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India Research

Sector: Retailing

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

"Historically there has been no clear link between economic transformation and high profits for the average company. In fact, the reverse is often true…"
- 'The Undercover Economist'

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"Historically there has been no clear link between economic transformation and high profits for the average company. Infact, the reverse is often true: economic transformation destroys the profitability of old firms, while the new firms that replace them often face a high failure rate and very large costs of building their business. The advantages are enjoyed by workers who are paid higher wages and by customers who pay lower prices or get new and better goods and services…

…(for example) even the rail companies weren't great investments, and the worst were financial disasters. But nobody disputes the railways completely transformed the developed economies…competition to build and operate rail lines kept profits modest. As long as competition is strong, the railways had little scarcity power."

– ***Tim Harford***
(The Undercover Economist)

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The First Global's 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 **The changing face of Indian Retail and the strategic challenges ahead**

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

Will such gigantic expansion plans be feasible?

This report is the second (Part II) of a five-part series of 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. The broad findings: While the likely size of the retail market by 2010-11 is around Rs. 1198 bn to Rs. 1565 bn, it is still about 25% lower than the market required to justify merely the investment announced by the retailers. (For details, see Part-I of '***The First Global's Series on the Indian Retail Sector***).

In this report, we have performed a feasibility study of the gargantuan expansion plans (announced by both existing players as well as new entrants) in the Indian retail sector and examined whether these plans will be able to generate reasonable returns for investors.

The Indian Retail sector currently has a turnover of Rs.360 bn and both the existing players as well as the new entrants have announced aggressive expansion plans to the tune of Rs.840 bn (please refer to Table II) over the coming years. The expansion plans of existing retail players, such as Pantaloon (Rs.40 bn), appear quite modest in comparison to the gigantic expansion plans of new entrants, such as Reliance (Rs.250 bn), Bharti-Wal Mart (Rs.300 bn) and A.V. Birla (Rs.150 bn). Moreover, due to the rising disposable income of Indian consumers, global players, such as Carrefour, Tesco, etc., are also planning to enter the Indian retail market. Although we do believe in the potential of the Indian Retail sector, the pace and size of these expansion plans are a cause for concern to us. Moreover this level of investment and hence competition, would be a dampener for profits and return ratios.

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… although we do believe in the potential of the Indian Retail sector, the pace and size of these expansion plans are a cause for concern to us. Moreover this level of investment and hence competition, would be a dampener for profits and return ratios

In order to study the feasibility of such massive investment amounting to Rs.840 bn, we have calculated the expected incremental revenues (assuming that organized retailers will be able to attract the unorganised retail customers) and the expected return to the investors. We have calculated whether such investments will be able to create any value for the investors in two scenarios – Case I, wherein 50% of the expected investment will be funded through debt and Case II, wherein 75% of the expected investment will be funded through debt. We have considered a minimum RoE of 14.4% on the basis of weighted average of RoE of the three retail players, Pantaloon, Shopper's Stop and Trent in FY06 (please refer to the underlying assumptions stated below) and also based on the current risk-free rate of return of 8-9% in the Indian economy.

As per our estimates, there is a significant mismatch between the pace of such massive investments and the expected growth in demand till 2011. There are very bleak chances of the retail companies generating a reasonable return for the investors. Mounting pressure at the margins front may further aggravate the investors' woes. Moreover apart from the lower investor returns, the retail companies also carry much greater financial risk (due to high leverage), apart from the high execution risk. We believe that the returns generated for the investors may not justify the huge financial as well as business risk. Such findings are in sync with our findings in the first part of our five-part series on the Indian Retail sector ***(for more details, please refer 'The First Global's Series on the Indian Retail Sector - Part-I').***

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Key findings…

- We believe that there is definitely a significant mismatch between the pace of such massive investments and the expected growth in demand till 2011

- As per our estimates, in a realistic scenario, the retail companies will not be able to justify such massive investments of Rs. 840 bn, since they will not be able to generate the minimum required return ratios, even under the best case scenarios till 2011 in Case-I (50% leverage).

- In order to generate a minimum RoE of 14.4%, the retail companies will have to record a minimum EBIT margin of 7-7.5% by FY2011, which at present looks like a near impossibility, given that organized retailers are averaging an EBIT margin of only 6-6.5% today; even in a much less competitive market and even this margin is under pressure.

