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India Research

Sector: Retailing

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

How the Changing face of Indian Retail will transform the Indian landscape

plus

The Strategic Challenges ahead

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IMPORTANT DISCLOSURES CAN BE FOUND AT THE END OF THIS REPORT.

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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 – Organized Retail or Kirana stores?

Part-IV - How the Changing face of Indian Retail will transform the Indian landscape 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 Big Picture of the Indian Retail sector

Organized retail is a true economic transformational leap that we are currently witnessing in India. Shopping malls may be old hat in the rest of the world, including Asia; but in India these are a fairly recent phenomenon - the story of the transformation of this part of Indian business, the Indian consumer behaviour and its impact on other parts of the economy from logistics & farming is still only beginning to unfold.

This report is the fourth (Part IV) of a five-part series on our comprehensive study of the Indian Retail sector (***"The First Global's Series on the Indian Retail Sector")***. In Part I, we had discussed the likely potential of the organized Indian Retail sector by FY2011 and cross-checked this against the market size required to justify the investments to be made by the players in the sector. In Part II, we had discussed the feasibility of the expected gargantuan expansion plans in the Indian market and if at all they will be able to generate a reasonable return for the investors. In Part III, we did a comprehensive analysis of Organized Retail store in a mall and Kirana store and discussed the critical success factors for a Retail store as well as a Kirana store and the expected scenario in the coming years.

In Part IV, we have analysed the changing face of the Indian Retail sector – the shift in revenue mix, expected margin pressures, and the growth opportunities, as well as strategic challenges ahead.

The Indian Retail sector is witnessing massive expansion plans by both existing players (like Pantaloon) and new entrants (such as Reliance, Bharti-Wal Mart, A V Birla, etc.). Although there are currently only a handful of listed players (Pantaloon, Shopper's Stop, Trent etc) in the Indian retail sector, we believe that the entry of both domestic (Reliance, Bharti-Wal Mart, AV Birla Group, etc.) as well as global companies (Wal Mart, Woolworths, Tesco, and Carrefour) will completely change the face of the entire Indian Retail sector.

TABLE – I
Expected upcoming Investments by 2010-11

Retail Players	Amt. (in INR bn)
Reliance Industries (in INR bn)	250
Bharti – Wal Mart	300
A V Birla Group	150
Pantaloon Retail	40
Others*	100
Aggregate Investments	**840**

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

At present, the organized Indian Retail sector currently has a turnover of Rs.360 bn and with the expected investment of Rs.840 bn *(please refer to Table I above),* we expect the potential of organized retail to grow at a CAGR of 35%-44% to around Rs.1200 bn-Rs. 1565 bn by 2010-11 (please refer to ***"The First Global's Series on the Indian Retail Sector"*** **Part I,** *"What is the real potential of the Indian Retail sector?"*). Given such a huge jump, the Indian Retail sector is bound to undergo significant changes in the coming years, which we have discussed in the next section of this report.

The changing face of Indian Retail

Food & Groceries to drive topline growth…

The entire retail industry can be divided into two segments - Value retailing, which is typically a low margin-high volume business (primarily food and groceries) and Lifestyle retailing, a high margin-low volume business (primarily apparel, footwear, etc.). Pantaloon is currently the only listed player in the retail industry that caters significantly to both the Value and Lifestyle business segments. Despite being a low margin business, Value retailing has been able to attract much greater customer traffic at retail malls and has helped retail companies, such as Pantaloon, to record a stupendous topline growth over the last few years. For Pantaloon, the contribution of the Value retailing business rose from 52% of the topline in Q1 FY05 (quarter ending Sep'04) to 72% in Q1 FY07 (quarter ending Sep'06).

Despite being a low margin business, Value retailing has been able to attract much greater customer traffic at retail malls and has helped retail companies, such as Pantaloon, to record a stupendous topline growth over the last few years

New entrants in the Indian retail industry, such as Reliance and the upcoming Bharti-Wal Mart, are also aiming to tap the Value-retailing segment in a big way and expect food and groceries to contribute around 40% to the topline. Both Reliance and Bharti-Wal Mart have already taken initiatives for regular supply of groceries and food items and are in the process of entering into agreements with big farmers for direct procurement of their food production at a price that is slightly higher than the prevailing market price. Such agreements between farmers and retailers will create a win-win situation for both the parties, as the former will obtain a better price for their production, while the latter will be able to attract increased customers by providing low cost products. The only losers will be the intermediaries.

