Equity Research | India

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MF Global Industry Update

Retailing

| FDI – Foreign Direct (Diluted) Investment in Retail; Expect Wal-mart to be a dominant force in North India

After 294 days of summer (given the heat this issue has generated) the Cabinet of Government of India has notified 51% FDI in multi-brand retail of initially approving and thereafter holding it abeyance with key change being that the final decision rests with the State Governments. We view this as a positive over the long term as it now gives access to most important resources of capital and technology to Indian retailers. The policy in the current form (with only 9 states and 1 union territory currently in favor of FDI) could deter entry of some players or slowdown plans as accessible market size is smaller than earlier anticipated. The impact of policy will be felt at the ground level only beyond FY14, for which there would have to be further reforms in areas such as taxation (GST), direct agri- sourcing (APMC Act). If the state of Punjab were to also accept the policy then it would give Wal-mart significant jumpstart in its Indian operations due to its existing presence through its JV. We maintain our recommendations as we expect impact of the policy on operations as near term opportunities of investment seem limited, **if at all**, not before FY14 and Trent would be the earliest beneficiary.

While the policy states that FDI funded stores can come up in cities with population over 1 mn the final decision rests with the state. There are 53 such cities (popn > 1mn) with an aggregate population of 160 mn (less than 10% of India's population). However, with only 9 states in favor of the policy there are effectively 15 such cities with an aggregate population of 65 mn. Thus, significantly diluting the earlier policy. However, we note that 7 out of the 9 states have initiated APMC (see annexure) reforms and hence would facilitated direct sourcing of agri output by retailers. If foreign retailers were to enter the country under current provisions their choice of partners with existing scale in FDI complaint locations would be severely limited. Also most companies would have to revisit their corporate structure to satisfy these conditions. Pantaloon and Reliance Retail (doesn't seek a foreign partner) being the players with significant presence in these locations.

We expect a re-rating of the entire sector only after foreign players warm upto the policy in its current form . We note that with important cities such as Bangalore, Chennai, Kolkotta and Ahmedabad alone aggregating to population of 38 mn outside the ambit of FDI tie ups will be either with players stong presence in the 15 cities or completely new ventures. The policy does give a roadmap for exisiting tie ups such as Tesco with Trent and Wal-mart with Bharti to be long term investors in these companies. However, given that 9 of Trent's 15 Star Bazaars are in Gujarat, Karnataka and Tamil Nadu investments, if any, by Tesco would be largely in future stores. But we do expect Tesco's operational involvement to increase further over the due course of time.

We also expect competetion to intensify in North Indian given that the states of Rajasthan, Haryana, Delhi and Uttarakhand would implement the policy and if Punjab were to join it would give significant to Bharti Wal-mart given their strong already presence in these regions through cash and carry as well front end Easyday stores. Moreover geographically these states are contiguous and hence would give it significant advantages in supply chain (already working with almost 2,000 suppliers). We note that although there are 195 easy day outlets over 180 of them are convenience stores, most of them in North India. With clarity on the policy we could see the roll out of it's large format stores.

We note that Pantaloon's board has recently approved the merger of its subsidiary Future Value Retail (FVRL) with its parent company. This move would be counter intitutive given that its the most likely beneficiary of this policy in its current form. The company is also likely to look for partners for its Home and Electroncis biz to begin with.We also highlight that only 45 stores out of the 162 operational stores would fall in cities with population above 1mn and where the state governments are in favor of FDI. Under these circumstances we see blue sky upside of 31% from CMP based on 1x EV/Sales for these 45 stores. **(Detailed analysis on pg 14).**

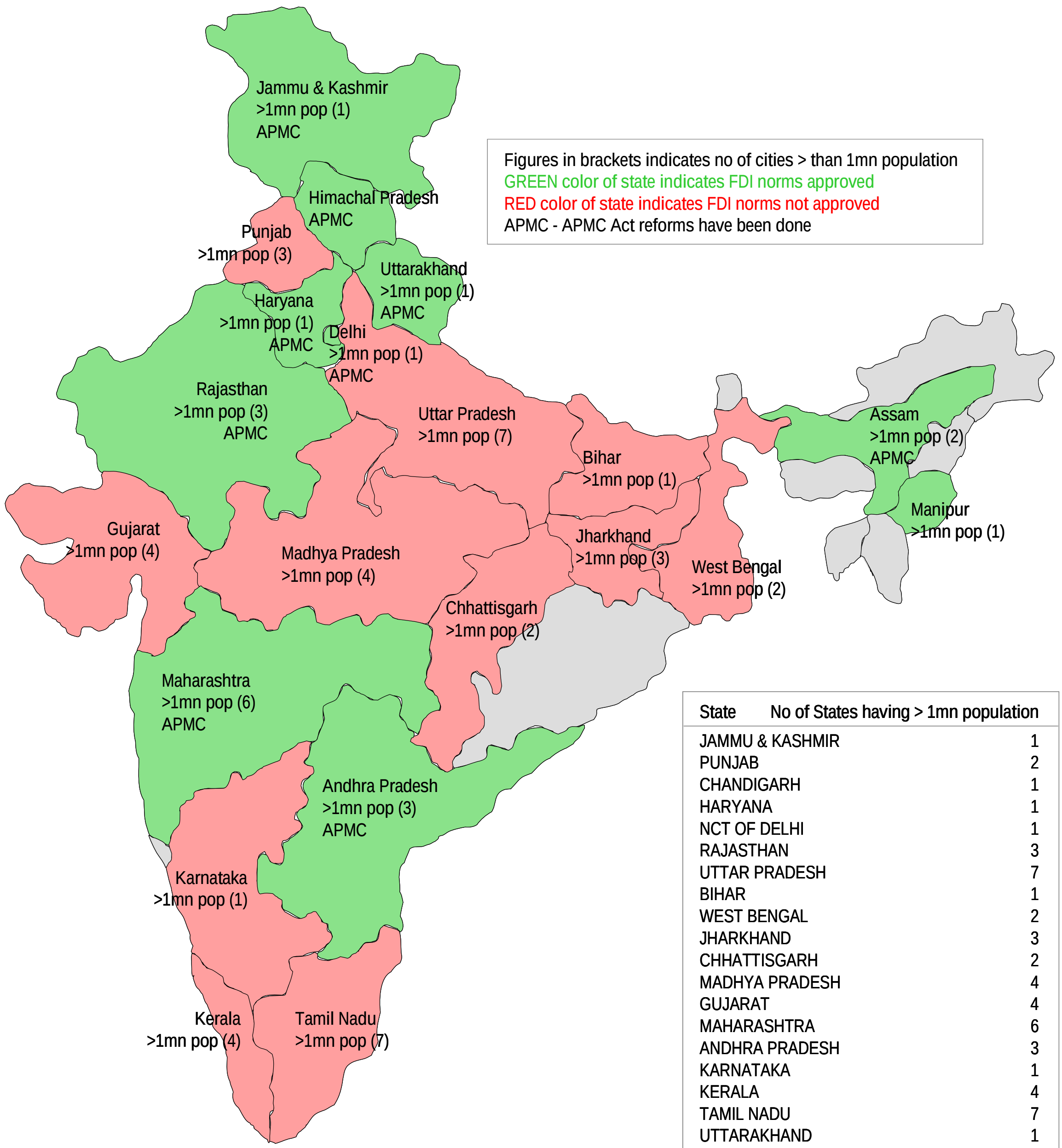
Implications: We see Wal-mart becoming a dominant player in the North India given their existing presence and acceptance of FDI by some of the states there. Trent's presence is West and South India and is likely to build on the same for efficient supply chain/back end. It remains to be seen if Pantaloon Retail decides to go ahead with its plans to merge its Hypermarket subsidiary with the parent company as the existing legal structure better facilitates partnership with foreign players. We maintain our recommendations and estimates (too early to assess operational benefits based on future tie-ups). Though Pantaloon Retail remains a potential beneficiary due to its size the conditions of operation of FDI funded stores in cities with population of over 1 mn with the States approval couple shrinks the bargaining chips for Pantaloon we estimate that only 45 of 162 Big Bazaars would satisfy these conditions .We could see more clarity emerging on Tesco's investment plans in Trent in the near future apart from increased involvement in its Star Bazaar business. We also expect Trent to bring in Inditex's (Zara) Massimo Dutti to India after relaxation of brand ownership rules in single brand retail. Shoppers Stop's Hypercity is likely to consider talks with foreign partners as well, however even their presence in largely in the States of Maharashtra and Karnataka (unlikely to implement the policy) We highlight that Trent (BUY) and Shoppers Stop (NEUTRAL) trade at ~1x FY13E sales whereas Pantaloon(NEUTRAL) trades at 0.7x/0.6x FY12E/FY13E sales. We continue to value Trent at 1x EV/Sales for its Hypermarket business and Shoppers Stop (with no tie up) at 1x EV/FY13E Sales.