- In a realistic scenario, (leave alone the pessimistic scenario), we find that the retail players are unable to cover their costs and are likely to record an RoE varying from a negative return to 10.0% till 2011 in Case-II (75% leverage). Although high leverage aids the retail companies to generate higher RoE in the optimistic scenario, we believe that it may be an uphill task for the retail players to generate a reasonable RoE in a realistic scenario

- The impact of such a change in the cost of debt was quite low in comparison to the impact of a change in the EBIT margin, both in Case-I and II. The slightest change in the EBIT margin (keeping other things constant) results in a higher incremental gain in the RoE.

- We believe that the retail companies will be able to justify such massive investments only in an optimistic scenario, with a combination of both high revenue per sq ft and higher margins, which to our mind amounts to wishful thinking. In fact, there is likely to be a trade-off between revenues and margins; and net results will be lower returns for investors.

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In a realistic scenario, (leave alone the pessimistic scenario), we find that the retail players are unable to cover their costs and are likely to record an RoE varying from a negative return to 10.0% till 2011 in Case-II (75% leverage)

The retail companies will be able to justify such massive investments only in an optimistic scenario, with a combination of both high revenue per sq ft and higher margins, which to our mind amounts to wishful thinking

Underlying assumptions…

Our study is based primarily on the following assumptions:

- We have assumed that organized retailers will be able to attract customers of unorganised retail in the coming years.

- Following are the assumptions considered to calculate the additional retail area (in mn sq ft) by FY2011:

TABLE – I		
Assumptions for calculation of additional retail area by FY2011		
	Particulars	***Amt. (in INR bn)***
(A)	Upcoming Investment **(say)**	100
	Less:	
(B)	Investment in Logistics (@30% of capital invested) (B) = (A) * 30%	30
(C) #	Working Capital Investment (@40% of capital invested) (C) = (A) * 40%	40
(D)	**Amount available for Capex (in INR bn)** (D) = (A)–(B)–(C)	**30**
(E)	Average construction cost per sq ft.	1200
(F)	**Expected area addition (in mn sq ft)** (F) = ((D)*1,000)/ (E)	**25**

Working Capital Investment as % of Capital employed is considered as per industry average

- We have assumed an average Rs. 1200 per sq ft as construction cost on the basis of current industry scenario. An average mall has a construction cost of around Rs.900 per sq ft, while a luxury (lifestyle retailing business) mall has a construction cost of around Rs.1400-1500 per sq ft.

- In order to undertake a sensitivity analysis, we have considered the existing revenues per sq ft (FY2006) for the three listed players, Pantaloon, Shopper's Stop and Trent, as base figures.

Retail Players	***Revenue per sq ft FY2006 (In INR)***
Pantaloon Retail *	5700
Shopper's Stop	7570
Trent	4840

** **Note**: Pantaloon Retail is the only listed player to have substantial presence in both lifestyle and value retailing segment*

- In order to justify such massive investments, we have considered a benchmark RoE of 14.4% (weighted average RoE of existing retail players; revenues considered as weights), based on the following assumptions:

Retail Players	***Revenues (FY06)***	***Weight (based on FY06 revenues)***	***RoE (FY06)***	***Weighted RoE (%)***
Pantaloon Retail	18,678	0.67	16.9%	11.32%
Shopper's Stop	5,882	0.21	14.6%	3.07%
Trent	3,464	0.12	9.8%	1.18%
Aggregate	***28,024***	***1.00***		***14.4%***

This is also in sync with the approximate cost of equity calculated based on the current risk-free long-term rate of 8-9% plus an equity premium.

- We have assumed a tax rate to be 30% for all calculations.

Study and findings…

Both the existing retail players like Pantaloon and the new entrants like Reliance, Bharti-Wal Mart, A.V.Birla group etc have declared their massive expansion plans. Based on such gigantic expansion plans and our underlying assumptions, we have calculated the expected additional retail area in the domestic retail market by FY2011 (for assumptions, please refer Table-I above).

TABLE – II
(Refer Table-I in underlying Assumptions)

Retail Players	***Upcoming Investments (In INR bn)***	***Additional area (In mn sq ft)****
Reliance Retail	250	62.5
Bharti – Wal Mart	300	75
A V Birla	150	37.5
Pantaloon Retail (*As announced by the company*)	40	20
Others (*Includes Hero Group, Shopper's Stop & other regional players*)	100	25
Aggregate additional developments	**840**	**220**

** Calculated as per Table-I*

Based on our calculations, we estimate an additional retail area of 220 mn sq ft (refer Table-II above) in the Indian retail sector by FY2011. On the basis of such upcoming retail area and expected revenues per sq ft, we have done a sensitivity analysis and estimated the incremental revenues till 2011 under three scenarios – pessimistic, realistic and optimistic.

