organized retailers provide discount on bulk purchase and on ambience, whereas, traditional retailers provide convenience and top-up shopping.

Consumers

Food and Grocery, followed by Apparels, accounts for a significant proportion of the expenditure of Indian consumers. The consumer is more brand conscious in Consumer Electronics, Footwear and to some extent in Apparels. For Food and Grocery, the expenditure is predominantly on non-branded products.

With the entry of foreign retailers in multi-brand retail, the consumer will have a wider choice and a better shopping experience. There might be a gradual shift in consumption patterns such as non-food items gaining a larger share of the pocket and consumption of branded products in grocery items.

Existing multi-brand retailers

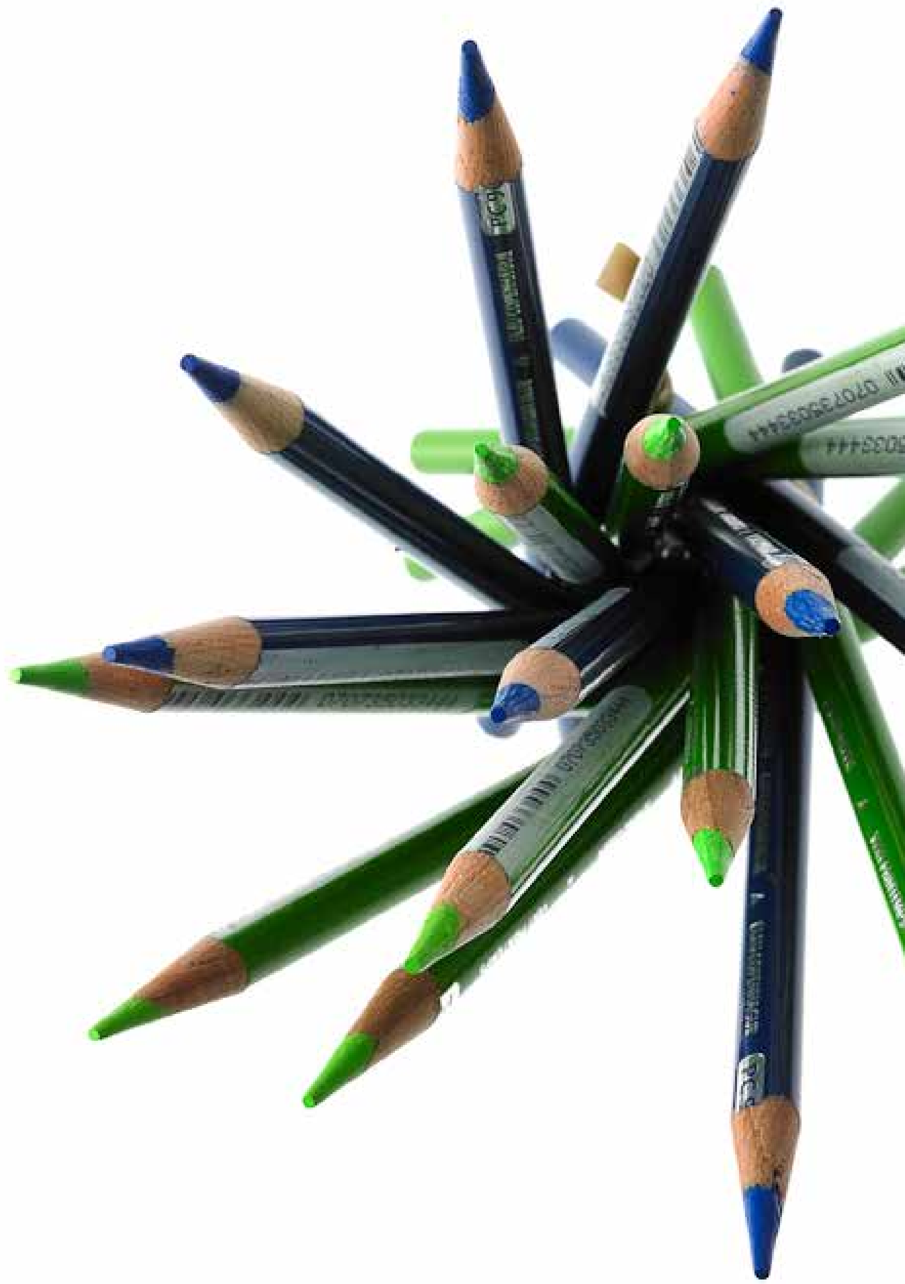
FDI in multi-brand retail would benefit capital constrained retailers and could reduce the piling debt of many Indian retailers. FDI would accelerate the pace of investment in the supply chain to meet the demands of increasing scale which would in turn benefit the existing players. Indian players have no restriction on sourcing, e-commerce, location of retail stores - investments in backend infrastructure etc. hence would hold a competitive advantage over any retail chain with FDI.

