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November 22, 2006

India Economics

The Retail Revolution – Part I – The Macro Story

What's New: Indian retail continues to be one of the largest sectors attracting fresh investments from the private sector. Apart from existing players (such as Pantaloon) ramping up their retail chain store operations, many large business groups, including Reliance Industries, Birla group, Bharti Enterprises have announced their intention to cumulatively invest over US$10 billion over the next five years to capture a share in the fast-growing pie of the organized retail sector.

Conclusion: In the first phase of the retail revolution, the focus of entrepreneurs has been largely on capturing the consumers' attention and providing them with a new shopping experience. There has been little effort on restructuring the back-end of the supply chain. However, going forward, the rising scale of organized retail distribution network and increasing competition will force players to focus on reforming the whole supply chain.

Implications: Although total spending through the organized retail chain store format is likely to be only about 10% of the total addressable market, the impact of this trend on productivity across the retail food chain can be more than proportionate. We believe it will help accelerate productivity growth and reduce inflation, increase export competitiveness, and increase productive job opportunities.

Risks: This risk is that political parties get overly concerned by the adverse impact on the welfare of a specific segment of the population dependent on mom and pop shops versus the overall big-picture positive impact on the lower middle-income group. Indeed, we believe the emergence of the organized retail sector will create new jobs for a different section of the lower middle-income group in small-scale manufacturing, construction, infrastructure and transport sector.

The Retail Revolution – Part I – The Macro Story

Domestic Private Sector Is Rushing to Announce Retail Plans

Even as the government continues to delay the decision to allow FDI in multi-product retail chains, the fast-emerging Indian retail sector is becoming widely recognized amongst domestic entrepreneurs and investors as one of the biggest opportunities in India. Apart from existing players (such as Pantaloon) ramping up their retail chain store operations, many large business groups, including Reliance Industries, Birla group, and Bharti Enterprises have announced their intention to cumulatively invest over US$10 billion over the next five years to capture a share in the fast-growing pie of the organized retail sector. In addition, various foreign players like Walmart and Tesco have announced their intentions to enter the domestic market via a joint venture with a domestic Indian player. Major consumer spending items currently form part of the addressable market for the retail chain stores format and include food and grocery, general merchandise (such as furniture and furnishings), and apparels. While growth estimates for the organized retail sector vary, forecasts by our Consumer analyst, Hozefa Topiwalla, indicate that India's organized retail market is likely to grow from the current US$4 bn (2.1% of total relevant consumer spending) to US$ 64 billion (10.8%) by F2015.

It's Not Just About the New Shopping Ambience

Up until 2002, even consumers in India's top cities, such as Mumbai, had no choice but to purchase their daily food and consumables from small-scale mom and pop stores. Meaningful introduction of organized retail chains across the major metros has started only over the past 3–4 years. Prior to this, the Indian consumer had access to a limited variety of goods and the quality of available goods was poor. The existing distribution system is completely fragmented with mom & pop shops that operate with little use of technology. Inventory management is inefficient and the fragmented structure implies that they have little negotiating power, while purchasing goods from wholesale traders.

However, the shopping experience for Indian urban consumers is now changing completely. What is triggering this change? On the demand side, rising per capita income of the fast emerging middle-aged population and easier access to credit are triggering a change in consumption patterns. On the supply side, the private sector is responding with investments, taking advantage of the positive support from capital markets. Retail shopping space is also growing exponentially. Mall space has increased to 54 million square