(Amount in INR bn)

TABLE - III
Expected Incremental revenue (in INR bn) by FY2011

	Revenue per sq ft per annum (in INR)								
Additional area in mn sq ft.	**4000**	**4500**	**5000**	**5500**	**6000**	**6500**	**7000**	**7500**	**8000**
180	720	810	900	990	1,080	1,170	1,260	1,350	1,440
190	760	855	950	1,045	1,140	1,235	1,330	1,425	1,520
200	800	900	1,000	1,100	1,200	1,300	1,400	1,500	1,600
210	840	945	1,050	1,155	1,260	1,365	1,470	1,575	1,680
220	880	990	1,100	1,210	1,320	1,430	1,540	1,650	1,760
230	920	1,035	1,150	1,265	1,380	1,495	1,610	1,725	1,840
240	960	1,080	1,200	1,320	1,440	1,560	1,680	1,800	1,920
250	1,000	1,125	1,250	1,375	1,500	1,625	1,750	1,875	2,000
260	1,040	1,170	1,300	1,430	1,560	1,690	1,820	1,950	2,080

Source: First Global Research

Pessimistic Scenario | Realistic Scenario | Optimistic Scenario

As per our estimates, the incremental revenues will vary from Rs. 720 bn to Rs. 2080 bn by 2011. In a realistic scenario, we expect the retail companies to generate Rs. 5500-6500 revenue per sq ft which translated into incremental revenues of Rs.1155 bn – 1495 bn by 2011. This is equivalent to a

total organized retail market size of Rs. 1190 bn – Rs. 1525 bn (adding the current revenues to the estimated incremental revenues). As discussed in Part-I of this series, the market may not be able to absorb this level of supply. We believe with the entry of giant players, such as Reliance and Bharti-Wal Mart, the revenue stream will become skewed towards value retailing (food and groceries). Moreover, value retailing could be one of the key factors to attract price-sensitive Indian consumers from unorganised retail to organized retail.

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Pantaloon, which is the only listed retail player with a substantial presence in both lifestyle retailing (apparels, footwear, etc.) and value retailing (food and groceries), has already recorded an increase in the contribution of value retailing to the topline from 52% in Q1 FY05 to 72% in Q1 FY07.

(Amount in INR bn)

TABLE - IV

Expected Incremental EBIT (in INR bn) by FY2011
(Based on revenues as calculated in Table-I)

	Revenue per sq ft per annum (in INR)									
Expected EBIT margin (in %)	**4000**	**4500**	**5000**	**5500**	**6000**	**6500**	**7000**	**7500**	**8000**	**Additional area in mn sq ft.**
3.5%	25	28	32	35	38	41	44	47	50	**180**
4.0%	30	34	38	42	46	49	53	57	61	**190**
4.5%	36	41	45	50	54	59	63	68	72	**200**
5.0%	42	47	53	58	63	68	74	79	84	**210**
5.5%	48	54	61	67	73	79	85	91	97	**220**
6.0%	55	62	69	76	83	90	97	104	110	**230**
6.5%	62	70	78	86	94	101	109	117	125	**240**
7.0%	70	79	88	96	105	114	123	131	140	**250**
7.5%	78	88	98	107	117	127	137	146	156	**260**

Source: First Global Research

Pessimistic Scenario | Realistic Scenario | Optimistic Scenario

In view of the higher contribution from the value-retailing segment, we expect the EBIT margin to remain under pressure. Moreover, increasing operating expenses, especially employee cost and selling & distribution cost (as discussed latter in the report) will further increase the pressure on margins. However the EBIT margins will vary with the business model – value retailing (food and groceries), which is typically a low-margin business and lifestyle retailing (apparels, footwear etc), which is typically a higher-margin (though lower turnover) business. Considering this, we have estimated the EBIT margin to vary from 3.5-7.5% by FY2011. In a realistic scenario, we believe that the EBIT margin will vary from 5.0%-6.0% by 2011.

