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Equities Research

The Asia Specialist

## INDIA

### Key listed retailers in India

| | Ticker | CMP Rs | Mkt Cap (US$ mn) | Consensus PER FY13E | Consensus PER FY14E | Avg. Traded value US$ mn |
|---|---|---|---|---|---|---|
| Pantaloon Retail | PF IN | 158 | 664 | 26.0x | 16.2x | 15.1 |
| Trent Ltd | TRENT IN | 1,085 | 652 | 125.4x | 55.1x | 0.7 |
| Shopper Stop | SHOP IN | 356 | 546 | 89.3x | 43.0x | 0.3 |

Source: Bloomberg, Macquarie Research, Sept 2012, Forward PER are Bloomberg consensus, All stocks are not rated, Prices as of 14 September 2012

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Macquarie Capital Securities India (Pvt) Ltd

# India Retail Sector

## Policy boost in multi-brand retail

### Event

- Indian government has approved the 51% foreign direct investment (FDI) in multi-brand retail (MBR). FDI in MBR was first approved in Nov-11, but the implementation was put on hold due to political opposition. Government has left the final decision to the state governments. 11 states have expressed their support for this policy, while six states have expressed their reservations.
- We view this as a positive for the Indian retailers as they will now have access to the much needed capital, scale advantage and global best practices.

### Impact

- **Key highlight of the policy allowing FDI in multi-brand retail:**
  - ⇒ Retail sales outlets may be set up only in cities with a population of more than 1mn as per 2011 Census (within a radius of 10kms).
  - ⇒ Retail sales outlets may be set up in those states which have agreed or agree in future to allow FDI.
  - ⇒ 50% of total FDI brought in will have to be invested in the `back-end infrastructure` within three years.
- **FDI is a positive, but it's not the panacea for the sector.** FDI approval will be a positive for retailers as they will now have access to the much needed capital. In India, organised retailers operate with several limitations, of which restricted access to capital is one. Even well funded business groups have not been able to grow their retail businesses rapidly. Similarly, despite its global expertise Wal-Mart hasn't been profitable in China for last 12 years.
- **Key reforms for retail sector** will be implementation of i) Model Agricultural Products Marketing Committee (APMC) Act across all states and ii) goods and services tax (GST). However, these reforms continue to face political opposition. Model APMC Act was finalised in 2003 with an aim to develop a "barrier-free national market", but many states are yet to adopt it. GST is likely to remove inefficiencies in logistics and taxations, but some states oppose it.
- **Incumbent retailers likely to divest stake to global partners.** The first beneficiaries of the FDI limit hike will be incumbent retailers, who will now look to unlock value by divesting stakes to strategic partners. From global retailers' perspective their expectations from Indian partners will be i) deep understanding of Indian consumers and ii) access to existing and future prime-retail space. The key challenge for Indian retailers will be to restructure their existing business to meet the stringent norms.

### Outlook

- **A positive step, but implementation will be key.** The Growth prospect of organised retail in India is large due to low penetration. However, profitable growth has eluded most of the retailers, so far. We view today's government decision to allow FDI in multi-brand retail as a step in the right direction; however implementation along with removing barriers (discussed above) is important.

# FDI is a positive step, but not the panacea

The inflow of foreign investments in India is governed and regulated by the government's Foreign Direct Investment (FDI) policy. Today's government move to permit 51% FDI in multi-brand retail is positive. Indian organised retail operates with several limitations, of which lack of capital is just one. Retail sector ails from the poor infrastructure, high real estate costs, inefficient supply chain, complex taxation and rigid labour laws. Given the opposition from several state governments, we believe the FDI will be gradual and any benefits will be realised only in the long-term.

We present three cases – i) METRO Cash & Carry ii) Reliance Retail and iii) Wal-Mart China to illustrate our point.

**Case study: METRO Cash & Carry – challenges for retail growth not limited to FDI**

METRO Group is one of the largest trading and retailing groups in the world with 2011 revenues of €67bn. METRO Cash & Carry started operations in India in 2003 by opening two distribution centers (DC) in Bangalore. METRO was the first company to introduce the concept of Cash & Carry to India. METRO has eight cash & carry stores in India today. They have two stores each in Bangalore, Hyderabad and Mumbai and 1 in Ludhiana, Jaipur, Delhi and Kolkata.

