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India Research

Sector: Retailing

The First Global Series on the Indian Retail Sector – Part I

What is the real potential of the organized Indian Retail sector?

Including

What is the most critical determinant of potential market size?
(see page 6-9)

plus

How does potential market size correlate with the plans of individual players? Can the market absorb the investments?
(see page 10-11)

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The First Global series on the Indian Retail Sector

The Indian retail sector is the new place to be with every possible player jumping into the fray - Reliance, Bharti-Wal Mart, A.V.Birla, Future/Pantaloon Group etc have all announced gargantuan expansion plans for the coming years, indicating that the companies are going full steam ahead to capitalize on the perceived opportunities arising from the tremendous growth in the retail sector. We do have faith in the potential of the Indian retail sector in the sense of its ability to change the behaviour of the Indian consumers But there are also many questions and unresolved issues. These include apprehensions over the feasibility of such massive expansion plans and whether merely because the retail revolution will transform the economy, it will also be a value-creator for the shareholders & investors in the retail industry.

We have, therefore, undertaken a study to ascertain the real potential of the Indian Retail sector and whether such expansion plans are feasible? We have divided our study on the Indian Retail sector (***"The First Global's Series on the Indian Retail Sector")*** into five parts, as outlined below:

Part-I **What is the real potential of the Indian Retail sector?**

Part-II **The gargantuan expansion plans of players in the Retail sector - Will they create any value for the investors?**

Part-III **Who will survive - Retail malls or Kirana stores?**

Part-IV **The changing face of Indian Retail and the strategic challenges ahead**

Part-V **Can India learn some lessons in Retail FDI from the 'Dragon'? How lucrative is FDI in Retail for India?**

The Short Story…

This report is the first (Part I) of a five-part series on our comprehensive study of the Indian Retail sector (***"The First Global Series on the Indian Retail Sector")***. In Part I, we have discussed the real potential of the organized Indian Retail sector by FY2011. We have also verified our findings by making some back-of-the-envelope calculations on the basis of the upcoming investments expected in the sector.

A few years ago, the Information Technology boom completely changed the face of the entire Indian economy. History now appears set to repeat itself with the boom in the domestic Retail Industry bringing about significant changes in the economy, although it sill remains to be seen whether this change will be as huge as the one created by the IT boom. To our mind, this will depend on the macro environment, primarily the Indian government's policies, as well as the microenvironment, primarily the growth plans of the players in the retail industry and their ability to execute them efficiently.

The interesting takeaway from our analysis is that the growth of organised retail is mainly dependent on replacing unorganised retail & the potential market size for organised retail is much more sensitive to what proportion of the total market & the GDP it manages to gain, rather than the growth in the overall economy.

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Given realistic assumptions, we can expect the organised retail market to grow at a CAGR of 35% - 44% upto 2011 to a size of Rs. 1198-1565 bn. This is significantly lower as compared to the retail market size (Rs. 1700 – 1800 bn, see page-10) that would justify the upcoming investment plans announced by the major players. In other words, the aggregate market does not appear to have the potential to absorb the planned investments.

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There is definitely some mismatch between the pace of such massive investments and the expected growth in demand till 2010-11. We believe gap between the demand & the level of operations needed to justify the investments made will be substantial. This will not only mount further pressure at the already stressed margins, but also deprive the investors of reasonable returns. This will be discussed in our forthcoming reports, along with other factors like execution risks, the likely profitability of this investment etc.

The background and the investment plans…

The Indian retail sector is still at a very nascent stage, with only one retailer, Pantaloon/ the Future Group having built a substantial presence in both value retail (food and groceries) and lifestyle retail (apparels, footwear etc). Although there are other retailers such as Trent and Shopper's Stop, but they operate primarily in the lifestyle segment and have a minimal presence in the value retail segment. However, the new entrants such as Reliance, A.V.Birla group and Bharti along with Wal Mart, have announced quite aggressive expansion plans in the value retail segment.

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Amongst the big players in the industry, Reliance has planned an investment of around Rs.250-300 bn, while Bharti-Wal Mart and A V Birla group have announced plans to invest around Rs.300 bn and Rs. 150 bn respectively by FY2011. With the expected entry of Bharti-Wal Mart in mid 2007, Reliance is already speeding up its expansion and looks all set to enter states like Madhya Pradesh, Maharashtra, West Bengal, etc apart from Andhra Pradesh (which it entered in October 2006). Bharti also appears keen to enter the Indian retail sector as early as possible and with Wal Mart as its partner, the company is expected to replicate the 'Airtel' success story in the Indian Retail market. The A V Birla group also appears to be in a big hurry to expand and has recently acquired Trinethra, a South-based retail chain.