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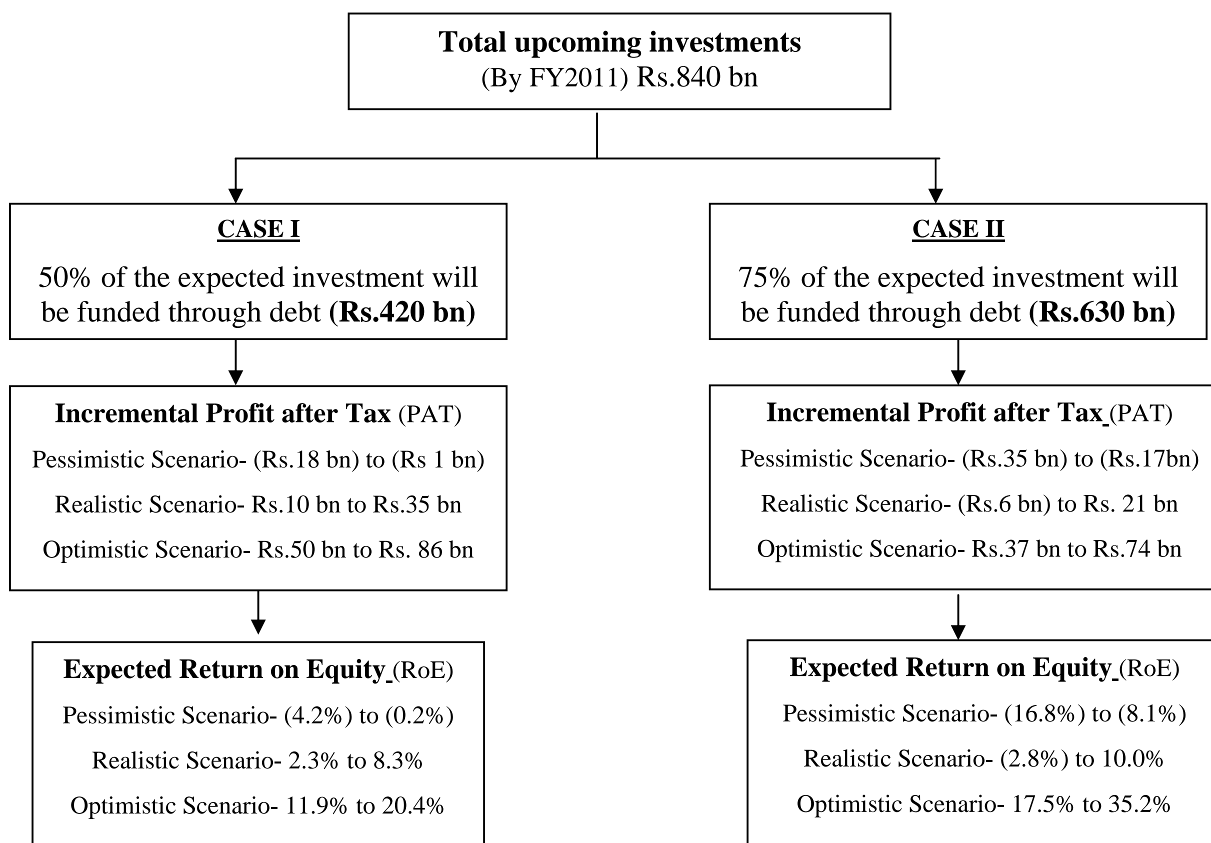
Two case studies

A higher contribution from value retailing may help retail companies boost their topline growth, yet the key question that needs to be answered is if this topline growth would translate into a reasonable return for shareholders. In order to judge the feasibility of such massive investments, we computed the expected RoE by 2011 under two prospective scenario: Case I, wherein 50% of the expected investment is funded through debt and Case II, wherein 75% of the expected investment is funded through debt.

A higher contribution from value retailing may help retail companies boost their topline growth, yet the key question that needs to be answered is if this topline growth would translate into a reasonable return for shareholders

We have considered the incremental revenues and EBIT (as calculated in Table III and IV) as the base figures and have calculated the expected incremental profit after tax (PAT) after assuming the tax rate to be 30% and assumed the cost of debt to vary from 8.0%-12.0% by FY2011. We have calculated the expected RoE under three scenarios-pessimistic, realistic and optimistic and assumed that investors would expect a minimum RoE of 14.4% as a benchmark return in order to commit investments in such retail ventures (for more details, please refer ***'Underlying Assumptions'*** on page 4).