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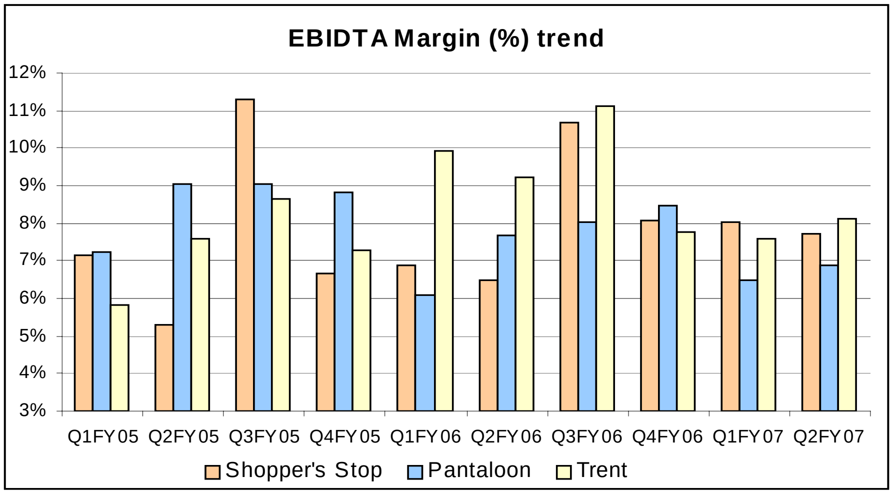
Margin pressure to continue into the future…

A higher contribution from the low margin Value retailing segment will maintain the pressure on the margins of retailers in the coming years. Moreover, higher operating expenses, primarily employee cost, lease rentals and selling and distribution expenses will further increase the pressure on margins in the coming years…

… with an increase in the number of retail players in the domestic industry, both the existing as well as the new entrants will be forced to incur higher selling and distribution cost towards brand promotion and efficient sourcing of goods

A higher contribution from the low margin Value retailing segment will maintain the pressure on the margins of retailers in the coming years. Moreover, higher operating expenses, primarily employee cost, lease rentals and selling and distribution expenses will further increase the pressure on margins in the coming years. The rise in employee cost is primarily due to shortage of talented and skilled manpower in the industry, which is typical of a fast growth industry. Moreover with an increase in the number of retail players in the domestic industry, both the existing as well as the new entrants will be forced to incur higher selling and distribution cost towards brand promotion and efficient sourcing of goods. ***The fact that the market is unlikely to grow fast enough to absorb the investments being made in the industry (see "The First Global's Series on the Indian Retail Sector", Part-I) only means greater competition to get the consumer's attention and share of wallet.***



Source: Company Financials, First Global

Even historically, such a rise in operating expenses has kept margins under pressure and we believe that a further rise is inevitable, which will therefore, mean a continued margin squeeze.. ***We believe that margin pressure will be common feature for all the industry players, as players in the Lifestyle segment, such as Shopper's Stop and Trent, who have minimum presence in the Value retailing segment, will also face the problem of high employee cost and selling & distribution cost, as well as competition from both nation-wide, as well as more regional chains.***

Even historically, such a rise in operating expenses has kept margins under pressure and we believe that a further rise is inevitable

Margin pressure to force introduction of private labels

In order to ease the pressure on margins and keep the bottomline growth in sync with the topline growth, most industry players have already introduced private labels, which enjoy comparatively higher margins. Apart from a higher contribution from the Lifestyle retailing segment, the significant contribution from private labels has helped retailers, such as Shopper's Stop and Trent, to maintain reasonably high margins (private labels contribute around 85-90% and 20-25% of Trent's and Shopper's Stop's topline respectively). Big players, such as Pantaloon, and new players, like Reliance, which has already opened 100 odd stores within nine months of its operations, have

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also introduced their private labels and plan to further increase their contribution over the coming years. Reliance has plans to introduce its own cola, juices, dairy products and cosmetics.

Of course, while private labels drive higher Gross Margins; given the brand-building & promotional expenses, the impact at the Operating margin level is less certain –especially, in the initial years. Globally, private labels are already a big trend and contribute to about 17% of the FMCG market (as per A C Nielson's report) – but then those markets are at a different stage of evolution.