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The existing industry players, such as Pantaloon, Shopper's Stop and Tata (with Trent and Infinity), have also announced their expansion plans, which however, appear quite tiny in comparison to the gigantic expansion plans of Reliance, Bharti-Wal Mart and A V Birla group. Moreover, other prospective and private players such as Reliance ADAG, Dabur, Vishal Megamart, and Subhiksha etc. are also looking to tap the huge potential of the domestic retail market.

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TABLE – I Expected upcoming (announced) Investments by 2010-11	
Retail Players	***Amt. (in INR bn)***
Reliance Industries (in INR bn)	250
Bharti – Wal Mart	300
A V Birla	150
Pantaloon Retail	40
Others*	100
Aggregate Investments	**840**

** Includes Shopper's Stop, Trent & other regional & private players*

Even global players, such as Carrefour, Tesco etc. have evinced keen interest in entering the Indian retail market. Despite the restrictions set by the Indian government for the entry of foreign players in the domestic market, both Wal Mart and Woolworths have capitalized on the loopholes in the existing policies to recently enter the Indian retail market. According to Press Note 3 (2006 series), the government has allowed FDI of up to 51% in 'single brand' products after due approval. It has permitted 100% FDI in companies that engage in wholesale trading or 'cash & carry' operations. With more and more players, domestic as well as global, willing to enter the sector, the question now is exactly how lucrative is the Indian Retail market and what is its expected potential?

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What is the most critical determinant of potential market size?

As per the AT Kearney's 2006 Global Retail Development Index (GRDI), India replaced Russia for the second time as the top retail investment destination among the 30 emerging markets across the world. According to the KSA Technopak India Retail report 2005, the Indian Retail sector is currently estimated to be around Rs.10,000 bn, with organized retail contributing merely 3.5% of the entire retail market and 1.23% of the entire GDP (at current prices), thus providing a great opportunity for further growth in this sector over the coming years.

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TABLE – II

Share of Organized Retail	1999	2002	2005
GDP at current prices (in INR bn)*	15,981	20,975	28,559
Total Retail market (in INR bn)	7,000	8,250	10,000
Organized Retail (in INR bn)	50	150	350
Organized Retail as % of Total Retail	0.7%	1.8%	3.5%
Organized Retail as % of GDP	0.31%	0.72%	1.23%

Source: KSA Technopak India Retail Report 2005
** Bloomberg database*

However, we are more concerned with the future growth of the organized retail market and have therefore modelled for the pessimistic, realistic and optimistic potential of the organized Indian retail sector by FY2011 with respect to the GDP growth and the variation in organized retail as a percentage of the GDP. We have assumed a pessimistic (CAGR 12.0%-12.5%), realistic (CAGR 13.0%-14.0%) and optimistic (CAGR 14.5%-15.0%) GDP growth rate and carried out a sensitivity analysis of the expected potential in the organized retail sector by FY2011. Similarly, we've assumed three potential ranges for the level reached by Organised Retail/GDP proportion by FY2011.

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(Amount in INR bn)

TABLE – III							
Expected Organised Retail Revenues							
2010-11	Expected GDP CAGR (in %) by 2010-11						
Org. Retail as % of GDP	**12.00%**	**12.50%**	**13.00%**	**13.50%**	**14.00%**	**14.50%**	**15.00%**
1.25%	716	732	749	765	782	800	817
1.50%	859	879	898	918	939	960	981
1.75%	1003	1025	1048	1072	1095	1120	1144
2.00%	1146	1172	1198	1225	1252	1280	1308
2.25%	1289	1318	1348	1378	1408	1440	1471
2.50%	1432	1465	1497	1531	1565	1599	1635
2.75%	1576	1611	1647	1684	1721	1759	1798
3.00%	1719	1757	1797	1837	1878	1919	1962
3.25%	1862	1904	1947	1990	2034	2079	2125

Source: First Global Research

	Pessimistic Scenario		Realistic Scenario		Optimistic Scenario

Our sensitivity analysis shows that the size of the organized retail market is more sensitive to the conversion of unorganised retail to organized retail, as compared to the GDP growth rate. Assuming that the GDP grows at a CAGR of 12.0%, revenues in the organized retail sector will grow from Rs.716 bn (1.25% of organized retail as percentage of GDP) to Rs. 1862 bn (3.25% organized retail as percentage of GDP) by 2010-11.

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Even a marginal improvement in the proportion of organized retail (as a percentage of the GDP) from 1.25% to 1.5% leads to a significant change in the expected potential of Indian organized retail from Rs.765 bn to Rs.918 bn (with the GDP growth at 13.5%). However, assuming organized retail as percentage of GDP to be constant, any change in GDP growth will not have any significant impact at the potential of the organized retail sector. Assuming 1.25% organized retail as percentage of GDP, the revenues will grow only Rs.101 bn from Rs. 716 bn (GDP CAGR 12.0%) to Rs.817 bn (GDP CAGR 15.0%).