Macroeconomic Impact

FDI in multi-brand retail is likely to bolster retail capabilities by attracting foreign investments. Appropriate implementation of the policy is expected to address a number of supply side constraints plaguing the Indian agricultural sector and help reduce inflationary pressures.

Indian agriculture has been traditionally plagued with low food-grains productivity and inefficient distribution. Increased scale of investments and better supply chain processes will help increase productivity and distribution efficiency. The agricultural sector can see higher use of technology in farming, packaging and storing leading to reduction in supply chain impediments, thereby, reducing supply side inflationary pressures.

Better retail access is also likely to provide consumers with wider product choice and rationalized prices.



Expected future trends in the retail segment in India

A. FDI in specialty stores: Multi-brand organized retail in specialty stores such as Consumer Electronics,Footwear, Furniture and Furnishing etc. are expected to expand and mature in the next few years. However the policy condition on sourcing will continue to be a major bottleneck for FDI in many of these segments

B. Dominance of unorganized retail: Flexible credit options and convenient shopping locations will help traditional retail to continue its dominance in retail sector.

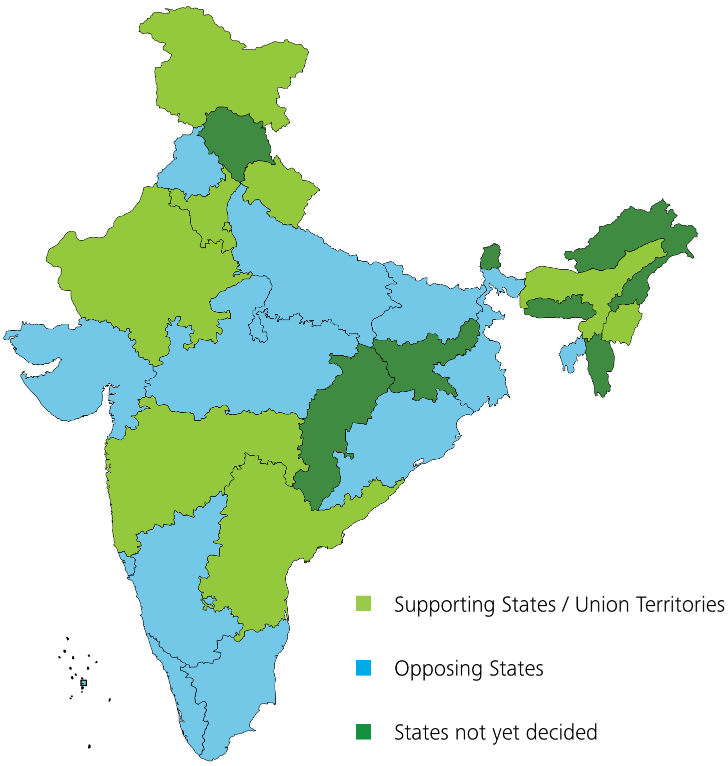
C. Growth in small cities and towns: Stiff competition and saturation of urban markets is expected to drive domestic retail players to tap the potential in small cities.

Political landscape with respect to new FDI policy

The main opposition party of India and its allies are currently opposing the FDI in multi-brand retail. Some of the ruling party allies such as DMK, UDF (Kerala) are also against the policy.

Elections are due in Karnataka, Madhya Pradesh, and Chhattisgarh in the next two years and hence these states may change their stance on FDI in MBRT depending on who comes to power.