Exhibit 1

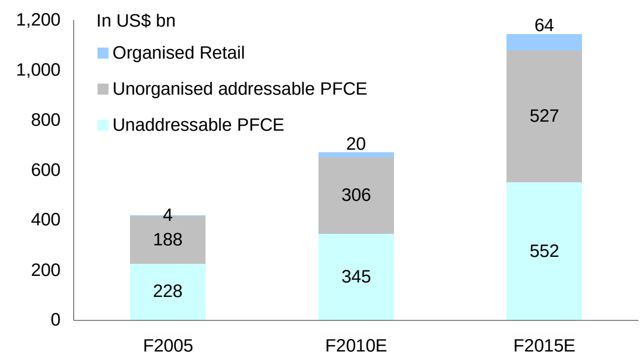
India's Retail Sector: Basic Facts

- India's *relevant* private final consumption expenditure (PFCE) is estimated to be about US$221 (28% of GDP) billion as of F2006. Note we are excluding part of PCFE such as rent, fuel & power from the relevant spending estimate.
- Currently, Indian retail distribution is completely fragmented with about 12 mn players operating from small shops and handcarts.
- Organized retail sector is currently just about 2.2% of the total relevant PFCE
- Overall PFCE is estimated to have grown at 11.6% over the last three years.
- Organized retail sector is estimated to be growing at 15-20%.
- Wholesale and retail trade sector currently contributes to about 13% of GDP and employs about 40 million people.
- Food and beverages account for 38% of the total retail spending.

Source: CSO, Morgan Stanley Research Estimates

Exhibit 2

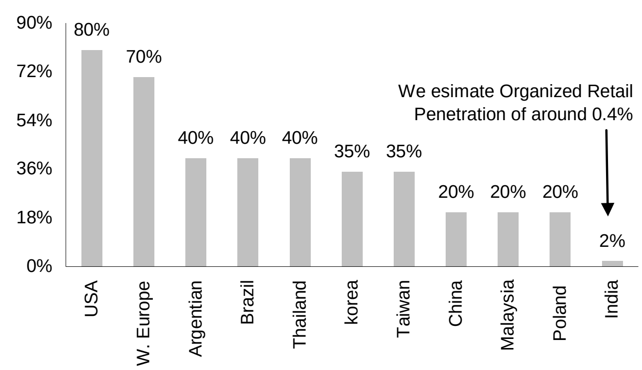
Organized Retail Opportunity



Source: CEIC, CSO, ACNielsen, Morgan Stanley Research
E= Morgan Stanley Research Estimates

Exhibit 3

Penetration of Organized Retail



Source: FDI In Retail Sector (ICRIER), Morgan Stanley Research feet (mn sq. ft) currently from 2.2 mn sq. ft four years back. According to Images Retail, the space is likely to rise further to 88 mn sq. ft by the end of 2007.

In the first phase of the retail revolution, the focus of entrepreneurs has been largely on capturing the consumers' attention and providing them with a new shopping experience. There has been little effort on reforming the back-end of the supply chain. However, going forward the rising scale of organized retail distribution network and increasing competition will force players to focus on reforming the whole supply chain to improve productivity and provide an attractive deal to customers.

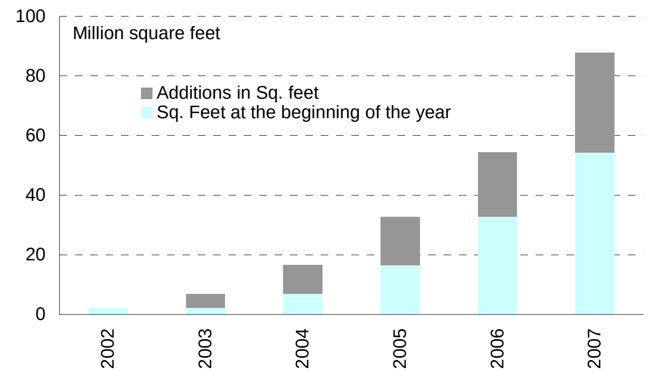
Restructuring the Supply Chain

The retail revolution, involving an increase in input of capital, technology and new management practices, can potentially reform each and every part of the retail business chain over the next few years. It will restructure: (a) retail distribution via higher asset turnover and better inventory management; (b) intermediary and logistics management; and (c) production management in the case of both agriculture and manufacturing. Although, total spending through organized retail chain store format is likely to be only about 10% of the addressable market by F2010, the impact of this trend on productivity across the retail food chain can be more than proportionate, in our view.

