

INDIA

Indian retail sector

9 May 2007

Companies discussed in this note

ITC

ITC IN		Outperform
Stock price as of 08 May 07	Rs	159.95
12-month target	Rs	195.00
Upside/downside	%	+21.9
Market cap	US\$m	14,804

Pantaloon

PF IN		Outperform
Stock price as of 08 May 07	Rs	407.05
12-month target	Rs	570.00
Upside/downside	%	+40.0
Market cap	US\$m	1,409

Shopper's Stop

SHOP IN		Outperform
Stock price as of 08 May 07	Rs	603.40
12-month target	Rs	786.00
Upside/downside	%	+30.3
Market cap	US\$m	510

Reliance Industries

RIL IN		Outperform
Stock price as of 08 May 07	Rs	1,593.65
12-month target	Rs	1,775.00
Upside/downside	%	+11.4
Market cap	US\$m	56,987

For details, please refer to:

1) India retail sector initiation report

"Ride the retail tide" (14 February 2007)

2) ITC initiation report

"Clearing the smoke" (9 April 2007)

3) Report on Reliance Retail

"Watch out for the retail Goliath" (10 April 2007)

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Food retail: Savour the opportunity

Event

- The government has finalised a "Vision 2015" plan to spend US\$24bn over eight years to develop the cold/ supply chain infrastructure. We believe this is positive for the food retail segment, which offers huge growth potential.

Impact

- Largest retail market segment with lowest penetration:** The US\$176bn food and grocery retail market constitutes >60% of the Indian retail market (Figure 1). The opportunity is highlighted by the miniscule penetration of organised retail of this segment (0.8%) versus 4.6% for overall retail.
- Food retail - the most profitable format:** Our analysis of the profitability of various retail store formats shows that food retail (and hypermarkets) are the most attractive on multiple quantifiable and subjective parameters (Figure 6).
- Huge investments expected in this segment:** The President and Chief Executive (foods business) of RIL Retail, Gunender Kapur has stressed that food & grocery retail will be a key target for RIL's staggering US\$6bn investment plans. He was speaking at the 'Agricorp' conference on 'modern food retail' organised by the Bombay Chamber of Commerce and Industry.
- Rapid growth expected:** We believe these factors will drive 35-40% CAGR in this market segment in the next five years.
- Fiscal benefits to support margins:** Rapid growth naturally implies that this segment will see the toughest competition. However, we expect that the fiscal benefits for cold chains extended in Vision 2015 will help drive volumes and provide some support against competitive pressures on margins.
- Focus on processed food to continue:** Vision 2015 re-iterates the view of S. K. Sahay, Minister of State Food-Processing Industries, who had indicated at the 'Agricorp' conference, that the trend of reduced taxation on processed food that emerged in the past three years is expected to continue.

Outlook

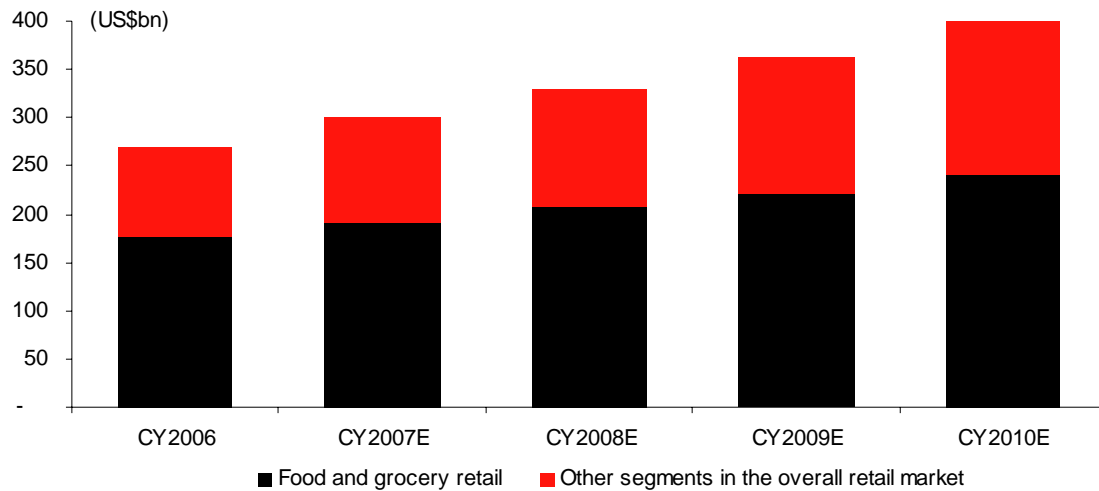
- Key beneficiaries of emerging trends in food retail are likely to be:
 - ⇒ Reliance retail (Reliance Fresh – food retail outlets and hypermarkets).
 - ⇒ Pantaloon (through Big Bazaar – hypermarkets and Food Bazaar – food retail outlets; which contribute 54% of consolidated revenue).
 - ⇒ The Bharti-Walmart alliance (unlisted), which indicated interest in this segment, and incumbents such as Subhiksha (unlisted).
 - ⇒ Minor positive for Shopper's Stop which holds an option to buy a 51% stake in hypermarket chain- HyperCITY.
- Fiscal benefits for processed food and cold chains would benefit procurement for ITC's agri-business (11% of revenue) and FMCG division (8% of revenue).
- We keep our bullish views on Pantaloon, RIL Retail, Shopper's Stop and ITC.

