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India Research

Sector: Retailing

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

Can India learn some lessons in Retail FDI from the 'Dragon'?

Including

How attractive is FDI in Retail for India?

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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 - Retail malls 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 attractive is FDI in Retail for India?

FDI in Indian Retail

This report is the Fifth (Part V) 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. **In Part IV,** we 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; as well as the impact of all of this on the broader economy.

In Part V, we have done a comprehensive analysis of Foreign Direct Investment (FDI) in Indian Retail dealing with questions like how attractive is FDI for Indian Retail Sector. We have also compared the Chinese FDI retail model and its impact on Chinese domestic retail industry.

The Government of India had already eased its FDI restrictions in the telecom sector in 2005 (and has further raised the bar to 74% foreign holding recently), which led to a stupendous growth in the mobile telephony market. However it is still indecisive on allowing FDI in the domestic retail sector and is concerned over the possible impact of such a move on the unorganised retail sector, especially mom-and-pop stores. The Government has even set a separate committee to adjudge the possible impact of such massive investment (as expected) on the unorganised retailers.

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In our view, the hue and cry over the much-hyped 'FDI in retail sector'. The real conflict, if any, will be between the organised & unorganised retail players, rather than foreign-owned & domestic ones. Even the gargantuan expansion plans (worth Rs.840 bn by 2010-11) by the domestic majors will have almost a similar impact (as that of FDI), on the unorganised retailers. Interestingly, in China, both the organized retailers as well as unorganised retailers are co-existing profitably, even several years after FDI in retail was allowed.

China opened 26% FDI in the retail sector in 1992 (Retail FDI of $ 22 bn till 2002), which led to a 5-fold jump in topline in a decade (FY92-FY02) from around $100 bn to more than $500 bn in 2002 (mind you, with still only 26% FDI). With the opening of FDI in retail, the global retailers not only came forward with huge funds, but also with better technology and much greater employment opportunities. Moreover the global retailers preferred to source their good from the local markets, which also strengthened the domestic manufacturing base.

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We believe that India can easily follow the Chinese model and ease its FDI regulations in the retail sector in a step-by-step manner, which will not only bring funds, but also bring better technology in the domestic retail sector. However, the government can always put in conditions (as done by the Chinese authorities) such as restrictions on the expansion of global retailers (as done in China), greater sourcing from the domestic market and job-creation for the local people. Apart from driving the growth in the retail sector, FDI will also help drive the growth in allied sectors such as agriculture, logistics and certain manufacturing industries. (Please refer to **Part-IV** of ***"The First Global's Series on the Indian Retail Sector"***)

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Existing FDI guidelines in India

According to Press Note 3 (2006 series), the Indian government has allowed up to 51% FDI 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 has been indecisive in allowing FDI in the domestic retail sector for quite a long time now, it has recently announced plans for allowing 51% FDI in select retail segments, such as sportswear, sports equipment and accessories, etc.

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Retail FDI – The China way…

China opened-up its domestic retail sector with 26% FDI in 1992, increased it to 49% in 2002 and later increased it to 100% in 2004-05. China benefited not only from the foreign capital, but also from the new and upgraded technology, which helped the entire retail sector to achieve immense growth since then. Chinese retail revenues grew at a CAGR of 15% to more than $500 bn in 2002 (with only 26% FDI), while the employment in Chinese retail sector grew at 6% CAGR (1992-2002). Prior to allowing FDI in the retail sector, the Chinese government undertook certain precautionary measures to protect its domestic players:

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- The Chinese government provided various incentives to the domestic retailers to build up scale and strengthen their position (through expansion or mergers) in the domestic retail sector to face the fierce competition from global retailers.

- The Chinese government restricted the expansion plans of foreign retailers to six big cities in the initial years to prevent the monopoly of global retailers.

- The Chinese government owns the land in China and provides it on a long-term lease to the retailers, which facilitated the government to keep a tab on the expansion plans of foreign retailers.

- China already had a strong manufacturing base even before easing the FDI regulations, which facilitated the global retailers sourcing from the local market and aided the manufacturing sector growth as well.