Key implications of the policy:

- **Allowing 51% FDI:** this will give controlling interest to foreign retailers and hence they will be willing to pay a premium to acquire stakes in Indian retailing companies. Hence we see a imminent re-rating of Retail stocks.
- **Local sourcing:** While there is a rider which states that 30% of the procurement of manufactured processed products shall be sourced from small industries, we don't view this as major issue as 30-40% of the merchandise sold is General merchandise and apparel. In these categories sourcing from small industries is possible.
- **Investment in back end:** The policy mandates at least 50 % of the total FDI brought in shall be invested in back-end infrastructure over a period of 3 years, where 'back-end infrastructure' will include capital expenditure on all activities, excluding that on front-end units; for instance, back-end infrastructure will include investment made towards processing, manufacturing, distribution, design improvement, quality control, packaging, logistics, storage, ware-house, agriculture market produce infrastructure etc. Expenditure on land cost and rentals, if any, will not be counted for purposes of backend infrastructure. We note that such investments are natural business decision for global retailers and hence we don't see this rider as a deterrent.
- **Where can the stores come up:** Retail sales locations may be set up only in cities with a population of more than 1 million as per 2011 Census. This still allows stores to come up in 53 cities with an aggregate population of 116 mn. However, the policy places the onus of approval on the State and there with only 9 states - Delhi, Assam, Maharashtra, Andhra Pradesh, Rajasthan, Uttarakhand, Haryana , Manipur and Jammu & Kashmir and the Union Territory of Daman &Diu and Dadra and Nagar Haveli are in favor of the policy there are effectively 15 such cities with an aggregate population of 65 mn. In States/ Union Territories not having cities with population of more than the stipulated 1 mn as per 2011 Census, retail sales outlets may be set up in the cities of their choice, preferably the largest city and may also cover an area of 10 kms around the municipal/urban agglomeration limits of such cities.

- **Impact on Stocks:**
  - **Pantaloon – Impact Moderate-** We assess the various transaction multiples (EV/Sales), which Pantaloon can attract from a foreign retailer for controlling interest. It is very interesting to note that a 20% upward swing in the multiple increases the transaction value by 50%). We arrive at these multiples based on the revenue CAGR which results in the 3 year hence i.e. EV/FY15E sales shrinking to 0.5x.
  - **Trent - Impact Maximum-** The Company has only 6 stores out of the 15 operational ones in states which are in favor of FDI and in cities therein with population of over 1 mn. Similarly their store pipeline is skewed towards locations of Karnataka, Gujarat, Maharashtra and Tamil Nadu. With the exception of Maharashtra the other states are not in favor of FDI currently. However, as the policy evolves Tesco's involvement likely to increase and hence their impact could be visible on the operations sooner than later. Also, Tesco may consider investing directly in the future. Details on any such understanding between Tesco and Trent are not in public domain. The government has also relaxed the brander ownership conditions for foreign single brands. The erstwhile condition mandated ownership of the brand by the company applying for FDI in single brand investment. This acted as a deterrent (rejection of application) for Inditex's (owner of Zara) plans to bring in its Massimo Dutti brand to India. Though Inditex owns the brand at group level, the entity for Indian operations was a step down subsidiary (for taxation purposes). Post the relaxation of this condition we expect the addition of Massimo Dutti to Trent's portfolio after the tremendous success of Zara in India.
  - **Shoppers: Impact – Minimal-** Shoppers Stop's Hypercity may not necessarily scout for a foreign promoter and given their scale of just 12 stores the company may look at doing so once they have crossed a threshold. However, the company has indicated that they are open to exploring opportunities and given that 49% of shareholding is still with the promoters the policy increases the possibility of exit by them to foreign retailers. Moreover the stock trades at 1x FY13E EV/Sales and hence in our view is fairly valued. Hypercity's quest for partner can lead to a re-rating if transaction values are higher than 1x EV/Sales

LIKELY STATE-WISE IMPLEMENTATION OF FDI IN RETAIL



State	No of States having > 1mn population
JAMMU & KASHMIR	1
PUNJAB	2
CHANDIGARH	1
HARYANA	1
NCT OF DELHI	1
RAJASTHAN	3
UTTAR PRADESH	7
BIHAR	1
WEST BENGAL	2
JHARKHAND	3
CHHATTISGARH	2
MADHYA PRADESH	4
GUJARAT	4
MAHARASHTRA	6
ANDHRA PRADESH	3
KARNATAKA	1
KERALA	4
TAMIL NADU	7
UTTARAKHAND	1
MANIPUR	1
ASSAM	2

Source: Census 2011 (Provisional), Govt. of India.