**Fig 1 METRO Cash & Carry store in Bangalore**


Source: Macquarie Research, September 2012

**Fig 2 Non-food assortment in METRO store**

Source: Macquarie Research, September 2012

- METRO focuses on cash & carry business in India. They expect Indian retail market to remain fragmented, which is a positive for cash & carry business.
- They found cash & carry business attractive as 100% FDI was allowed and globally this format has been their key strength.
- METRO has 11 stores in India and they would like to double the number of stores in one year. METRO had revenues of €200mn in India last year. They have been slow in adding new stores as it took them time to get the 'right model' for India.
- Key challenges that they face in India: Red tape makes doing business in India very difficult, multiple approvals/licenses from various agencies and availability of reasonable priced real estate.
- Only seven states have implemented the model APMC Act. Initially, they were not allowed to sell fresh foods in their stores. They took the legal route and got a favourable verdict after 5 years of legal process.
- Even the states that have reformed APMC act are not implementing it due to the vested interests. For example, Karnataka doesn't allow a private player to set-up a mandi within 25km of an existing mandi, thus protecting the trading community.

**Case study: Reliance Retail – Not constrained for capital, but success eludes them**

Reliance Industries (RIL IN, Rs842, Neutral, TP: Rs759, covered by Jal Irani) is the largest corporate in India. RIL's market capitalisation is US$50bn and they make annual profits of >US$4bn. RIL had entered the retail business in 2006 and had set ambitious growth targets for 4-5 years. Given the growth potential of organised retail in India combined with Reliance's financial and execution strengths, these targets were seen as realistic.

During the last five years, Reliance Retail has changed the senior management team three times. Recently, they have hired a team from Wal-Mart China that will be replacing the previous team that was hired from Tesco Lotus, Thailand.

Company's focus area has also undergone a big change during the last three years. Initially, *Reliance Fresh* was the focus area. Now, company is focusing mainly on *Reliance Mart*, *Reliance Trends* and other speciality formats.

**Reliance Retail – 2007**

- **Investment**
  - ⇒ **Expected investment** over the next 4–5 years: US$6bn.
- **Operations**
  - ⇒ **Planned retail space:** 100m sqf in ~800 cities and towns by CY10 (FY11).
  - ⇒ **Target revenues:** US$22bn by FY11.
  - ⇒ **Brands:** Reliance Fresh – food retail; Ranger Farms – wholesale-format stores.
  - ⇒ **Store lease versus ownership:** Combination (we estimate 50% owned and 50% leased).
  - ⇒ **Store formats**: Hypermarkets, smaller formats for food & general merchandise, specialty retail.
  - ⇒ **Business model:** 'Hub-n-spoke' and 'cash-n-carry' outlets in stores for distribution to local retailers. May convert local stores into Reliance franchisees
  - ⇒ **Procurement:** Direct from farmer 'mandis' (markets). Contract farming possible.

Source: Company data, Press reports, September 2012

**Reliance Retail – 2011**

- **Reality versus targets**
  - ⇒ **Investment** (till FY11): US$1.3bn
  - ⇒ **Expansion:** Retail expansion was put on hold for two years. After several round of restructuring, company is now ready for expansions
  - ⇒ **Number of stores:** 1,050, number of stores has come down after company closed several unviable stores
  - ⇒ **Retail space:** Largest retailer has 16mn sqf of retail space. We expect Reliance to be at 4-5mn sqf in 86 cities.
  - ⇒ **Revenues:** US$1.1bn in FY11. Net loss of US$100mn.
  - ⇒ **Management team:** 3rd overhaul in last 5 years. New team is from Wal-Mart China that will replace the previous team that was hired from Tesco Lotus, Thailand.

Source: Company data, Press reports, September 2012

**Case study: Wal-Mart China – Global model doesn't ensure success in all markets**

Wal-Mart is the world's largest retailer. They use the most sophisticated supply-chain management system to source goods from the lowest wage countries, which it sells for the lowest price to the most customers in the world's largest consumer market, US.