At present, around 40 of the top 50 foreign retail players are present in the Chinese retail market. The opening up of FDI in the retail sector in China led to a positive growth for domestic and foreign retailers, as well as domestic suppliers. A strong manufacturing base in China facilitated global retailers like Wal Mart, Carrefour and Tesco sourcing their domestic requirements (in China), as well as their global requirements from China only (over 80% of the requirements for local Chinese stores were met through domestic sourcing).

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Interestingly, despite the fierce competition from global retailers, domestic unorganised Chinese retailers (those who were operationally efficient and were able to match the offerings of global retailers) were able to co-exist profitably with the organized global retailers in the Chinese retail sector. Wal Mart, the global retail giant, was unable to gain significant market share (it is currently not among the top 5 retailers in China) due to fierce competition from players such as Carrefour, Tesco etc. Even globally, the fundamental Law of Evolution - Survival of the Fittest – has led to the exit of global giants from foreign markets. Wal Mart and Carrefour had to exit Germany and South Korea, since they were unable to compete with domestic retailers – so foreigners gaining the upper hand is not a certainty, especially in markets with many local peculiarities.

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However, the opening up of FDI in China was not all that smooth. While the Chinese retail sector did witness a tremendous growth, there were some adverse implications for small retailers and suppliers in China. In order to bring down costs, the foreign retailers, especially Wal Mart and Carrefour (with high bargaining power), squeezed their suppliers to the last penny, which led to dissatisfaction amongst local suppliers.

Although the Chinese government took a number of initiatives to protect the interests of small domestic retailers, the penetration of supermarkets and hypermarkets (some time after the opening of FDI in the retail sector in China) had an adverse impact on the inefficient small mom-and-pop stores. We believe that although such massive expansion plans from the organized retailers will have an adverse impact on inefficient mom-and-pop stores, the efficient ones will still be able to co-exist with organized retailers, as witnessed in global markets, such as China (please refer to **Part-III** of ***"The First Global's Series on the Indian Retail Sector"***)

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How attractive is FDI in Retail for India?

The organized retail in India is still at a nascent stage (~4% of the total retail sector and almost 1.3% of the nominal GDP), with only Pantaloon present significantly in both the value retailing (food and groceries) and lifestyle retailing (apparels, footwear etc) segments, while other players, like Trent and Shopper's Stop, are primarily present in the lifestyle segment. Moreover, with the entry of industry majors, like Reliance, Bharti-Wal Mart and A.V. Birla etc, the industry dynamics are bound to undergo a significant change in the coming years. At present, the organized Indian retail market is worth around Rs.360 bn and has the potential to grow at a CAGR of 35%-44% to Rs. 1200 bn – Rs.1565 bn by 2010-11. (Please refer **Part-I** of "***The First Global's Series on the Indian Retail Sector")***

With the opening of FDI in retail, the global retailers will not only come forward with huge funds, but also with better technology and much greater employment opportunities. Moreover the increased sourcing from global retailers from the local markets (as happened in China) will also strengthen the domestic manufacturing base.

FDI to drive much faster growth in agriculture sector

Similar to China, the value-retailing segment (food and groceries) will be the primary contributor to the topline in India as well. Food and groceries contribute over 40% of the topline in China. However, in order to achieve its full potential, the food and groceries segment requires a significant investment, primarily in infrastructure development. Due to such lack of proper infrastructure facilities, the organized retail players have recorded inventory shrinkage of 25-40% in the fruits and vegetables segment. The fruits and vegetable supply chain is still underdeveloped, primarily due to obsolete technology and lack of basic facilities such as power, water etc. Moreover, fragmented land ownership further increases the cost of agricultural production, which ultimately leads to lower productivity.

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We believe that a substantial investment, primarily in the development of basic infrastructure and new technology (for better agricultural production) is the need of the hour. At present, the agriculture produce, primarily food and groceries (which includes fruits and vegetables segment), contribute over 50% of the retail sector's revenues, which may increase in the coming years. All the players in the value-retailing segment, including existing players like Pantaloon, and new players like Reliance and Bharti-Wal Mart, are looking to grab a substantial share in the domestic market.