Riders to permit FDI in multi-brand retail trading in all products, in a calibrated manner, subject to the following conditions:

1. FDI in multi-brand retail may be permitted to the extent of 51 per cent with government approval.
2. Minimum amount to be brought in as FDI by a foreign investor would be around $100 million.
3. At least 30 % of the procurement of manufactured processed products shall be sourced from small industries, in the country, that have total investment in plant and machinery not exceeding $100 million.
4. The government will have the first right to procurement of agriculture products. Fresh agricultural products, including fruits, vegetables, flowers, grains, pulses, fresh poultry, fishery and meal products may be unbranded.
5. At least 50 % of the total FDI brought in shall be invested in back-end infrastructure. Back-end infrastructure will entail capital expenditure on all activities, excluding that on front-end units. For instance, back-end infrastructure will include investment made towards processing, manufacturing, distribution, design improvement, quality control, packaging, logistics, storage, warehouse, agriculture market produce, infrastructure, etc. This valuation refers to the value at the time of installation without providing for depreciation.
6. Further, if at any point in time, this valuation is exceeded the industry shall not qualify as a small industry for this purpose.
7. Expenditure on land cost and rental, if any, will not be counted for purposes of back-end infrastructure.
8. Self-certification will be done by the company to ensure compliance of all the conditions.
9. Retail sales locations may be set up only in cities with a population of more than 1 million as per 2011 Census and may
10. Retail locations will be restricted to areas as per the master zonal plans of the cities concerned and provisions will be made for requisite facilities such as transport connectivity and parking.

Source: Ministry of Commerce

Wal-mart – Likely to emerge as a dominant force

Wal-mart through its tie up with Bharti Retail (likely Indian partner in front end) could emerge as an dominant force in North Indian given that the states of Rajasthan, Haryana, Delhi and Uttarakhand would implement the policy and if Punjab were to join it would give significant to Bharti Wal-mart given their strong already presence in these regions through cash and carry as well front end Easyday stores. Moreover geographically these states are contiguous and hence would give it significant advantages in supply chain (already working with almost 2,000 suppliers). We highlight that 9 of the 17 cash and carry stores they operate are in North India, We note that although there are 195 easy day outlets over 180 of them are convenience stores, most of them in North India. With clarity on the policy we could see the roll out of its large format stores.

Also the FDI policy excludes investment in front end stores for the calculation of investment in back-end and this seems to suit Wal-mart well as they are yet to invest sizably in large format stores (15) and is most likely to focus on the above mentioned states for rolling out stores.

BHARTI WAL-MART CASH AND CARRY STORES

STATE	CASH AND CARRY
PUNJAB	5
HARYANA	0
DELHI	0
UTTAR PRADESH	3
HIMACHAL PRADESH	0
UTTARAKHAND	0
RAJASTHAN	1
JHARKHAND	0
MADHYA PRADESH	2
JAMMU AND KASHMIR	1
MAHARASHTRA	2
KARNATAKA	0
CHHATTISGARH	1
ANDHRA PRADESH	2

TOTAL	17

Source: Company, MF Global Research Estimates

Opportunity still remains large

Foreign players can bring in operating efficiencies through their knowledge, back-end systems and supply chain efficiencies, which can help Indian retailers they choose to partner with. The move would also increase the depth of under penetrated (6%) organized retail market (which is growing rapidly) whereby we would see a structural shift of consumers from unorganized to organized sector thus opening up a wider consumer base. Over the longer term these initiatives will influence the product mix and supply chain making Indian retailer more profitable (high gross margins) and more capital efficient (lower working capital employed).

Even as it seems likely that FDI funded stores will be allowed only in cities with population over 1mn as per the 2011 census it nevertheless opens window of opportunity as there are 53 such cities with aggregate population of 116 mn in these cities.

If Foreign Direct Investment (FDI) in India's multi-brand retail is allowed across the country in 2013 we expect Modern Retail sales in India to grow at least eight fold from $17.5bn in 2009 (5.5% share) to $83bn by 2015, equal to 14% of total retail. This implies 30% pa sales growth in Modern Retail, better than any other emerging market. But given the current policy we expect the growth to be in range of 12-15%.

We expect Modern Retail Sales to improve by 20% driven by +7% household spend growth amongst the young and rapidly growing +300m middle income Urban Indian population. In addition, primary food staples price inflation is averaging +17.9% in 2010 and 10.3% in 2011.

Modern Grocery Retail in India consists of c.300 hypermarkets, c.1700 supermarkets and c.700 convenience stores, mainly located in Tier 1 cities which account for 7.2% of the 1.17bn population.

Increasing participation and frequency in fresh produce means investment in farming, IT systems and supply chain logistics is critical. This could save $10bn in retail COGS with the outcome for lower retail pricing, higher farming incomes, improved retail sales and higher EBIT margins.

Tesco and Wal Mart have already made contributions to India's Modern Retail operations. We see plenty of opportunities for FDI/partnerships in India, from Sainsbury, Carrefour, Metro, Aldi, Casino and US grocery/non-food retailers. Pantaloon, India's largest retailer ($2.3bn of sales in FY11E, 0.1% of GDP) with an 8.5% share of modern retail remains without an international partner.