The principal opposition party supported the FDI in Multi-Brand Retail when it was in power at the Center in 2002. Further, many of the current allies who oppose the policy are still supporting the UPA Government.



Tax and Regulatory Structure

Capital Structuring

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. While it is an attractive investment destination, India poses some unique and interesting challenges to potential investors. Thus, navigating such risks not only requires one to be aware of the available options, but also identify all exogenous factors that can probably 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. So, 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. Thus, investors would typically structure their 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.

Multi-Brand Retail Trade (MBRT)

As FDI in MBRT is restricted to 51 per cent, the foreign investor shall require an Indian joint venture partner to invest the balance 49 per cent. A new joint venture company may be set-up in India, which shall have multi-brand retail stores in India.

Alternatively, the foreign investor may also consider acquiring 51 per cent stake in the existing business set-up of the potential Indian joint venture partner. However, due to the location restrictions and State Government policies, the existing Indian business may need to be reorganized before the foreign investor can consider investing in the existing Indian business.

Repatriation strategy

Foreign capital invested in India is generally allowed to be repatriated along with capital appreciation, if any, after payment of tax dues 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	• Review of financial model from a tax perspective to eliminate any tax inefficiencies
Review of Royalty agreements	• In the case of Joint Venture (JV) arrangements 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	• Jurisdiction Analysis for tax efficient investing • Analyzing/following alternatives for structuring investments in India: – 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	• Transfer Pricing planning and analysis for facilitating arm's length transactions and proper documentation
Indirect taxation	• Indirect taxes play a very important role in deciding the costing and consequently, the pricing model in a supply chain.

Paradigm Shift in tax reforms

India is currently undergoing a saga of changes in its tax laws. Direct taxes Code, Goods and Services Tax Act, Recommendations made by the Dr. Shome Committee on General Anti Avoidance Regulations (GAAR) and retrospective amendments on indirect transfers are all documents indicating a complete overhaul of the tax laws in India.

Road Ahead

The key challenges for international players looking to enter the Indian retail sector are high real estate rentals and an uncertain political environment of the country

Execution Challenges

The advent of FDI policy of September 2012 can pave the way for modernization of the Indian retail sector, however, the journey ahead is challenging. Even well-heeled MNC retailers will have to pay heed to the Indian political, social and competitive landscape, if they want to succeed in the Indian retail sector.

Availability of Retail Space: Hypermarkets require more than 60,000 sq. ft. and departmental stores require more than 20,000 sq. ft. of retail space. Such retail space in prime locations in the big cities is scarce and available only at high rental costs.

High rental cost: The Indian retail rentals have been quoted to be around 300-400 basis points higher than international rentals. Rents in prime properties have increased by 50 per cent in just three years. According to an industry estimate, rentals comprise approx. 40 per cent of total cost of sales in the retail sector. Thus, successful negotiation of rents would constitute a key success factor for MNC retailers.

Clarification on certain policy features: The policy note does not specify whether investment in back end infrastructure needs to be a fresh investment or if foreign companies can buy stakes in already established backend infrastructure.

Red Tape – Getting various government approvals: Entry of a multi-brand MNC retailer in the retail sector would fall under the approval route. This implies that the MNC retailer would have to go through different layers of Government departments before getting the go ahead.

Political Risk: The largest opposition party in India has opposed FDI in retail and some of its leaders have indicated that they will scrap the policy if their party comes to power. A political change in state and central governments puts a lot of political risk on investment in retail.

Skilled Manpower: One of the major challenges faced by the existing players is the availability of skilled manpower; any foreign retailer planning to enter India will have to face similar challenges.

Infrastructure Challenge: Roads, ports, electricity are some of the infrastructure challenges, which increase the operational cost of the retail chain.

Currency Fluctuation: In the past three months, the dollar/INR exchange rate has fluctuated by approx. 8 per cent. This may put considerable currency risk on any foreign investment in India.

Way ahead for international retailer

MNC players need to take cognizance of a host of consumer behavioral issues and policy implications before deciding on their foray into the Indian retail market.

Right Partner: The success of the business will be heavily influenced by the choice of partner. International players should partner with players who will help them reach the end customers and possess lucrative front-end retail infrastructure. An established player in the retail market will help bring in customers while the foreign player can used its expertise in supply chain and logistics to further enhance the operational efficiency.