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Reliance and Bharti-Wal Mart are already holding talks with big farmers for directly procuring their agricultural produce, which will be a win-win situation for both the farmers as well as retail companies, since the latter will be able to procure goods at a much lower cost (due to the elimination of intermediaries), while at the same time, the farmers may get a substantially higher price than the prevailing market price. Moreover, we believe that the government should introduce some regulatory mechanism to restrict hoarding of agriculture produce and prevent artificial inflation.

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Increased sourcing to scale-up operations in manufacturing sector, but stringent labour laws a concern

Globally, retailers prefer to source goods from the domestic manufacturing sector, which helps them customize their goods for local customers. These foreign players source their requirements for their local stores (in the foreign countries) as well as for their stores worldwide from domestic manufacturers. For instance, Wal Mart sources over 80% of its local requirements (Chinese stores) from local producers and also sources for its stores worldwide. Although Wal Mart is not presently operating in India, it still sources a significant amount of Indian-made goods, including home textiles, apparels, jewellery and house wares, etc., which is expected to increase by almost 50% in the coming years.

In China, before allowing FDI, a strong and efficient domestic manufacturing sector helped it capitalize on the increased sourcing that led to an increase in exports. On the contrary, the Indian manufacturing sector is quite fragmented, which may lead to sourcing problems for retailers in the coming years. Moreover, stringent labour laws and the varying state-wise sales tax add to the displeasure of retailers as well as manufacturers and restrict the industry's fast paced growth. The implementation of VAT (Value Added Tax), which is still being discussed, will help improve the efficiency of the domestic manufacturing industry.

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Other benefits

❑ *Infrastructure development*

Although the retail companies have declared massive investment amounting to Rs.840 bn *(as discussed earlier, please refer to Table-I)* in the coming years, bottlenecks like inadequate infrastructure (lack of proper roads, weak supply chain, cold storage etc.) may restrict the growth potential of the domestic retail sector. However as in Bharti-Wal Mart agreement, the foreign partner will aid the backend management and logistics support, while the domestic partner will manage the front-end retail. This format may be followed in other JVs as well. Such foreign investment will strengthen the backend operations and will increase the operational efficiency.

❑ *Employment Opportunities*

The retail sector employs almost 8% of the population and is the second largest employer after agriculture in India. With the opening up of retail FDI, the scale of operations in the retailing as well as manufacturing sector (especially apparels etc.) will increase, which will create much greater employment opportunities for the young population in India. Moreover, with the use of upgraded and better technology in the agriculture sector, the problem of disguised unemployment could also be dealt with to some extent.

❑ *Greater source of revenues for the Government*

A shift from unorganized retail to organized retail will keep a check on tax evasion and will increase the government's revenues in the form of higher tax collection. Unorganized retailers, especially the mom-and-pop and kirana stores, generally evade taxes by issuing improper bills or under-billing, which leads to revenue loss for the government.

Our view…

We believe that India should follow the Chinese model and ease its FDI regulations in the retail sector in a step-by-step manner, which will not only bring funds, but also bring better technology in the domestic retail sector. However, the government must take preventive measures such as restrictions on the expansion of global retailers (as done in China), greater sourcing from the domestic market and job-creation for the local people. Apart from driving the growth in the retail sector, FDI will also help drive the growth in allied sectors such as agriculture, logistics and certain manufacturing industries. (Please refer to **Part-IV** of ***"The First Global's Series on the Indian Retail Sector"***).

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We believe that it may not be a cakewalk for foreign players to match the customized services provided by the unorganised retailers and attract their customers. The personalized treatment offered by the local kirana shop-owners, which can be considered their USP (Unique Selling Proposition), will definitely have an edge over big retail malls (whether domestic players or foreign) in terms of service. (Please refer to **Part-III** of ***"The First Global's Series on the Indian Retail Sector"***)

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 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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