***Transformation in retail distribution*:** Currently, Indian retail distribution is completely fragmented with about 12 million players. The majority of these are very small players operating from small shops (below 50 square feet in size) and handcarts. These retail outlets are spread across the country in over 5,000 towns and 600,000 villages. In the absence of complete data related to the distribution of current mom and pop retail shops, distribution of fast-moving consumer goods (FMCG) distribution could be used a proxy, in our consumer analyst's view. Data from AC Nielsen indicates that the top six cities contribute around 19% of FMCG consumption, whereas the top 23 towns represent around 29%, and the top 301 towns about 48%. In our view, large retail companies are likely to be more aggressive in the top 20–30 towns. Penetration in the smaller towns is not likely to begin in a hurry. Apart from obvious improvement in consumer satisfaction, retail chain store distribution will help improve efficiency in distribution via higher asset turnover and better inventory management.

Reducing large inefficiencies in the agriculture related supply chain: This segment suffers from maximum inefficiency currently. Cumulative wastage in this supply chain

Exhibit 4
Growth in Mall Space



Source: Images Retail, Morgan Stanley Research

is estimated to be about US$11 billion, or 9.8% of agriculture component of GDP. Over the years, owing to government intervention in the input and output pricing, there has been little incentive for farmers to improve efficiency. Moreover, in the past few years, public investment in agriculture as a percentage of GDP has also been gradually declining. The archaic infrastructure for reaching the agricultural produce from farm-gate to consumers has meant huge losses in transit and large markups in pricing due to extra layers of intermediation. Until recently, most states controlled the marketing of agricultural produce through the Agricultural Produce Marketing Committee (APMC) Act. Not surprisingly, due to this lack of government support on infrastructure and restrictions on private sector participation, the agricultural sector has only been growing at an annual average of 1.8% over the past five years.

However, the outlook for the agricultural sector is finally improving as state governments have started implementing legislative reforms. Thirteen states and three union territories have amended the APMC Act allowing private sector participation in direct purchases of agricultural produce from farmers. We believe that the rise in presence of the organized retail sector will accelerate reform in the agriculture sector. Farmers will be incentivised to adopt improved management techniques to increase efficiency, better quality output and also provide the needed variety to consumers. As scale builds up, increased commercial opportunity should also attract the private sector in agriculture logistics management, reducing the number of intermediaries. The plans announced by some of the likely large retail players reflect the potential food-chain restructuring that could take place.

Indeed, certain large players have already begun participating and investing in this area. For instance, ITC – a large Indian FMCG company – has initiated an effort to place computers with Internet access in rural farming villages (known as e-choupals[1]). Via these kiosks, the company provides the farmers with a more transparent pricing mechanism and secure operating framework. The company has been able to procure agricultural products are at a lower cost and farmers are able to increase their realizations.

SME manufacturing will get major demand boost and also face pressure to increase efficiency: The development of the organized retail sector should also result in restructuring of small and medium scale manufacturing. We believe that some of the large players in the retail business will encourage the emergence of efficient small and medium-sized suppliers of modern retail goods. Two major segments in the small and medium scale manufacturing sector that could get a boost from the emergence of the retail chain stores are textiles & clothing and food processing industries. In industries such as fast moving consumer goods, where India already has a large organized sector presence in the supply chain (via MNC's and domestic companies), efficiency will come from better inventory management and responsiveness to customer feedback.

However, in the near term, the organized retail chain stores could rely on imports for certain segments such as toys, select types of general merchandise and electronics goods. Unlike India, China's organized retail sector is being developed before a globally competitive SME sector has been developed. Moreover, China has already built economies of scale advantages in certain goods where it will be difficult for Indian players to compete in the near term. Success of Indian players will also be dependent on the government's support in improving infrastructure and enabling tax legislations.