Policy protects the expansion of domestic retailers in small towns and cities

India is not one market: States in India differ in terms of culture, language, socio-economic development etc. Further, different spending power results in different customer segment even within a state. This makes it imperative on the part of the international retailers to customize their offerings to suit regional Indian tastes.

Real Estate Choice: Another critical success parameter is the real estate choice at prime location and reasonable rentals. This is especially true for a multi-brand retailer, which requires a large retail space.

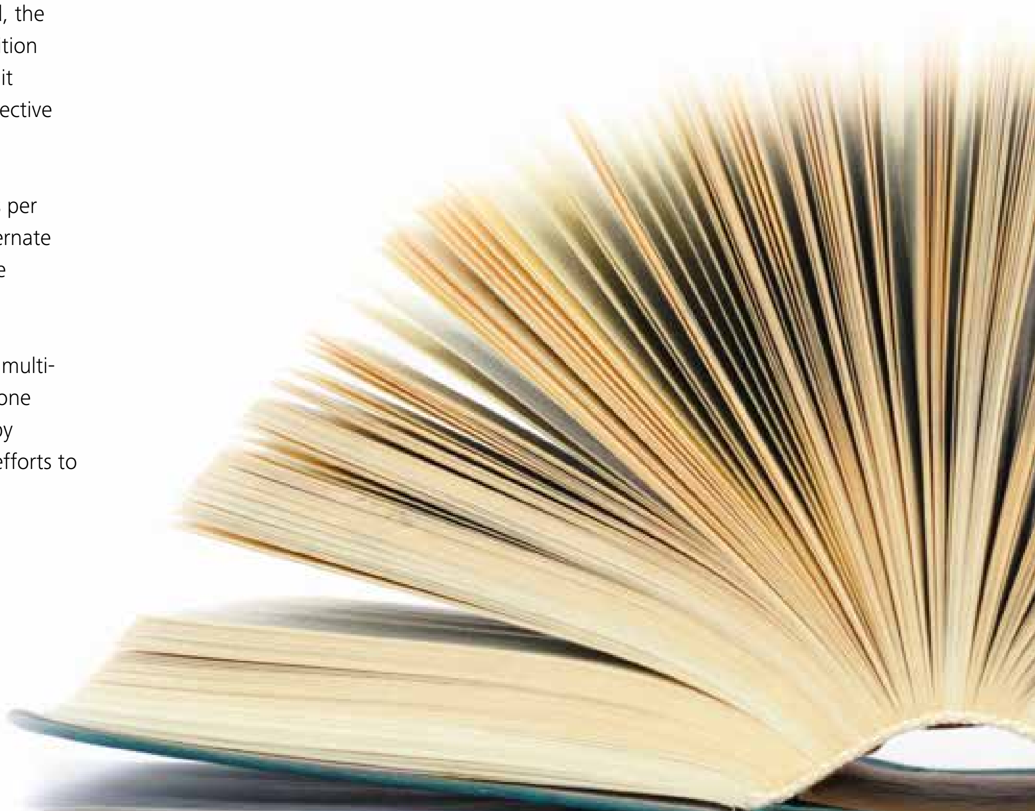
Private Label brand: To meet the policy guidelines on sourcing and to have better margins, foreign retailers would need to cultivate relationships with local manufacturers to drive strong private label brand.

Way ahead for domestic retailers

The new FDI policy also presents a unique set of implications for domestic retailers. On one hand, the policy exposes the domestic retailers to competition from foreign retailers; while on the other hand, it seeks to safeguard them through a slew of protective measures.

FDI in multi-brand retail is a state subject and as per the policy, e-commerce is not allowed as an alternate channel as it can serve the customer beyond the physical location of the store.

Restriction on foreign retailers from conducting multi-brand retail in towns with population less than one million can be construed as an enabling policy by domestic retailers who should now focus their efforts to expand their retail footprint.



Finally

Our opinion is that policies evolve with changes in the business environment and the political landscape. The FDI policy for single brand retail has evolved as the Indian market becomes more mature and the political situation more stable. Similarly, FDI policy for multi-brand retail or its implication on the business may also evolve in future.

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