Focus to be on logistics and supply chain management

Logistics play an important role in the retail industry for maintaining regular and efficient supply of goods, especially perishable items, such as food and groceries, where freshness is the key concern. Globally, big industry players, such as Wal Mart, have capitalized on their strong backend logistics and supply chain, which has helped them operate at minimal inventory level and simultaneously provide a regular supply of low priced goods to its customers. Such strong backend operations will help retail players to achieve operational synergies and operate on a much larger scale, thereby keeping their overall procurement costs low.

Globally, big industry players, such as Wal Mart, have capitalized on their strong backend logistics and supply chain, which has helped them operate at minimal inventory level and simultaneously provide a regular supply of low priced goods to its customers.

Until now, there have been no significant efforts to maintain an efficient logistics and supply chain management in the domestic market, although the expected rise in scale and operations ahead will result in both logistics and supply chain management becoming an integral part of any retail chain. Worldwide, led by Wal Mart, managing this efficiently, has become the most critical success factor in this business. Indian companies have a long way to go in this area. Moreover, with food and beverages expected to be the key topline contributors, logistics will play a vital role in efficient inventory management.

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Pantaloon, which is currently the largest Indian retail player, has decided to enter the logistics space with an investment of Rs.4-5 bn, thereby helping the company in making its processes much more efficient. Reliance has announced plans to invest around Rs.80 bn towards setting up its logistics and supply chain management system. Bharti has not declared any concrete plans for a foray into logistics as of now, although Wal Mart is expected to take care of the back end operations and logistics, thus making it highly possible that the company could replicate its global sourcing model and set up its own distribution and logistics system.

The Intended & Unintended consequences on allied & ancillary sectors

As concluded in our Part-II of the five-part series on Indian retail sector ***("The First Global's Series on the Indian Retail Sector"),*** although there is no dispute that the massive upcoming investment (as announced) will completely transform the entire economy, the organized retail players may not be able to justify the investors' returns generated vis-à-vis such massive investments. On the other hand, we believe that the growth in the Indian Retail sector will definitely aid the growth and development of the Indian economy as a whole, since it will help the allied sectors, such as agriculture, banking (especially rural credit), autos, logistics etc., to grow and develop further.

The Value retailing segment, especially the food and groceries segment, is expected to be the primary topline contributor in the coming years. Both Reliance and Bharti-Wal Mart are looking to enter into an agreement with big farmers for directly procuring their food requirements. We believe that such an agreement will be a win-win situation for both farmers as well as retailers, since the former will obtain a reasonably higher price for their production, while the elimination of intermediaries will simultaneously help retailers source their goods at a much lower cost. Reliance is already holding talks with the Maharashtra and Karnataka government for leasing land to produce vegetables, etc. Similarly, Bharti has already tied-up with some large farmers in Punjab to buy-back their produce directly.

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Agriculture based/Fertilizer industry

In order to optimise food production and meet the expected demand of retailers, farmers will need new and upgraded variety of seeds, fertilizers and advanced agricultural equipments for efficient agricultural production. However, domestic retailers may face some constraints in maintaining regular supply of quality products due to the fragmented and small operational scale of Indian farmers. Thus, in order to build up operational scale and overall efficiency, farmers will have to use better quality seeds and new upgraded technology. We believe that due to the expected rise in such agreements between retailers and farmers (for direct procurement of food production), the demand for high quality seeds, fertilizers and technologically advanced agricultural equipments will increase.

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Micro Finance/Rural Credit

The demand for high quality seeds and upgraded technological initiatives will require significant investments from farmers as well as retailers. Although some retailers like Reliance and Bharti-Wal Mart, are willing to extend credit to farmers, we believe that such massive demand from farmers for technologically advanced equipments will create sufficient lending opportunities for financial institutions, especially Banks and Non-banking financial institutions (NBFCs), for further growth and development in rural credit.

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Consumer Credit

The boom in the Indian retail market is primarily on account of the Indian economy's consumption led growth and there could be increased focus on consumer credit in order to keep this growth intact. In anticipation of such demand, a few retail companies, such as Pantaloon and Reliance, have already declared plans to enter the consumer credit business. Pantaloon has tied up with GE Money to provide consumer finance to its customers and it has also tied up with a Fortune 22 company, Assicurazioni Generali, which is the third largest European insurance company through its subsidiary. Reliance is also looking at setting up a credit arm for financing its customers, either through an NBFC or through an agreement with some banks.