Case I

50% of investment funded through debt

(Amount in INR bn)

TABLE - V

Expected Incremental PAT (in INR bn) by FY2010
(Based on revenues & EBIT as calculated in Table-III&IV)

Case - I (50% funds, i.e. Rs.410bn generated through Debt)

Expected EBIT margin (in %)	Cost of Debt (in %)									Additional area in mn sq ft.
	12.0%	11.5%	11.0%	10.5%	10.0%	9.5%	9.0%	8.5%	8.0%	
3.5%	(18)	(14)	(10)	(7)	(3)	1	4	8	12	180
4.0%	(14)	(10)	(6)	(2)	3	7	11	15	19	190
4.5%	(10)	(5)	(1)	4	8	13	18	22	27	200
5.0%	(6)	(1)	4	10	15	20	25	30	35	210
5.5%	(1)	4	10	16	21	27	33	39	44	220
6.0%	3	10	16	22	29	35	41	47	54	230
6.5%	8	15	22	29	36	43	50	57	64	240
7.0%	14	21	29	37	44	52	59	67	74	250
7.5%	19	28	36	44	53	61	69	77	86	260
	4000	4500	5000	5500	6000	6500	7000	7500	8000	
	Revenue per sq ft per annum (in INR)									

Source: First Global Research

Pessimistic Scenario | Realistic Scenario | Optimistic Scenario

Considering 50% of the upcoming investments being funded through debt, we found that the retail players are unable to generate profit under a pessimistic scenario. Although any change in the cost of debt will definitely have an impact on the profitability level, we believe that the impact of such a change in the cost of debt was quite low in comparison to the impact of a change in the EBIT margin. The slightest change in the EBIT margin (keeping other things constant) results in a higher incremental gain in the RoE. For instance, assuming revenues per sq ft of Rs. 6500 and the cost of debt at 9.5%, with a 0.5% change in the EBIT margin from 6% to 6.5%, the RoE increases from 8.3% to 10.3%.

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As per our estimates, in a realistic scenario, the retail companies will not be able to justify such massive investments, since they will not be able to generate a minimum RoE of 14.4% to the investors and have recorded an RoE varying from 2.3% to 8.3% till 2011. The only possibility for the retail players to generate reasonable return to the investors is to make over-optimistic assumption. ***Our analysis shows that in order to generate a minimum RoE of 14.4%, the retail companies will have to record a minimum EBIT margin of 7-7.5% by FY2011 (please refer***

Table-VI below), which at present looks like a near impossibility, given that organized retailers are averaging an EBIT margin of only 6-6.5% today; even in a much less competitive market…and even these are showing signs of pressure.

TABLE - VI

Expected Incremental PAT (in INR bn) by FY2010
(Based on revenues & EBIT as calculated in Table-III&IV)

Case - I (50% funds,i.e. Rs.410bn generated through Debt)

	Cost of Debt (in %)									
Expected EBIT margin (in %)	**12.0%**	**11.5%**	**11.0%**	**10.5%**	**10.0%**	**9.5%**	**9.0%**	**8.5%**	**8.0%**	**Additional area in mn sq ft.**
3.5%	-4.2%	-3.3%	-2.5%	-1.6%	-0.7%	0.2%	1.1%	1.9%	2.8%	**180**
4.0%	-3.3%	-2.4%	-1.4%	-0.4%	0.6%	1.6%	2.6%	3.6%	4.5%	**190**
4.5%	-2.4%	-1.3%	-0.2%	0.9%	2.0%	3.1%	4.2%	5.3%	6.4%	**200**
5.0%	-1.4%	-0.2%	1.1%	2.3%	3.5%	4.7%	6.0%	7.2%	8.4%	**210**
5.5%	-0.3%	1.0%	2.4%	3.7%	5.1%	6.5%	7.8%	9.2%	10.5%	**220**
6.0%	0.8%	2.3%	3.8%	5.3%	6.8%	8.3%	9.8%	11.3%	12.8%	**230**
6.5%	2.0%	3.7%	5.3%	7.0%	8.6%	10.3%	11.9%	13.6%	15.2%	**240**
7.0%	3.3%	5.1%	6.9%	8.7%	10.5%	12.3%	14.1%	15.9%	17.7%	**250**
7.5%	4.6%	6.6%	8.6%	10.5%	12.5%	14.5%	16.5%	18.4%	20.4%	**260**
	4000	**4500**	**5000**	**5500**	**6000**	**6500**	**7000**	**7500**	**8000**	
	Revenue per sq ft per annum (in INR)									

Source: First Global Research

Currently, almost all retail companies are facing margin pressure. Moreover, with new players, such as Reliance, Bharti-Wal Mart and AV Birla entering the Indian retail sector, the pressure on margins will be inevitable. The increased contribution from the low margin-high volume value retailing and any further rise in operating expenses, primarily employee cost and selling & distribution cost, will further increase the pressure on the operating margin in the coming years.