Outside US, Wal-Mart's expansion has been bumpy. Mainly through the acquisition of its rivals, it has become a dominant retailer in Canada, Mexico and UK, but it has done poorly and pulled out of other markets like Germany, Japan and South Korea.

In recent times, Wal-Mart's main preoccupation has moved from enlisting more suppliers in China to attract more Chinese shoppers.

**Fig 3 China market is fragmented – top 10 players account for 5% of retail sales**

| Company | Main formats | Sales (US$ bn) | Growth (%) |
|---|---|---|---|
| Sunning Appliance Group | Electronics speciality | 17 | 14.3 |
| Gome Electrical Appliances | Electronics speciality | 15 | 2.1 |
| Bailian Group | Supermarket, Department Stores, Convenience | 14 | 3.8 |
| Dashang Group | Supermarket, Department Stores, Electronics | 10 | 12.8 |
| Vanguard | Supermarket | 10 | 6.6 |
| RT-Mart International | Supermarket | 6 | 20.5 |
| Carrefour (China) | Supermarket | 5 | 8.2 |
| Anhui Huishang Group | Supermarket, Department Stores, Electronics | 5 | 13.5 |
| Wal-Mart China | Supermarket | 5 | 22.2 |
| Wumart Holding | Supermarket, Department Stores, Electronics | 5 | 6.7 |

Source: Company data, Macquarie Research, September 2012

- Foreign chains such as Carrefour, Wal-Mart and Tesco have been present in China for years. Yet neither they nor any of their local rivals comes close to dominating China.
- Wal-Mart entered China in 1996, five years before the country liberalised its retail industry. Yet despite starting early, it has advanced slowly.
- Next big thing for retailers in China is the less-developed cities of the country's interior. It's a "land-grab situation". Everyone is vying for first-mover advantage.
- Retailers depend on local government for a licence and a place to operate. The prime space always goes to local players. Bailian group, China's biggest retailer, is state-owned.
- Neither Carrefour nor Wal-Mart has much more than 6% of the organised retail market.

**Key challenges faced by Wal-Mart in China**

<u>Logistics and supply-chain</u>

China's infrastructure – while more efficient than other developing countries, there are still plenty of bottlenecks. Some of these are physical, most of it is attitudinal. Many Chinese suppliers are having a tough time adjusting to the rigorous standards of the modern supply chain management systems. Another bottleneck is scale; Wal-Mart's operations in China are not yet large enough to reap benefits from its logistics system.

Wal-Mart's global sourcing strategies are forcing changes in the way Chinese suppliers operate. Suppliers have resisted against razor-thin margins.