The key themes

- Economic growth, lifestyle changes and working women
- What is the market size and scope of the grocery retail industry in India
- Rising consumption and sustained food price inflation
- What are the growth prospects
- What are the margin opportunities if FDI is allowed in 2012

Economic growth and market size

KEY ECONOMIC AND RETAIL STATISTICS FY09 TO FY15E

US$ (bn)	FY09	FY10E	FY11E	FY12E	FY13E	FY14E	FY15E	CAGR %
Total retail sector size	320	353	395	445	495	543	590	
Growth %	8%	10%	12%	13%	11%	10%	9%	10.7%
Modern retail sector size	**17.5**	**21**	**27**	**37**	**50**	**65**	**83**	
Growth %		**20%**	**29%**	**37%**	**35%**	**30%**	**28%**	**29.6%**
% of total retail	5.5%	5.9%	7%	8%	10%	12%	14%	
Modern Retail % of private consu	2.1%	2.5%	3.0%	3.9%	4.9%	6.0%	7.2%	17.1%
Unorganised retail	303	332	368	408	445	478	507	
Growth %		9.8	10.8	10.9	9.1	7.4	6.1	9.0%
GDP	**1,393**	**1,507**	**1,638**	**1,773**	**1,911**	**2,054**	**2,208**	
Growth %	**7.7**	**8.2**	**8.7**	**8.2**	**7.8**	**7.5**	**7.5**	**8.0%**
Population (m)	1,161	1,177	1,193	1,208	1,224	1,239	1,254	
Growth %		1.4	1.3	1.3	1.3	1.2	1.2	1.3%
Urban population %	340	347	353	360	367	374	381	
GDP per capita ($)	**1,200**	**1,281**	**1,374**	**1,467**	**1,561**	**1,658**	**1,761**	
Growth %		**6.7**	**7.3**	**6.8**	**6.4**	**6.2**	**6.2**	**6.6%**
Private consumption % of GDP	59	56	55	54	53	53	52	

Source: ICRIER report BMI Retail Report, World Bank, Ministry of home affairs, Global demographics Ltd, MF Global UK Ltd estimates

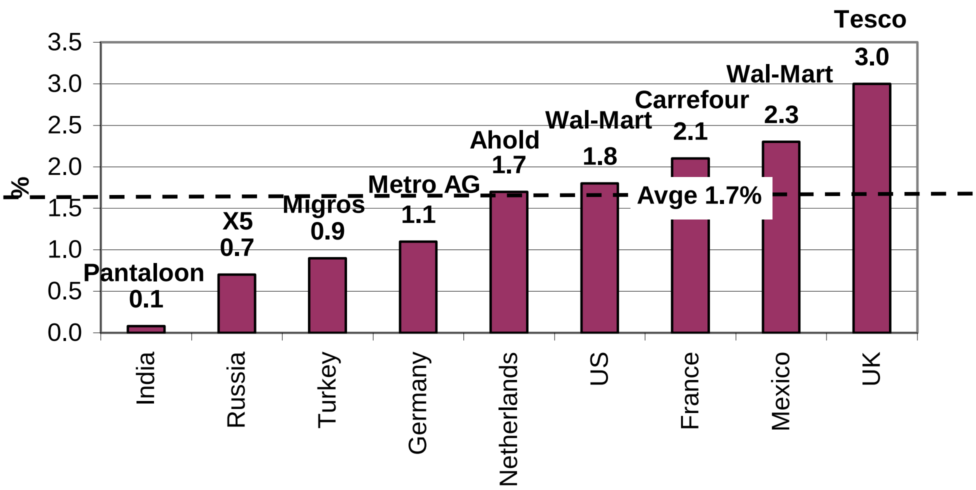
Source: ICRIER report BMI Retail Report, World Bank, Ministry of home affairs, Global demographics Ltd, MF Global India estimates

Management from one Indian retail company stated that if International retailers want to be market leaders in the Asia region they will need to be established in India. The 2010/11 population census is currently underway in India and expectations are that India could have added 164m to its population between 2001 and 2011, equal to half of Western Europe's population. For the next decade India could add another 150m people to over 1.34bn. 65% of the current population is under 40 years old and the calorific-intake demand from these age groups should rise faster than the simple 1.3% per annum increases in the population. See table above.

We expect real GDP per-capita to increase by 47% in the next five years from $1,200 to $1,761. This income growth is partly fueled by the steady migration to large cities of the 800m Indian population still at or below the poverty line living in rural areas moving to metro areas. In 2010 28.7% or 347m people live in major Cities and aim to improve their incomes. We believe the first category to benefit from this increased spending power will be food.

Scope for growth

SHARE OF GDP TO TURNOVER OF TOP GROCERY RETAILERS 2009



Source: IMF, Company data, Economic Intelligence Unit, Sales calendarised to Dec yr end

The above table shows the potential upside in modern grocery retail formats in India. This shows the relative share of Gross Domestic Product for the leading grocery retailers across the world. The leading modern retail brand in India, Pantaloon (Department stores, Hypermarkets, Supermarkets and Discount stores), has sales of $1.6bn or 0.1% of India's $1.39tn GDP in 2009 compared to Tesco's £39bn of UK sales equal to 3% of UK GDP. If Pantaloon were to reach the same share 0.7% of GDP as X5 in Russia by 2015 Pantaloon would have sales of $15.4bn. History tells us not all market leaders go on to dominate their domestic markets but the opportunity over the next 15 to 20 years to build a significant $50bn grocery/non-food business in India is possible.

The evolving palate and changing lifestyle

The outcome of a rapidly growing and young population (50% less than 25 yrs old) is a rapidly evolving palate and lifestyle changes. This added to the increasing nuclear families with more working women means a greater need for convenient, quality, low cost weekly food solutions. This combined with increased globalization (media access, 73% of Indian urban households and 31% of rural households have TV) means many more Indian families are becoming more adventurous and exploratory in what, where and when they eat. This in itself we believe will have a profound impact on the dynamics of 'kitchen' and 'dining table' habits in India. This change in eating habits is accelerating as more women join the +200m working women in India who have reduced time in the kitchen and reduced their "expertise" in cooking per se.

Indian consultancy Technopak believe that eating out and demand for multi-cuisine "ready-to-cook" food will increase. This could happen as more households experiment with new cuisines and try to satisfy newly acquired tastes that go "beyond" mom's home cooking. In addition, the growing urban population is eating on the move and has shorter meal times which lead to more convenience foods. Technopak estimate one or more weekday meals could become "convenience" driven. This explains Domino pizza, Yums Inc and MacDonalds interest in rapid expansion plans in India as sales in takeaway food increase by 25% y-o-y.

Rising consumption and food price inflation

One of the Indian Government's main drivers for opening up FDI into multi-brand retail is based on the fact that agriculture productivity is rising much slower than consumption. This is fast eroding the security of food supply with land and water resources already under pressure. This pressure is set to increase as more of India's mainly vegetarian society consumes more meat and dairy as well as vegetables. This means that unless India opens up to more global sourcing they could have many more years of sustained primary food price inflation.

Wal Mart, Carrefour and Tesco's discussion papers to the Indian ministries all refer to the benefit of more investment into contract farming, direct sourcing, one-touch supply chains to reduce waste, improve product consistency and quality of supply. Many companies estimate 30% of India's primary crops go to waste. Furthermore, one discussion paper submitted by an International retailer showed that Tomato pricing in June 2010 had increased to Rs60 per kg from Rs17 per kg in the previous month and this is not entirely due to unseasonal North Indian weather as farmers continued to sell tomatoes for Rs5. The variation came as many different middlemen mark-up the prices at various stages by 3-12 times creating uncontrollable inflation. More competition and direct sourcing would eliminate many of these inflation spikes.