Food, Beverages & Entertainment Industry

The growth of the Indian retail sector depends on the ability of retailers to convert unorganised retail customers to organized retail customers. In order to attract more customers, organized retailers will not only have to provide low cost-good quality goods, but also deliver a complete entertainment, food and shopping experience to its customers. In order to boost revenues, retailers may tie-up with some theatres (entertainment industry) or provide similar facilities in-house. We believe that there is tremendous opportunity for players in the food & beverages, as well as the entertainment (especially theatres) industry to expand their market presence. ***In fact, in many shopping malls, the outlets doing the best are the food outlets & the multiplexes!***

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Commercial Vehicles

The need for better and efficient logistics and supply chain management will lead to an increase in the demand for commercial vehicles for both inbound as well as outbound transportation. We believe that most industry players will follow the hub and spoke system, thus maintaining a number of warehouses across the nation for catering to the individual demands of retail stores. Such a hub and spoke system will require a significantly large network of commercial vehicles, especially refrigerated vehicles for an efficient inventory replenishment system. Moreover such a demand will have a multiplier effect on other allied sectors like auto ancillary, tyres etc.

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Retail companies may also enter into an agreement with some local transportation companies, although that still remains a distant possibility, since inventory management is quite a delicate issue due to minimum tolerance level in the retail industry and retailers may not like to compromise on this front, since any delay could directly impact the customers. We believe that in order to maintain an efficient inventory management system (which is quite essential for all retail players), most companies will prefer to have their own fleet of vehicles, instead of being dependent on any other company. Alternatively, they may insist on a dedicated fleet from their transport providers.

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Margin/ Working Capital squeeze for FMCG and Consumer Durables companies ahead…

Till now, the big FMCG giants and consumer durable companies had much greater bargaining power, which provided them enough muscle to arm-twist the small unorganised retailers. However, with the conversion of unorganised retail to organized retail, several large organized retail players will emerge, which will lead to a decline in the bargaining power of the former and may have an adverse impact on their margins and/or working capital. This is something, which is already visible in developed economies.

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The success of both organized retail companies as well as the FMCG/Consumer durables company are complementary to each other. For instance, both Reliance and HLL are complementary for each other's success, since a Reliance store without any HLL product may not be able to attract much customers and similarly HLL may miss an opportunity if its products are not available in a Reliance store, especially considering its fast-pace expansion plan. We believe that since the FMCG/Consumer durable companies will not be able to enjoy the same high bargaining power with organized retailers, as earlier with the unorganised (primarily Kirana stores) retail players, they will definitely face margin pressure in the coming years. The extent of such margin pressure will depend upon the bargaining power of both organized retail players as well as the FMCG/Consumer durables companies, since both are complementary to each other. ***The more likely impact will be on working capital management, where the negative working capital historically enjoyed by major FMCG companies, which could arm-twist their distributors to pay cash in advance, may be a thing of the past.***

Professionalization of supplier & ancillary industries

At present there are certain unorganised and fragmented industries like plastics, packaging material, steel utensils, low-end kitchen appliances etc in India. We believe that with the conversion of unorganised retail to organised retail, there will be a significant rise in the demand for such products, which will aid the unorganised and small industry players to scale-up their operations. Such an increased scale of operations will lead to rise in the profitability and professionalism of the industry players.

Strategic challenges ahead…

Delivering the right 'Shopping Experience'

Unlike foreign customers, Indian customers may prefer not to buy their monthly groceries in bulk. Most of the customers would not like to take the trouble of carrying their purchases from the shopping mall to their home and would instead prefer to enjoy free home delivery. The personalized treatment offered by local kirana shop-owners will definitely have an edge over big retail malls in terms of service, since it will be an uphill task for them to provide similar personalized treatment to customers. A long billing-queue, non-availability of particular goods etc. may have a negative impact on the customers' shopping experience. Thus, it could hardly be a cakewalk for retailers to deliver the right 'shopping experience' for the customers.

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Smaller neighbourhood stores is a format that is being explored by some players, and these may provide head-to-head competition for Mom and Pop kirana stores.

Availability of 'Right location at right price'

There are some key factors that have a direct impact on the topline of any retail company. One such factor is the availability of the right location for any retail mall, so that the mall is able to attract significant customer traffic. Moreover, apart from the right location, the land should also be available at a reasonable price, so that the high lease rentals do not have an adverse impact on the bottomline. Although many companies, such as Reliance, Bharti-Wal Mart and Pantaloon, have declared huge expansion plans, we are most concerned over the availability of the right location and the cost incurred (in terms of lease rentals) for companies in the retail industry.