<u>Labour issues</u>

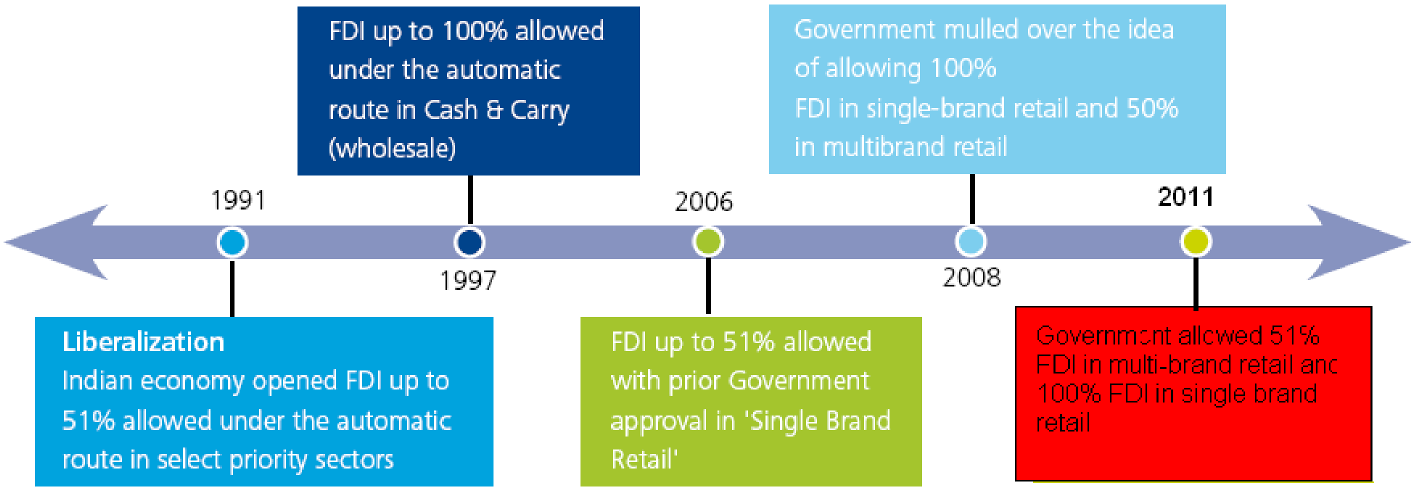
Wal-Mart has been facing labour issues in their operations as well as at the suppliers' factories. Wal-Mart and other retailers have been under-pressure to allow branches of state run trade unions into its stores. In China labour unions are vastly different from their western counterparts. After years of fierce opposition, Wal-Mart has accepted labour unions.

## Retail sector has gradually been opened up for FDI since 1997

Since 1997, government has gradually opened up the retail sector for foreign investments despite the reservations in certain quarters that opening up of retail sector will lead to job losses, predatory pricing, reduction in farmers' price realisation and loss of entrepreneurial opportunities. The response from foreign retailers to the earlier attempts of partial liberalisation was very cautious. No retailer has made any major investment commitment yet.

The retail sector in India is organised into three categories i) single brand retail ii) multi brand retail and iii) cash & carry. In 2006, FDI in single-brand retailing was permitted to the extent of 51%. An FDI inflow of nearly US$194mn was received between April 2006 and March 2010, comprising 0.21% of the total FDI inflows during the period.

**Fig 4 Retail sector has gradually been opened-up for foreign retailers since 1997**




Source: Company data, Macquarie Research, September 2012

Last year, government raised FDI limit in single brand retail to 100% from 51% earlier. In the multi-brand retail, government has now allowed 51% FDI. Foreign retailers will be allowed to open stores in cities with >1mn population (53 cities). 100% FDI is permitted in the cash & carry segment.

FDI in multi-brand retail is likely to be beneficial for the country as it will lead to:

- **Improvement in the supply chain infrastructure**: FDI can bring about an improvement in supply chain infrastructure and investment in technology and skill development.
- **Improvement in farmer income:** Price realisation for farmers selling directly to organised retailers is expected to be much higher than that received from selling in the mandis.
- **Benefits to customers in the form of better quality** of products and lower prices: Past trends indicate that consumers will benefit from organized retail in the domestic market.

The earlier attempts by the government to partially open the retail sector for foreign retailers have attracted limited investments so far. Global retailers didn't commit large investments as FDI in the front-end retailing was not permitted. However, as 100% FDI was allowed in cash & carry, companies have opened few stores and built back-end capabilities and developed an understanding of the Indian consumers. Since the opening of the sector in 1997, the penetration of organised retail has increased from 1% to 7%.

## Model APMC and GST implementation are the crucial reforms

We think key drivers for the sector will be implementation of i) Model Agricultural Products Marketing Committee (APMC) Act across all states and ii) implementation of goods and services tax (GST). Model APMC Act was finalised in 2003 with an aim to develop a "barrier-free national market", but many states are yet to adopt the Model Act. GST is likely to remove inefficiencies in logistics and taxation system, but some states oppose it.

# Great Indian retail opportunity

According to A T Kearney study, Indian retail market is ~US$435bn. Modern retail currently accounts for 7% of the total retail market and is expected to reach ~20% by 2020. Format like hypermarkets has gained higher acceptability. Among categories, food constitutes ~70% of Indian retail, although it has less penetration in modern retail where apparel and clothing continue to have ~31% share. The home segment shows promise, growing 20 to 30 percent per year. India's more urban consumer mindset means this sector is poised for growth.