Growth in new market entrants

MARKET SHARE IN SELECTED FMCG CATEGORIES IN MODERN RETAIL

Market share %	FY07/08	FY08/09	FY09/10	FY10/FY09 (%)
Big/Food Bazaar	30.2	26.1	25.4	-3%
Reliance	12.9	14.3	13.8	-4%
ABRL	13.8	13.4	11.2	-17%
D Mart	5.4	7.0	7.7	10%
Metro C&C	10.9	7.1	6.9	-3%
Spencer's	13.4	8.0	5.9	-27%
Vishal/Shriram Grp	0.0	2.7	4.2	54%
Foodworld/Dairy Farm	6.4	4.7	3.9	-18%
Wal-Mart	**0.0**	**1.4**	**3.4**	147%
Apollo	0.0	2.0	2.9	46%
Nilgiris	0.0	0.4	2.5	581%
Hypercity	1.6	1.8	2.4	34%
Tesco/Trent	**0.8**	**1.5**	**2.1**	38%
Heritage	0.0	1.2	1.4	17%
SPAR	0.5	0.9	1.0	12%
Total	95.9	92.5	94.5	

Source: MF Global India Research

The above table shows the Modern Retail Market in Indian from a FMCG manufacturers view point over the last three years. The market is still dominated (50.4%) by three retail groups, Pantaloon's Big/Food Bazaar, Reliance Retail stores and Aditya Birla Retail Grp's More stores. However, all of them are losing share to new International or private equity backed entrants and new premium concepts like HyperCity. The retail brands that seem to be in the worst position in terms of loss of market share are Spencer's part of the RPG group (-27% to 5.9% share) and 'More. For you' stores of the Aditya Birla Retail Grp (-17% to 11.2% share). There could be plenty of explanations for their loss of branded market share but it would seem the retail brands with large losses have either low sales densities or strategies that lead to rapid store openings without understanding the local markets followed by store closures.

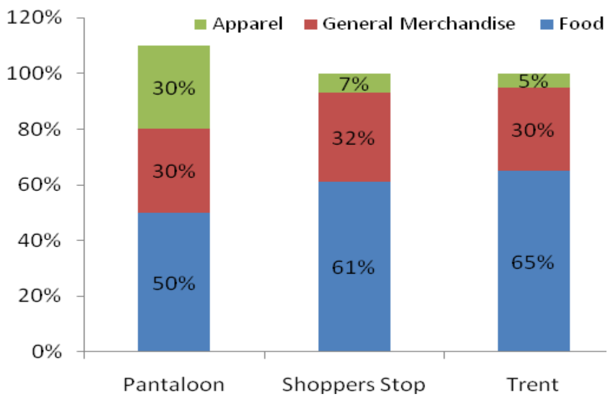
What are the margin opportunities?

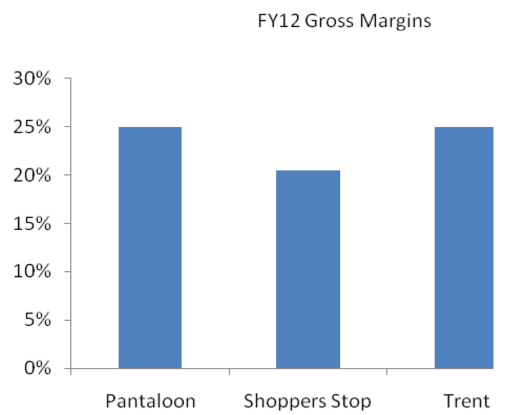
This is where we believe International retailers could have a massive strategic advantage in terms of sophisticated site research techniques, pricing, ranging, store processes and superior analytics on loyalty data, like Tesco's DunnHumby. Either way the opportunity to partner with existing Indian retailers who have established loyalty cards should rapidly change range, price and merchandising within stores to better suit local demand and tastes. It should not be lost on investors that India is a country with 7 different religions, 22 official languages, a wide diversity in habits and food tastes across 35 metro areas, 5,500 urban towns and 700,000 villages. Through our various store visits in Mumbai we noted how some International retailers have already influenced their partner brands by rearranging store layouts, adding new merchandising to fresh foods in Green crates and creating open market self service concepts within stores. We expect FDI could dramatically change the way many local grocery stores are ranged and add huge volume opportunities to existing brands and new own brand products. So how big is the margin opportunity?

Gross margin expansion, building a better business model

- Few existing Indian Grocery formats make any profit contribution or break out the EBIT contributions between their brands, like Pantaloon's Big Bazaar and Food Bazaar. This makes it difficult for investors to quantify the potential upside from International FDI.
- We point out that Trent has a working relationship with Tesco for star bazaar while Shoppers Stop's Hypercity with 12 stores offers an opportunity albeit with not a significant footprint. Whereas, Pantaloon retail with nearly 8 msf of retail space in its big bazaar format offers the largest front end for tie ups which would be crucial for paybacks on the backend investments which foreign retailers would be required to make.
- Pantaloon enjoys higher gross margins of 25% in its hypermarket because of high share of apparel (30%) in its product mix. Whereas Hypercity's margins are around 20% as food constitutes nearly 60-65% of sales. Trent operated star bazaar has a sales mix similar to that of Hypercity but now operates a Gross margin of 25%. This is primarily due to the franchise agreement (for sourcing and supply chain) that it has with Tesco.

SALEX MIX AND GROSS MARGINS FOR HYPERMARKET FORMAT





Source: Company, MF Global India Research Estimates

- **Scope of margin improvement evident from Trent:** Sourcing capabilities of foreign retailers can improve gross margin across a categories such as fresh, FMCG (due to global sourcing agreements) and general merchandise. (The Carrefour Group already works with 78 factories /46 suppliers within India.) Indian retailers have gross margins in the range of 18-25%. This compares with a c30% commercial gross margin ex fuel for the majority of UK food retailers and 22-24% after distribution, loyalty costs, marketing and stock loss. We believe the 5-6% gap in gross margin could be partly closed by International retailers helping Indian counterparts with global sourcing of opening price point value lines, category management, negotiations with global suppliers, own brand development and many other enhancements through pricing and range extensions on premium lines.