Intermediation/Logistics: One of the key hurdles to Indian agriculture and small/medium scale manufacturing sector productivity growth has been lack of infrastructure support from the government. In 2005, infrastructure spending was US$28 billion in India (3.6% of GDP) compared with US$201 billion in China (9.0% of GDP). The IMD World Competitiveness Year Book (2006) ranks India 47th among 61 nations in terms of distribution efficiency. The reason for this poor score is inadequate investment in infrastructure and the fragmented nature of the logistics industry. We believe that development of the organized retail sector could trigger a change in this industry as manufacturers and retailers rely on outsourcing to third-party logistics providers and also create economies of scale advantages for warehousing and transportation.

[1] "Choupal" is a Hindi word that translates into meeting place.

Macro Impact – More Positive than Negative

The emergence of the organized retail sector is likely to have a transcending impact on India's macro. Some of the key macro implications are summarized as follows:

Productivity growth and inflation: The obvious positive effect of the emergence of organized retail trade in the competitive market will be an increase in productivity and reduced inflation in the economy. The productivity benefit will stem from the aforementioned supply chain changes and the increased disintermediation in the system. For instance, according to a study by the McKinsey Global Institute, the retail sector contributed to nearly one-fourth of the productivity growth jump in the United States from 1987-95 to 1995-99. The productivity benefit will likely be shared with the consumers (lower end-product prices) – hence leading to lower inflation.

Trade balance and export competitiveness: Initially, due to supply-side constraints and lack of economies of scale in select goods, increased demand could lead to an increase in imports from other countries and a wider trade deficit. Our discussion with the existing retail chain store players indicates that currently, chain stores that cater to the middle class segment of the population already have an import content of about 15%. Chain stores that cater to the upper middle class and higher income population tend to have an even higher proportion of import content. Over the next few years, as the small and medium scale sector further builds scale and capabilities to manufacture, they could be able to substitute imports of some of these goods as well as improve their revenues from exports of agricultural and manufactured products. We believe this trend will be further supported if the FDI in retail is allowed.

Employment trend: The retail and wholesale trade sector contributes to 13% of GDP and employs about 40 million people (9% of workforce). It is the third-largest employer after the agriculture and manufacturing sectors. The sensitivity of the retail sector restructuring on lower middle class population is indeed very high. A large of number of households depends directly on this sector for their livelihood. A majority of these mom and pop shops are very small in size (below 50 square feet) and are being used as a last resort employment opportunity by many of the low skilled working-age population. In many ways, it has been acting as a safety net for a specific section of the poor.

Over the next two-three years, the development in the retail sector may not have significant impact on the existing mom and pop shops. However, in the medium term, as the reach of chain stores increases, some adverse impact on mom and pop shops is inevitable. We believe that not allowing FDI in the retail sector is hardly a solution to prevent the adverse effect, as the domestic private sector will still be a force to reckon with. In our view, opposition to evolvement of organized sector retail chain stores is no less legitimate than opposition to removal of protection provided to many sectors in the early 1990s liberalization program. The liberalization program of the 1990s had also forced a major restructuring of the workforce. Restructuring of an economy that is still at a developing stage in today's globalizing, competitive world is inevitable. Embracing such a change for less difficult for a country like India who's population has a median age of 24 years.

The issue of employment should not only be assessed from the perspective of welfare of specific segment of lower middle-income group (LMIG) population dependent on mom and pop shops but also from the viewpoint of welfare of the overall LMIG population. Although a specific section of LMIG already employed in mom and pop shops may be adversely affected, the emergence of the organized retail sector will create new jobs for a different section of lower middle class in low-end modern retailing distribution, small-scale manufacturing, packaging, construction, infrastructure and transport sector. Moreover, we believe that the lower middle-class also stands to gain from the higher productivity (in the form of lower inflation) benefit that the organized retail sector offers. The quality of employment will also see a vast improvement as larger institutions will be able to provide better social security, training and growth opportunities. Indeed, increased organized sector activity should help increase aggregate tax to GDP that would allow the government to initiate measures for direct intervention for reducing the adverse impact on any specific section of the population.