Domestic players are now drawing expansion plans more judiciously and increasingly focusing to tier-II and tier-III cities. Expansion plans of domestic and International retailers in India as announced:

⇒ Aditya Birla Retail has recently acquired 50.1% stake in Pantaloon fashion format from Pantaloon for Rs16bn with a total deal value of ~Rs32bn.

⇒ Aditya Birla Retail, operator of More stores, will invest about Rs15bn in the next five years as it plans to add 12-13 (60-70k sq ft.) *More Megastore* hypermarket and 150 *More* supermarket chain of stores each year for the next five years.

⇒ Bharti plans to have 160 Easyday stores and 22 Easyday Markets by end-2011. It has also opened its first hypermarket store *Easyday Hyper* in Mumbai in Oct-2011.

⇒ Reliance retail plans to open 2 hypermarket stores every month and currently operates 12 hypermarkets in India. Company currently operates ~1,100 supermarket and other speciality stores in India.

⇒ Wal-Mart to have 12 outlets in its cash-and-carry format by the end of 2011.

⇒ Metro Group plans 50 wholesale stores in the next five years.

⇒ International food retailer Spar plans to open 24 hypermarkets in the next two years.

⇒ RPG’s Spencer is expected to add up to 25 hypermarkets by 2012.

⇒ Carrefour is planning to have10-12 cash-and-carry outlets in India and is currently finalising lease deals.

**Tier-II and tier-III cities are the new battleground**

Although large metro cities will continue to be fulcrum of organised retail in India for medium-term, retailers have shifted gear to tier-II and tier-III cities to get first-mover advantage and sign deals of retail real estate which is still in limited supply. Growing consumerism coupled with rising disposable income in these cities has drawn attention of retailers in a big way. Pantaloon with presence in 85 cities is leading at the moment, but other players such as Spencer's, Spar, Reliance Retail, Shoppers Stop and Trent are incrementally focusing on these cities.

**Why consumers prefer modern retail…**

⇒ Convenience of getting most of the brand under single umbrella in case of departmental and hyper markets stores

⇒ Better shopping experience and ambience relative to mom and pop stores

⇒ Rising population of working women and growth of nuclear family led to higher monthly/fortnightly shopping in stead of shopping when need arise

⇒ Wider choice of products which is missing on the shelf of nearby corner stores

⇒ Discount, freebies and better deals further attract shoppers to hypermarket/ departmental stores due to deal seeking nature of Indian consumers

## Fast urbanisation will accelerate modern retail boom

As urban population set to almost double in the next 25 years on account of higher employment opportunity (~70% of India’s GDP by 2030) and migration for better living, Shopping via modern retail trend is set to increase significantly. Bulging middle class (expected to go up by 100mn by 2030), working female households as well as rural areas in close proximity to cities should also add to modern retail boom.

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Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

Benchmark return is determined by long term nominal GDP growth plus 12 month forward market dividend yield

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Underperform – expected return <-10%

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

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Outperform – return >5% in excess of benchmark return
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Underperform – return >5% below benchmark return

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Outperform (Buy) – return >5% in excess of Russell 3000 index return
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### Volatility index definition*

This is calculated from the volatility of historical price movements.

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**Recommendations** – 12 months
**Note:** Quant recommendations may differ from Fundamental Analyst recommendations

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Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

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**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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# Asia Sales

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| Paul Colaco (New York) | (1 212) 231 2496 |
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| Angus Innes (UK/Europe) | (44) 20 3037 4841 |
| Rob Fabbro (UK/Europe) | (44) 20 3037 4865 |
| Sean Alexander (Generalist) | (852) 3922 2101 |

## Regional Head of Distribution

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## Sales Trading

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| Matthew Ryan (Singapore) | (65) 6601 0216 |

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| Kenneth Cheung (Malaysia) | (603) 2059 8888 |
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| Michael Santos (Philippines) | (632) 857 0813 |
| Isaac Huang (Taiwan) | (8862) 2734 7582 |
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