RETAIL DASHBOARD

	FY10			FY11			FY12		
	PF	SHOP	TRENT	PF	SHOP	TRENT	PF	SHOP	TRENT
SALES AND SALES MIX									
DEPT STORE	40,974	14,490	5,875	40,974	17,120	7,167	43,172	20,601	8,219
HYPERMARKETS	69,148	3,048	2,895	69,148	5,511	5,193	75,449	7,025	6,961
GROSS MARGINS									
DEPT STORE	35%	38%	54%	35%	36%	54%	35%	35%	46%
HYPERMARKETS	25%	19%	24%	25%	20%	25%	25%	20%	25%
EBITDA MARGINS									
DEPT STORE	11%	8%	5.67%	11%	9.3%	4.6%	12%	6.8%	-1.5%
HYPERMARKETS	8%	-11%	-7.40%	8%	-5.5%	-5.1%	8%	-5.2%	-4.8%
PAT MARGINS									
DEPT STORE	2%	2.5%	7%	2%	4.4%	6%	1%	3.1%	5.8%
HYPERMARKETS	2%	-19%	-10.60%	2%	-12%	-9.80%	1%	-13%	
SPACE MIX									
DEPT STORE	3.8	2.2	0.9	3.8	2.7	1.1	7.2	3.6	1.3
HYPERMARKETS	9.8	8.6	0.4	9.8	9.9	0.7	9.1	1.2	0.8
DEBT-EQUITY RATIO	1.0	0.5	0.4	1.6	0.5	(0.0)	2.0	1.1	0.2
INVENTORY P.S.F.	1818	668	1196	2352	689	1377	2,400	700	1700

Source: MF Global India Research Estimates

We have listed four key areas that we believe have substantial headroom for improve. We also note that many Indian companies believe they do not need FDI or International operators to solve these issues. Some retailers point to having hired various European and US directors from global retail groups and copying best practice to help solve these issues. Despite this the majority of India retailers make little or no group EBIT contributions. The four key areas that can improve the most are;

1. Higher sales densities
2. Gross margin mix expansion from 20% to 25%+: range, mix, cost of goods, own brand, direct delivery
3. Store expenses reduction from 17-19% of sales to 13%
4. Overheads reduced from 5% of sales to 2%

Interestingly one metric that might see some cost increase is distribution. Given distribution is c65% wages and labour is very cheap in India we could see distribution cost/sales rise from c1.6% (UK is c3.7% to 4.5%) as modern IT and chilled distribution infrastructure is added increasing short term costs. It's already known that Wal-Mart is helping Bharti Retail in supply chain processes by using hand held scanners to allow staff to accurately monitor availability and colour code the sell rate of products from back room to front of store.

In terms of store costs we believe these could be rapidly reduced via higher sales densities as more people shop in modern retail stores. We believe the level of store expenses as a percentage of sales could be halved from 18-19% to 9% if sales densities improve covering more of the fixed costs of lighting, refrigeration and IT systems are used.

We highlight that that quite a few stores in India have a shelf ready products and well filled shelves but a lot had very poor fill rates which still run in the 60-70% range. This is partly due to a lack of central distribution, a lack of investment by manufacturers and the fact that many stores receive 20-25 deliveries a day with most not on time. To solve the problem we believe Indian retailers need outside support and influence. The reason being that suppliers in India are very strong and distribute products in a very different way to over 12 million Kirana stores which account for 94% of the whole market and 85-90% of the Urban markets.

Conclusion

We believe there is a considerable opportunity for International retail to participate in the substantial long term growth of the Modern Indian grocery and non-food markets. If as we believe Modern grocery/department store retail sales reach $83bn or 14% of total retail sales by 2015 and grocery formats account for $25bn then we might expect many of those operators achieving 4-5% store margins with their participating international retailers. In terms of balancing the opportunity with the risks we would highlight that we see considerable issues around property prices, political interest in primary produce supplies, illegal passing off of brands and a lack of key infrastructure let alone a need to overcome considerable weather effects from the monsoon season.

The Shift to transaction values

What this policy does for retailing stocks is that it changes the valuation parameters by moving towards transaction based value multiples (EV/Sales) over the conventional going concern valuation parameters (EV/EBITDA, P/E).

What are the transaction values in the sector?

EMERGING MARKETS M&A (TESCO & CARREFOUR)

DATE	TARGET	COUNTRY	STORES	SALES £M	ACQUIRER	EQUITY %	EXIT VALUE	EV/SALES (%)	EV/EBIT (X)
MAR-94	GLOBAL	HUNGARY	43	30	TESCO	51	29	98%	NA
NOV-95	SAVIA	POLAND	31	30	TESCO	79	10	34%	NA
MAR-96	K-MART	CZECH	13	115	TESCO	100	79	69%	NA
MAY-98	LOTUS	THAILAND	13	241	TESCO	75	275	114%	NA
MAY-99	SAMSUNG	SOUTH KOREA	2	130	TESCO	81	321	247%	NA
2-JUL	HIT	POLAND	47	390	TESCO	100	420	108%	35
3-NOV	KIPA	TURKEY	5	124	TESCO	100	75	60%	16
6-JUL	LEADER PRICE	POLAND	76	167	TESCO	100	72	43%	NA
8-MAY	HOMEVER	SOUTH KOREA	36	1100	TESCO	100	958	87%	NA
MAR-00	GRUPPO GS SPA	ITALY	160	4248	CARREFOUR	96	NA	NA	NA
5-MAY	GIMA	TURKEY	81	264	CARREFOUR	60	NA	NA	NA
5-MAY	ENDI	TURKEY	45	120	CARREFOUR	82	NA	NA	NA
5-JUN	SONAE	BRAZIL	10	NA	CARREFOUR	100	NA	NA	NA
7-APR	ATACADAO	BRAZIL	34	1500	CARREFOUR	100	825	55%	NA
10-MAY	IPEK	TURKEY	27	41	CARREFOUR	100	24	59%	NA
10-JUL	BAOLONGCANG	HEBEI/CHINA	11	113	CARREFOUR	51	NA	NA	NA

Source: MF Global India Research Estimates

How sacrosanct are the valuation multiples in context of the Indian market?