Please refer to the important disclosures on inside back cover of this document, or on our website www.macquarie.com.au/research/disclosures.

Food & grocery retail is most attractive segment

The US\$176bn food and grocery retail market constitutes more than 60% of India's retail market (Figure 1). This segment's strong growth potential is highlighted by the fact that the penetration of organised retail here is extremely low at less than 1% versus 4.6% for the overall retail market.

Fig 1 Food & grocery: Largest retail segment, with 0.8% organised retail penetration



Source: Estimates based on NCAER information, Macquarie Research, May 2007

Food retail: The most profitable format

What formats work best?

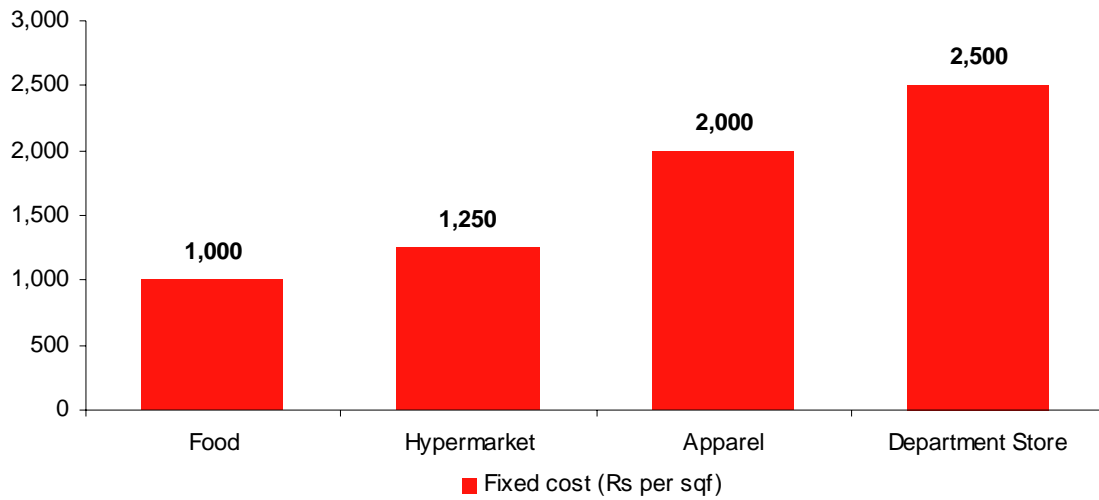
In order to compare the profitability of various models, Cris Infac (a leading Indian industry information service) has studied four business models/ store formats that have seen the fastest growth rates in the past few years. These are:

- Food retail.
- Hypermarkets (catering to the food & groceries and clothing segments in addition to other items of day-to-day consumption; these stores typically offer discounts on merchandise).
- Apparel retail.
- Department stores (catering to the apparel, accessories and lifestyles segment).

Food and hypermarkets typically require the lowest fixed costs...

As most stores are acquired on a lease basis, capital costs consist chiefly of the furnishing costs incurred for a store. Food retail and hypermarkets focus less on ambience than department stores and apparel retail stores. Consequently, they have comparatively lower fixed costs in terms of setting up a store (Figure 2).