Even a marginal improvement in the proportion of organized retail (as a percentage of the GDP) from 1.25% to 1.5% leads to a significant change in the expected potential of Indian organized retail from Rs.765 bn to Rs.918 bn (with the GDP growth at 13.5%). However, assuming organized retail as percentage of GDP to be constant, any change in GDP growth will not have any significant impact at the potential of the organized retail sector

TABLE - IV							
Expected Organised Retail Revenues CAGR (%)							
2010-11	Expected GDP CAGR (in %) by 2010-11						
Org. Retail as % of GDP	**12.00%**	**12.50%**	**13.00%**	**13.50%**	**14.00%**	**14.50%**	**15.00%**
1.25%	19%	19%	20%	21%	21%	22%	23%
1.50%	24%	25%	26%	26%	27%	28%	28%
1.75%	29%	30%	31%	31%	32%	33%	34%
2.00%	34%	34%	35%	36%	37%	37%	38%
2.25%	38%	38%	39%	40%	41%	41%	42%
2.50%	41%	42%	43%	44%	44%	45%	46%
2.75%	45%	45%	46%	47%	48%	49%	49%
3.00%	48%	49%	49%	50%	51%	52%	53%
3.25%	51%	52%	52%	53%	54%	55%	56%

Source: First Global Research

	Pessimistic Scenario		Realistic Scenario		Optimistic Scenario

Although the GDP growth does play a role in maintaining a positive sentiment for the growth story, we believe that the growth in organized retail will depend mainly on the ability of the organized retailers to attract the unorganised retail customers. As per our estimates, in a pessimistic scenario (expected GDP CAGR of 12%-12.5%, Organised Retail/GDP at 1.25%-1.75%), we expect the organized retail revenues to grow at a CAGR of 19-30% to around Rs. 716 bn - 1025 bn by 2010-11. In an optimistic scenario (expected GDP CAGR of 14.5%-15.0%, Organised Retail/GDP at 2.75%-3.25%), we expect the organized retail revenues to grow at a CAGR of 49-56% to around Rs. 1759 bn - 2125 bn by 2010-11. However in a realistic scenario (expected GDP CAGR of 13.0%-14.0%, Organised Retail/GDP at 2.0%-2.5%), we expect the organized retail revenues to grow at a CAGR of 35-44% to around Rs. 1198 bn - 1565 bn by 2010-11.

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TABLE - V							
Expected Organised Retail Revenues as % of Total Retail							
2010-11	Expected GDP CAGR (in %) by 2010-11						
Org. Retail as % of GDP	**12.00%**	**12.50%**	**13.00%**	**13.50%**	**14.00%**	**14.50%**	**15.00%**
1.25%	3.6%	3.6%	3.6%	3.6%	3.6%	3.5%	3.5%
1.50%	4.4%	4.3%	4.3%	4.3%	4.3%	4.3%	4.2%
1.75%	5.1%	5.1%	5.0%	5.0%	5.0%	5.0%	4.9%
2.00%	5.8%	5.8%	5.8%	5.7%	5.7%	5.7%	5.7%
2.25%	6.5%	6.5%	6.5%	6.4%	6.4%	6.4%	6.4%
2.50%	7.3%	7.2%	7.2%	7.2%	7.1%	7.1%	7.1%
2.75%	8.0%	7.9%	7.9%	7.9%	7.8%	7.8%	7.8%
3.00%	8.7%	8.7%	8.6%	8.6%	8.6%	8.5%	8.5%
3.25%	9.4%	9.4%	9.4%	9.3%	9.3%	9.2%	9.2%

Source: First Global Research

	Pessimistic Scenario		Realistic Scenario		Optimistic Scenario

At present the organized retail is around 3.5% of total retail market in India. Assuming the total retail sector to grow at a CAGR equivalent to the nominal GDP growth rate (12% - 15%), we have calculated the expected organised retail as percentage of total retail under the three scenarios till 2010-11. In a pessimistic scenario (expected GDP CAGR of 12%-12.5%, Organised Retail/GDP at 1.25%-1.75%), we expect the organised retail to grow to 3.6%-5.1% of total retail till 2010-11. In an optimistic scenario (expected GDP CAGR of 14.5%-15.0%, Organised Retail/GDP at 2.75%-3.25%), we expect the organised retail to grow to 7.8%-9.2% of total retail till 2010-11. However in a realistic scenario (expected GDP CAGR of 13.0%-14.0%, Organised Retail/GDP at 2.0%-2.5%), we expect the organized retail to grow to 5.8%-7.1% till 2010-11.

As per AT Kearney survey, even globally organized retail is around 9% of the entire world's GDP. Even developed (and very small) nations like Hong Kong and Singapore have recorded around 16% and 18% organized retail as percentage of GDP.

How does potential market size correlate with the plans of individual players?…

In order to substantiate our estimates, we linked it to the investment plans of the players in the sector.