Pace of Change Will Depend on Government's Response Function

While we believe that the emergence of the organized sector will itself be a trigger to restructuring of the supply chain, government's response in enabling this transition will be a key factor in determining the pace of the improvement. Some of the areas where a supportive role from the government will be important:

Infrastructure investments: Although we expect some push to infrastructure investments from the private sector as it attempts to build an organized supply chain, there is clearly a need for a strong response from the government in building the infrastructure needed for quick transition in the supply chain. We believe that the primary responsibility for development of infrastructure lies with the government. These projects by their very nature are long-gestation and low ROE projects that are highly dependent on government regulations. The response from the government on infrastructure development will determine Indian producers' (SMEs and farmers) capability to compete with other developing economies like China in filling up the shelves of the organized retail format. Although infrastructure spend is finally picking up as a percentage of GDP, the pace needs to be more rapid.

Foreign direct investment: In January 2006, the government approved new FDI norms for the retail sector and allowed up to 51% FDI in single-brand retailing. However, the decision to allow foreign direct investment in the multi-product retail chain stores has been delayed and remains a politically sensitive issue. There are some political groups who are opposing this decision due to its perceived implications on the mom and pop shops. We believe that not allowing foreign players is hardly resolving the issue as the domestic private sector is continuing to ramp up retail chain stores in any case. Indeed, if participation of foreign players is allowed in partnership with domestic players, it can help evolve the sector in a more efficient manner as these foreign players bring technology and expertise. Increased presence of the foreign players can also potentially help Indian manufacturers participate in the international goods outsourcing market – an area where India has struggled to compete with China. We believe that if the government desires to be conservative, it could allow FDI with certain restrictions. The entry of foreign players could be restricted by limiting the geographical distribution and the quantum of stores that can be opened in a particular region. The government could screen the entry of foreign players on the basis of minimum investment requirements. Foreign players could also be required by the government to have a minimum domestic sourcing requirement or even have a reciprocal goods outsourcing requirement.

Agriculture sector: One of the key reasons for the low growth in the agriculture sector over the past few years has been the gradual decline in the government's capital spending on the sector to 0.5% of GDP in F2006 from 1.2% in F1982. Although the government has finally started initiating measures on improving agricultural productivity, the pace of the change is still slow. The government needs to make a concerted effort to increase capital investment in the agriculture sector and improve the effectiveness of current spending. In addition, the government also needs to support an acceleration in agriculture productivity growth in the sector (via a better fertilizer pricing policy and improved irrigation facilities) and also help diversify the agriculture product mix (via provision of better storage facilities, encourage the development of the food processing industry and provide proper crop insurance products). Finally, the government also needs to further liberalize trade in the agriculture commodities so that farmers become more commercially oriented towards export markets.

Legislative Reforms: The government needs to create an enabling environment in many areas to ensure swift development of the sector.

Various states are yet to implement legislative reforms in property related laws such as the Urban Land Ceiling Act, Stamp Duty laws and Rent Control Act. These laws have been slowing property development in the country and hence have been one of the factors resulting in rising property prices (and hence rentals). These high prices could prove to be a major hurdle for the organized sector retail players in acquiring the necessary real estate.

In addition, the government also needs to ensure quick implementation of the reform in the inter-state trade-related taxation law. Currently, the central government charges 4% sales tax on all inter-state sales of goods. This regime encourages companies to set-up storage facilities in each state to avoid being taxed on these movements. This proves to be a disincentive to the development of a nation-wide distribution system, especially via third-party logistics providers. Indeed, the government has announced a road-map wherein the levy on output by the central government (central sales tax) will be merged in common nation-wide rate by April 2009.

In part-II (to be released on November 24, 2006) we will focus on how the emergence of organized retail will benefit the entire agriculture supply chain

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