Fig 2 Apparel and department stores: Higher capex due to stress on ambience



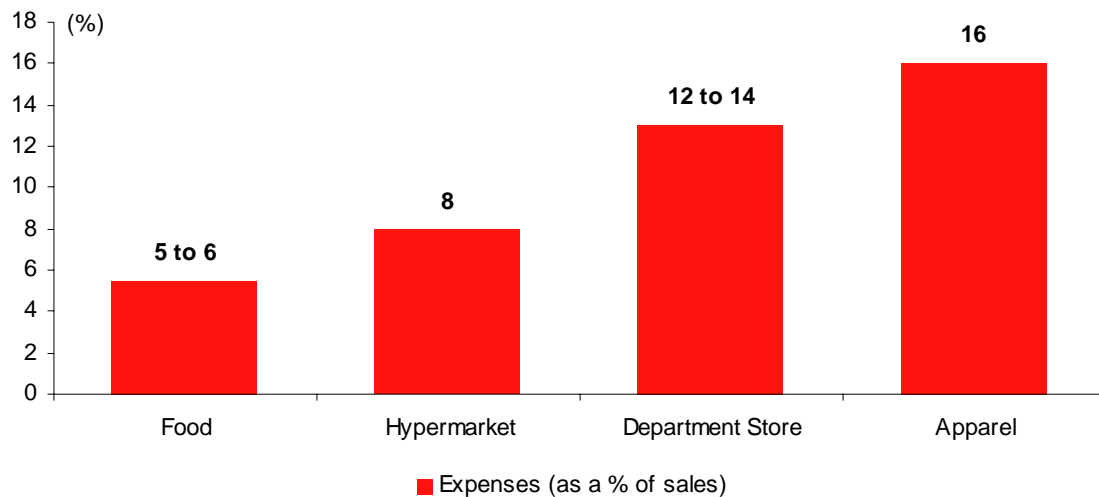
Source: Cris Infac, Macquarie Research, May 2007

... which is also the case for operational expenses

Typical operational costs for a retail store include:

- Staff costs (notably for formats, such as apparel and department stores, which require higher involvement in selling and hence more skilled sales people).
- Administration costs (include power costs, general maintenance, corporate overheads, etc).
- Selling expenses.

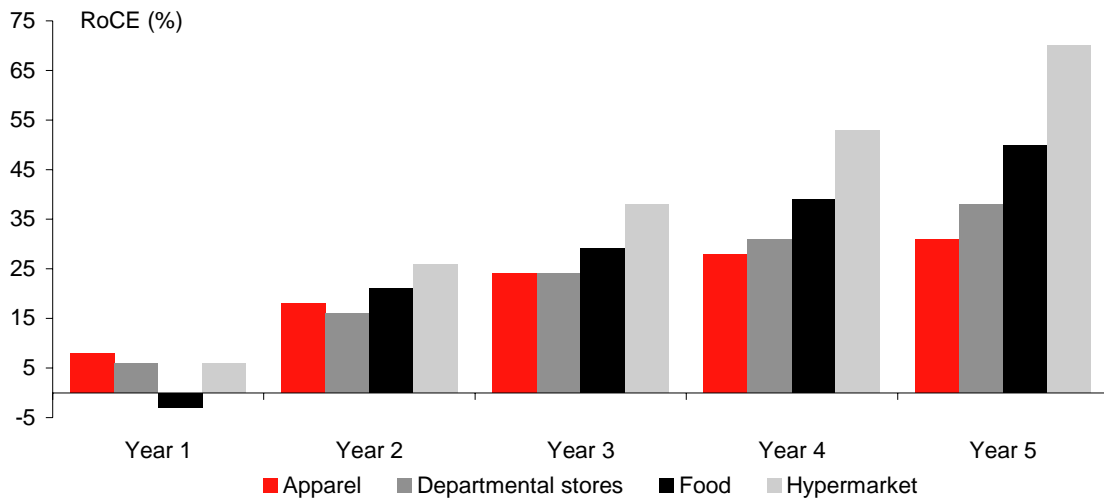
Fig 3 Food retail and hypermarkets have lowest operational costs