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The demand for the 'right location' will always be higher than supply, as a result of which, retail companies may have to compromise on either location or lease rentals. We believe that retailers may compromise on rentals, but not on the location. Over the past few years, the aggressive expansion plans across the retail industry have already led to a rise in lease rentals, which is expected to continue in the future.

However, such an increase in lease rentals will ultimately have an adverse impact on the bottomline. ***Lease rentals in India already form almost 6-10% of the topline, as compared to the global average lease rentals of up to 5-6% of the topline. For some domestic companies, such as***

Shopper's Stop, lease rentals account for almost 10-11% of the topline. Such high rental costs will lead to further pressure on margins.

We believe that in order to ease the pressure on the bottomline, domestic retail companies will follow the global model of retail malls on the city's outskirts, which will protect the company from high rentals, while simultaneously providing a much-improved shopping experience to customers.

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Inadequate supply of goods

Sourcing of low price-high quality products is quite important for retail companies, since an efficient and regular supply of such products will help them record better margins as well as gain market share. Global players, such as Wal Mart, Carrefour, Tesco, etc., are already sourcing their products from various low cost countries, like India and China, which helps them keep costs lower and improve their product portfolio. Wal Mart sources a large amount of made-in-India goods, including home textiles, apparels, jewellery, house wares, etc., and is expected to increase the same by almost 50% to more than Rs.27 bn by FY08.

We believe that with the entry of new players, such as Reliance and Bharti, the biggest problem could come in the form of sourcing, primarily due to fragmented and comparatively smaller operational scale of suppliers. Even if a retail company manages to procure products for all its stores, there would surely be a marked increase in the suppliers' power, which would ultimately be reflected in the form of increased pressure on margins. Moreover keeping the Indian consumers' price sensitivity in consideration, the retail companies may have to compromise on product quality, which may have an adverse impact on goodwill.

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Lack of talented manpower

Apart from sourcing, manpower management could also be a cause for concern to retail companies. The problem does not lie in the shortage of manpower, but rather in the shortage of the requisite talented and skilled manpower, which is an industry-wide feature. Moreover, being a high growth sector, retail companies are witnessing high attrition rates, which vary from player to player and are as high as 35-40% for some companies. Although some retail companies, such as Pantaloon, have already tied up with a number of management institutes for recruitment, we believe that finding adequately skilled and experienced personnel will be a big problem for the companies.

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Government Restrictions & Regulations

According to Press Note 3 (2006 series), the Indian government has allowed FDI of up to 51% in 'single brand' products with due approval. The government has permitted 100% FDI in companies that engage in wholesale trading or 'cash & carry' operations. It has enforced such restrictions primarily to protect the interest of small kirana shop-owners.

Although the government is in talks to allow FDI in certain selected retail segments like sports goods, consumer durables etc, it has not taken any particular decision whether to allow FDI in the Indian retail sector or not. We believe that with the opening of FDI in the retail sector, the scale of operations will increase substantially, which will create much greater employment opportunities in the coming years. However, stringent labour laws and the disparate state-wise sales tax are further adding to the woes of organized retailers.

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The huge investments required

A glance at the gargantuan expansion plans announced by retail majors, such as Reliance, Pantaloon and Bharti-Wal Mart, shows that retail companies are going all out to woo more customers. We estimate the retail sector to invest around Rs.840 bn by 2011 (refer Table-I) towards capital expenditure and working capital requirements. Moreover, the retail companies may face the problem of huge blocked investments in maintaining its inventory level (in the form of displayed and buffer stock), which may require further investments in the coming years.

Such gargantuan expansion plans will require huge funds, which may not be easy to manage. Apart from the availability of such funds, the cost of funding such huge investment requirements poses a serious concern. Any further rise in the interest rates will take a toll on the margins of retailers and will put further pressure on the already squeezed bottomline.

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Lack of adequate infrastructure

India is viewed as one of the most favoured FDI destinations worldwide. However, there are still some basic roadblocks, primarily infrastructure development, which are slowing down the pace of growth. Bumpy roads, irregular electricity and water supply are having an impact on the growth of the Indian economy. While the government is making efforts to overcome these roadblocks, the slow pace of infrastructure development remains a concern.

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IMPORTANT DISCLOSURES

Price Target

Price targets (if any) are derived from a subjective and/or quantitative analysis of financial and nonfinancial 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 development of the industry 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: S&P CNX Nifty

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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