EV/Sales would be the multiple to track as this valuation parameter would capture the essence and motivation for a tie up – retail space. Sales capture the current essence/quality of retail space that retailers operate. The profitability and capital efficiency is dictated by the merchandise mix and strength of the supply chain. In our view foreign retailers such as Wal-mart, Carrefour would believe that they can address the profitability and capital efficiency through their strengths in back-end and supply chain efficiencies. However, a pre-condition to the same would be scale of the front end, which boils down to quality retail space. Therefore, space under operation/tied up space would become an important criterion in choice of partner selection. Its pertinent to note that in the event a foreign retailer values an Indian retail business at 1x FY12E , the valuation would not appear steep if one factors in the growth prospects. To elucidate this further (see scenario A) 1x EV/FY12E sales paid for a business which can grow at a CAGR of 25% of next 3 years would then make the business look available at 0.5x FY15E sales in a high growth market. While these are early days to wager on the multiples we highlight that changes in CAGR assumptions upwards will translate to higher transaction multiples as investors become more willing to pay for the higher growth. An 500 bps increase in CAGR assumptions from 25% to 30% will yield the same EV/Sales multiple of 0.5x in FY15E at a transaction value of 1.2x, which however is 20% higher than 1x that one may be willing to pay for a 3 year CAGR of 25%.

DEAL SCENARIO A

	FY12	FY13	FY14	FY15
SALES	100	125	156	195
ASSIGNED EV	100			
EV/ SALES	1	0.8	0.64	0.51
ASSUMED CAGR	25%			

Source: MF Global India Research Estimates

DEAL SCENARIO B

	FY12	FY13	FY14	FY15
SALES	100	125	156	195
ASSIGNED EV	120			
EV/ SALES	1.2	0.80	0.64	0.51
ASSUMED CAGR	30%			

Source: MF Global India Research Estimates

How does Pantaloon retail's valuation on transaction values look like under different scenarios?

We asses the various transaction multiples (EV/Sales), which Pantaloon can attract from a foreign retailer for controlling interest. It is very interesting to note that a 20% upward swing in the multiple increases the transaction value by 50% (see Scenario 1 and 2). We arrive at these multiples based on the 3 year revenue CAGR which results in EV/FY15E sales shrinking to 0.5x, thus making the acquisition look fair for the foreign retailers. We note that Pantaloon Retail's revenues grew at 24% CAGR at FY08-11 and expect Future Value retail's revenues to grow at FY10-FY13 CAGR of 14% (largely due to lower SSS). It's pertinent to note that post a controlling stake a foreign retailer would expect to improve the operating metrics such as merchandise mix, same store sales, inventory turns. Hence this CAGR of 14% can be scaled up as SSS sales improve.

The current policy, in our view, dilutes Pantaloon's key strength - enormous scale of 9.2msf in this space as effectively only 28% of this space would be in FDI compliant locations. Though Pantaloon Retail remains a potential beneficiary due to its size the conditions of operation of FDI funded stores in cities with population of over 1 mn with the States approval couple shrinks the bargaining chips for Pantaloon we estimate that only 45 of 162 Big Bazaars would satisfy these conditions. The company's plans to consider a foreign partner in the hypermarket business under these circumstances will have to be watched carefully for any of the below mentioned scenarios to play out.

	SCENARIO 1	SCENARIO 2	SCENARIO 3	SCENARIO 4
TRANSACTION VALUE MULTIPLE SCENARIOS				
	1.2X	1X	0.75X	0.6X
COMMENTS	REVENUE CAGR OF 30%	REVENUE CAGR OF 25%	REVENUE CAGR OF 15%	REVENUE CAGR OF 7%
TOTAL NO OF STORES	157	157	157	157
STORES WHERE FDI IS ALLOWED	45	45	45	45
FY12E FVRL SALES (RS MN)	73,156	73,156	73,156	73,156
EV/SALES MULTIPLE FOR STORES OF INTEREST	1.2	1	0.75	0.6
EV/SALES MULTIPLE FOR REMAINING STORES	0.75	0.75	0.6	0.5
IMPLIED TRANSACTION VALUE FOR FVRL (RS MN)	64,303	60,109	47,039	38,675
VALUE OF STANDALONE BUSINESS (0.75 X SALES) RS MN	20,831	20,831	20,831	20,831
PANTALOON'S EV (RS MN)	85,134	80,940	67,870	59,506
RETAIL DEBT (RS MN)	45,000	45,000	45,000	45,000
PROCEEDS FROM FCH SALE	4,100	4,100	4,100	4,100
VALUE OF PANTALOON FORMAT (AS PER ABNL TRANSACTION)	7,854	7,854	7,854	7,854
IMPLIED MARKET CAP (RS MN)	52,088	47,894	34,824	26,460
EQUITY VALUE PER SHARE	225	207	151	115
TARGET PRICE	225	207	151	115
CMP	158	158	158	158
EXPECTED RETURN	43%	31%	-5%	-28%

Source: Company, Census 2011 (provisional), MF Global India Research Estimates

LOCATION OF BIG BAZAAR STORES

STATE	NO OF STORES IN THE STATE	STORES INN CITIES WITH OVER 1 MN POPULATION	TOTAL SQ FT	AVG SIZE	STATE GOVT PARTY	ALLY OF	NEXT STATE ELECTION IN (MM/YY)	NO OF CITIES IN STATES WITH POPULATION > 1 MN	NO OF STORES IN CITIES WITH POPULATIO N > 1 MN	STATES IN FAVOR
ANDHRA PRADESH	7	3	495,206	70,744	CONGRESS	UPA	2014	3	7	Y
ASSAM	2	2	96,000	48,000	CONGRESS	UPA	2016	0	0	Y
BIHAR	1	1	40,801	40,801	BJP + JDU	NDA	2016	1	1	N
CHHATTISGARH	4	2	192,957	48,239	BJP	NDA	2013	1	2	N
DELHI	6	1	337,524	56,254	CONGRESS	UPA	2013	1	6	Y
GUJARAT	10	7	516,408	51,641	BJP	NDA	2012	4	7	N
HARYANA	3	3	158,698	52,899	CONGRESS	UPA	2014	1	1	Y
HIMACHAL PRADESH	1	1	29,787	29,787	BJP	NDA	2012	0	0	N
JHARKHAND	4	4	212,025	53,006	BJP	NDA	2014	2	2	N
KARNATAKA	19	7	1,138,538	59,923	BJP	NDA	2014	1	13	N
KERALA	6	5	345,572	57,595	UDF	NA	2016	0	0	N
MADHYA PRADESH	4	4	155,256	38,814	BJP	NDA	2013	4	3	N
MAHARASHTRA	32	15	1,380,642	43,145	CONGRESS+NCP	UPA	2014	10	22	Y
ORISSA	2	2	62,000	31,000	BJD	NA	2014	0	0	N
PUNJAB	7	6	236,254	33,751	BJP+AKALI DAL	NDA	2017	2	1	N
RAJASTHAN	7	5	237,843	33,978	CONGRESS	UPA	2013	3	5	Y
SIKKIM	1	1	23,558	23,558	SIKKIM DEMOCRATIC FRONT PARTY	NA	2014	0	0	N
TAMIL NADU	6	4	290,029	48,338	AIADMK	NA	2016	3	4	N
UTTAR PRADESH	16	8	670,660	41,916	SP	NA	2017	7	14	N
UTTARAKHAND	1	1	35,851	35,851	CONGRESS	UPA	2017	0	0	Y
WEST BENGAL	18	8	689,013	38,279	TRIMULA+CONGRESS	UPA	2016	2	11	N
GRAND TOTAL	157	90	7,344,622	46,781				45	99	