Our back-of-the-envelope calculations based on the plans announced by the existing players, as well as the investment expected by potential entrants, we estimate the total investment in the organized Indian retail industry to be around Rs.840 bn by 2010-11 (refer Table-I). Using the bottom-up approach, we have estimated this expected investment to be justified by incremental revenues of around Rs.1680 bn for the organized Indian retail industry.

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Back-of-the-envelope calculations for expected revenues

TABLE – IV		
	Expected Scenario by 2010-11	**Amt (INR bn)**
(A)	Expected upcoming Investment #	840
(B)	Expected RoCE (Based on the current Industry average)	11%
(C)	Incremental EBIT expected (C) = (A)*(B)	**92**
(D)	Average EBIT margin (Based on the current Pantaloon's margin)	*5.5%*
(E)	Incremental revenues expected in 2009-10 (E) = (C)/(D)	**1,680**

Source: First Global estimates

Note:

1) *# Refer to Table – I above for upcoming investments.*
2) *We have considered Pantaloon's EBIT margin due to its diversified (both value retail and lifestyle retail) business model. Even matured players like Wal Mart recorded an EBIT margin of 5.9% in FY07*

Given the huge potential for growth in the booming retail market, we believe that the industry majors such as Bharti-Wal Mart, Reliance, A V Birla Group, Pantaloon etc. will soon ramp up their expansion plans in order to capitalize on the arising opportunities as early as possible and as a pre-emptive competitive move. Apart from the listed players, even regional and private players such as Vishal Megamart, Subhiksha etc. have been doing well in their respective markets. Other international players may also enter through the JV/ other tie-up route. As the competition intensifies over the coming years, retail behemoths, such as Reliance, Bharti and Pantaloon, may

explore the option of acquiring some of these regional domestic players in order to increase their market presence in an inorganic manner.

In the current scenario, it appears quite feasible for 5-6 retail players, with core competencies in different segments, such as value retailing or lifestyle retailing, to maintain a reasonable pace of growth in the Indian retail market over the coming years.

The more important fact is that, as per our estimates, the upcoming investment of Rs. 840 bn looks much ahead of time. There is definitely some mismatch between the pace of such massive investments and the expected growth in demand till 2010-11. Moreover with almost every possible corporate house ready to jump in the retail foray, we believe that this demand-supply gap may further widen with due course of time, which will not only mount further pressure at the already stressed margins, but also deprive the investors of reasonable returns. More on this in our forthcoming pieces.

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IMPORTANT DISCLOSURES

Price Target

Price targets (if any) are derived from a subjective and/or quantitative analysis of financial and non-financial data of the concerned company using a combination of P/E, P/Sales, earnings growth, discounted cash flow (DCF) and its stock price history.

The risks that may impede achievement of the price target/investment thesis are -

- **Slow down in consumer spending**
- **Unfavourable developments in other macroeconomic factors**
- **Competitive moves by other players, especially if substantial FDI is allowed**
- **Failure of its new store formats**
- **Unexpected increases in raw material, personnel & other costs**

Rating system of First Global

Our rating system consists of three categories of ratings: Positive, Neutral and Negative. Within each of these categories, the rating may be absolute or relative. When assigning an absolute rating, the price target, if any, and the time period for the achievement of this price target, are given in the report. Similarly when assigning a relative rating, it will be with respect to certain market/sector index and for a certain period of time, both of which are specified in the report.

Rating in this report is relative to: CNX Nifty 50 Index

Positive Ratings

(i) Buy (B) *– This rating means that we expect the stock price to move up and achieve our specified price target, if any, over the specified time period.*

(ii) Buy at Declines (BD) *– This rating means that we expect the stock to provide a better (lower) entry price and then move up and achieve our specified price target, if any, over the specified time period.*

(ii) Outperform (OP) *– This is a relative rating, which means that we expect the stock price to outperform the specified market/sector index over the specified time period.*

Neutral Ratings

(i) Hold (H) *– This rating means that we expect no substantial move in the stock price over the specified time period.*

(ii) Marketperform (MP) *– This is a relative rating, which means that we expect the stock price to perform in line with the performance of the specified market/sector index over the specified time period.*

Negative Ratings

(i) Sell (S) *– This rating means that we expect the stock price to go down and achieve our specified price target, if any, over the specified time period.*

(ii) Sell into Strength (SS) *– This rating means that we expect the stock to provide a better (higher) exit price in the short term, by going up. Thereafter, we expect it to move down and achieve our specified price target, if any, over the specified time period.*

(iii) Underperform (UP) *– This is a relative rating, which means that we expect the stock price to underperform the specified market/sector index over the specified time period.*

(iv) Avoid (A) *– This rating means that the valuation concerns and/or the risks and uncertainties related to the stock are such that we do not recommend considering the stock for investment purposes.*

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