Source: Cris Infac, Macquarie Research, May 2007

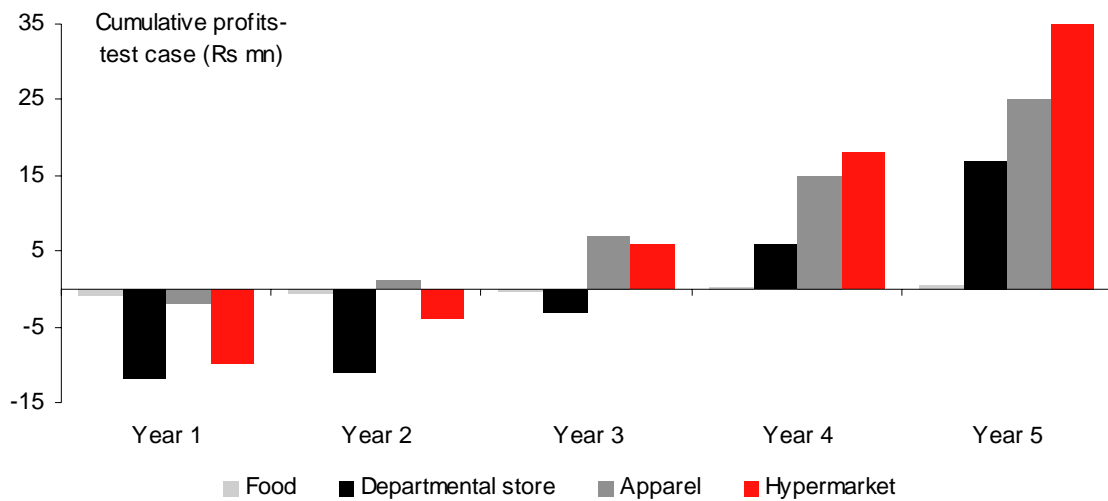
Consequently: Hypermarkets offer higher returns and have a quick payback period

Fig 4 Hypermarkets have highest returns



Source: Cris Infac, Macquarie Research, May 2007

Fig 5 Payback period is best for hypermarkets and apparel retail



* Note that this graph denotes absolute profits for test cases and is not indicative of profitability. We have used this chart to only compare the payback period

Source: Cris Infac, Macquarie Research, May 2007

In summary; we rank the profitability of various formats based on attractiveness on multiple quantifiable and subjective parameters (Figure 6). While the returns (ROCE) for all formats are attractive, food retail and hypermarkets also clearly score better than the other segments.

We also note that current anecdotal evidence in India suggests that we are seeing the highest revenue per sqf in food retail and hypermarkets.

Fig 6 Overall attractiveness of the four models

Format	Initial size	Capital employed	Stock turns	Working capital intensity	Revenue per sqf	Overall rank
Food						
Hypermarket						
Apparel						
Department store						
Highest rank on parameter attractiveness						
Lowest rank on parameter attractiveness						

Source: Cris Infac, Macquarie Research, May 2007

Important disclosures:

Recommendation definitions

Macquarie Australia/New Zealand

Outperform – return >5% in excess of benchmark return (>2.5% in excess for listed property trusts)
 Neutral – return within 5% of benchmark return (within 2.5% for listed property trusts)
 Underperform – return >5% below benchmark return (>2.5% below for listed property trusts)

Macquarie Asia

Outperform – expected return >+10%
 Neutral – expected return from -10% to +10%
 Underperform – expected return <-10%

Macquarie First South Securities (South Africa)

Outperform – expected return >+5%
 Neutral – expected return from -5% to +5%
 Underperform – expected return <-5%

Recommendations – 12 months

Note: Quant recommendations may differ from Fundamental Analyst recommendations

Recommendation proportions

	AU/NZ	Asia	RSA
Outperform	44.37%	58.37%	42.60%
Neutral	44.01%	21.30%	46.80%
Underperform	11.62%	20.33%	10.60%

For quarter ending 31 March 2007

Volatility index definition*

This is calculated from the volatility of historic price movements.

Very high–highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30–40% in a year.

Low–medium – stock should be expected to move up or down at least 25–30% in a year.

Low – stock should be expected to move up or down at least 15–25% in a year.

* Applicable to Australian/NZ stocks only

Financial definitions

All "Adjusted" data items have had the following adjustments made:
 Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
 Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit / efpowa*

ROA = adjusted ebit / average total assets

ROA Banks/Insurance = adjusted net profit / average total assets

ROE = adjusted net profit / average shareholders funds

Gross cashflow = adjusted net profit + depreciation

*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

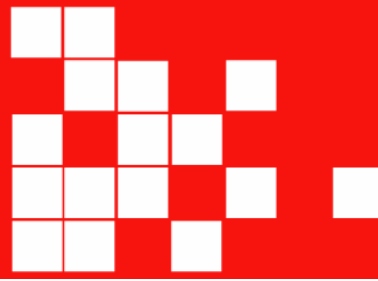
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