Source: Company, Census 2011 (provisional), MF Global India Research Estimates

Appendix

CITIES WITH POPULATION OF 1MN AND ABOVE (AS PER 2011 CENSUS)

STATE	CITY	POPULATION (MN)
JAMMU & KASHMIR	SRINAGAR UA	1.3
PUNJAB	LUDHIANA (M CORP.)	1.6
PUNJAB	AMRITSAR UA	1.2
CHANDIGARH	CHANDIGARH UA	1.0
HARYANA	FARIDABAD (M CORP.)	1.4
NCT OF DELHI	DELHI UA	16.3
RAJASTHAN	JAIPUR (M CORP.)	3.1
RAJASTHAN	JODHPUR UA	1.1
RAJASTHAN	KOTA (M CORP.)	1.0
UTTAR PRADESH	KANPUR UA	2.9
UTTAR PRADESH	LUCKNOW UA	2.9
UTTAR PRADESH	GHAZIABAD UA	2.4
UTTAR PRADESH	AGRA UA	1.7
UTTAR PRADESH	VARANASI UA	1.4
UTTAR PRADESH	MEERUT UA	1.4
UTTAR PRADESH	ALLAHABAD UA	1.2
BIHAR	PATNA UA	2.0
WEST BENGAL	KOLKATA UA	14.1
WEST BENGAL	ASANSOL UA	1.2
JHARKHAND	JAMSHEDPUR UA	1.3
JHARKHAND	DHANBAD UA	1.2
JHARKHAND	RANCHI UA	1.1
CHHATTISGARH	RAIPUR UA	1.1
CHHATTISGARH	DURG-BHILAINAGAR UA	1.1
MADHYA PRADESH	INDORE UA	2.2
MADHYA PRADESH	BHOPAL UA	1.9
MADHYA PRADESH	JABALPUR UA	1.3
MADHYA PRADESH	GWALIOR UA	1.1
GUJARAT	AHMADABAD UA	6.4
GUJARAT	SURAT UA	4.6
GUJARAT	VADODARA UA	1.8
GUJARAT	RAJKOT UA	1.4
MAHARASHTRA	GREATER MUMBAI UA	18.4
MAHARASHTRA	PUNE UA	5.0
MAHARASHTRA	NAGPUR UA	2.5
MAHARASHTRA	NASHIK UA	1.6
MAHARASHTRA	VASAI VIRAR CITY (M CORP.)	1.2
MAHARASHTRA	AURANGABAD UA	1.2
ANDHRA PRADESH	HYDERABAD UA	7.7
ANDHRA PRADESH	GVMC (MC)	1.7
ANDHRA PRADESH	VIJAYAWADA UA	1.5
KARNATAKA	BANGALORE UA	8.5
KERALA	KOCHI UA	2.1
KERALA	KOZHIKODE UA	2.0
KERALA	THRISSUR UA	1.9
KERALA	MALAPPURAM UA	1.7
KERALA	THIRUVANANTHAPURAM UA	1.7
KERALA	KANNUR UA	1.6
KERALA	KOLLAM UA	1.1
TAMIL NADU	CHENNAI UA	8.7
TAMIL NADU	COIMBATORE UA	2.2
TAMIL NADU	MADURAI UA	1.5
TAMIL NADU	TIRUCHIRAPPALLI UA	1.0

Source: Census 2011 (provisional), MF Global India Research

STATE WISE STATUS OF APMC REFORMS

STATE	STATUS OF APMC REFORMS
ANDHRA PRADESH	DONE FOR DIRECT MARKETING; CONTRACT FARMING AND MARKETS IN PRIVATE/ COOP SECTORS
ASSAM	DONE FOR DIRECT MARKETING; CONTRACT FARMING AND MARKETS IN PRIVATE/ COOP SECTORS
BIHAR	APMC ACT ALREADY PROVIDES FOR THE REFORMS
CHHATTISGARH	DONE FOR DIRECT MARKETING; CONTRACT FARMING AND MARKETS IN PRIVATE/ COOP SECTORS
GUJARAT	DONE FOR DIRECT MARKETING; CONTRACT FARMING AND MARKETS IN PRIVATE/ COOP SECTORS
HARYANA	DONE PARTIALLY - CONTRACT FARMING
JAMMU & KASHMIR	ADMINISTRATIVE ACTION IS INITIATED FOR THE REFORMS
JHARKHAND	DONE FOR DIRECT MARKETING; CONTRACT FARMING AND MARKETS IN PRIVATE/ COOP SECTORS
KARNATAKA	DONE FOR DIRECT MARKETING; CONTRACT FARMING AND MARKETS IN PRIVATE/ COOP SECTORS
KERALA	THERE IS NO APMC ACT AND HENCE NOT REQUIRING REFORMS
MADHYA PRADESH	DONE PARTIALLY - DIRECT MARKETING & CONTRACT FARMING
MAHARASHTRA	DONE FOR DIRECT MARKETING; CONTRACT FARMING AND MARKETS IN PRIVATE/ COOP SECTORS
MANIPUR	THERE IS NO APMC ACT AND HENCE NOT REQUIRING REFORMS
NCT OF DELHI	DONE PARTIALLY - DIRECT MARKETING & CONTRACT FARMING
PUNJAB	DONE PARTIALLY - CONTRACT FARMING
RAJASTHAN	DONE FOR DIRECT MARKETING; CONTRACT FARMING AND MARKETS IN PRIVATE/ COOP SECTORS
TAMIL NADU	APMC ACT ALREADY PROVIDES FOR THE REFORMS
UTTAR PRADESH	ADMINISTRATIVE ACTION IS INITIATED FOR THE REFORMS
UTTARAKHAND	DONE FOR DIRECT MARKETING; CONTRACT FARMING AND MARKETS IN PRIVATE/ COOP SECTORS
WEST BENGAL	ADMINISTRATIVE ACTION IS INITIATED FOR THE REFORMS

Source: Agricultural Ministry of India

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