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… the increased contribution from the low margin-high volume value retailing and any further rise in operating expenses, primarily employee cost and selling & distribution cost, will further increase the pressure on the operating margin in the coming years

Thus, our analysis shows that it may be an uphill task for retail companies to generate a minimum return (RoE) of 14.4% on such huge investment. Although the companies are taking initiatives (such as private labels that have comparatively higher margins) to keep their bottomline growth intact, we believe that the pressure on margins will result in miserable returns, which are unlikely to justify the gigantic investments that are underway.

Although the companies are taking initiatives (such as private labels that have comparatively higher margins) to keep their bottomline growth intact, we believe that the pressure on margins will result in miserable returns, which are unlikely to justify the gigantic investments that are underway

Case II

75% of investment funded through debt

(Amount in INR bn)

TABLE - VII

Expected Incremental PAT (in INR bn) by FY2010
(Based on revenues & EBIT as calculated in Table-III&IV)

Case - II (75% funds, i.e. Rs.615bn generated through Debt)

	Cost of Debt (in %)									
Expected EBIT margin (in %)	12.0%	11.5%	11.0%	10.5%	10.0%	9.5%	9.0%	8.5%	8.0%	Additional area in mn sq ft.
3.5%	(35)	(31)	(26)	(22)	(18)	(13)	(9)	(4)	0	180
4.0%	(32)	(27)	(22)	(17)	(12)	(7)	(2)	2	7	190
4.5%	(28)	(22)	(17)	(12)	(6)	(1)	4	10	15	200
5.0%	(24)	(18)	(12)	(6)	0	6	12	18	24	210
5.5%	(19)	(13)	(6)	0	7	13	20	26	32	220
6.0%	(14)	(7)	(0)	7	14	21	28	35	42	230
6.5%	(9)	(2)	6	14	21	29	37	44	52	240
7.0%	(4)	4	13	21	29	38	46	54	63	250
7.5%	2	11	20	29	38	47	56	65	74	260
	4000	4500	5000	5500	6000	6500	7000	7500	8000	
	Revenue per sq ft per annum (in INR)									

Source: First Global Research

Pessimistic Scenario | Realistic Scenario | Optimistic Scenario

Considering 75% of the upcoming investments expected through debt (Rs. 630 bn) till 2011, we found that the retail players were unable to generate profit in more than 40% of the cases. In a realistic scenario, (leave alone the pessimistic scenario), we find that the retail players are unable to cover their costs and are likely to record an RoE varying from a negative return to 10.0% till 2011. Although high leverage aids the retail companies to generate higher RoE in the optimistic scenario, we believe that it may be an uphill task for the retail players to generate a reasonable RoE in a realistic scenario.

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As mentioned earlier, margins do play a crucial role in determining the feasibility of such investment in Case II as well (similar to Case I), since a slight change in the EBIT margin leads to a much higher variation in the RoE. ***In Case II, retail companies will have to record a minimum EBIT margin of 6.0-6.5%, which although lower, as compared to Case I, is still a hard nut to crack***.

TABLE - VIII										
Expected Incremental ROE (in %) in FY2010 (Based on PAT as calculated in Table-VII)										
Case - II (75% funds, i.e. Rs.615bn generated through Debt)										
	Cost of Debt (in %)									
Expected EBIT margin (in %)	**12.0%**	**11.5%**	**11.0%**	**10.5%**	**10.0%**	**9.5%**	**9.0%**	**8.5%**	**8.0%**	**Additional area in mn sq ft.**
3.5%	-16.8%	-14.7%	-12.6%	-10.5%	-8.4%	-6.3%	-4.2%	-2.1%	0.0%	**180**
4.0%	-15.1%	-12.8%	-10.4%	-8.1%	-5.8%	-3.5%	-1.2%	1.2%	3.5%	**190**
4.5%	-13.2%	-10.7%	-8.1%	-5.6%	-3.0%	-0.5%	2.1%	4.7%	7.2%	**200**
5.0%	-11.2%	-8.4%	-5.6%	-2.8%	0.0%	2.8%	5.6%	8.4%	11.2%	**210**
5.5%	-9.1%	-6.0%	-2.9%	0.1%	3.2%	6.3%	9.3%	12.4%	15.5%	**220**
6.0%	-6.8%	-3.5%	-0.1%	3.3%	6.6%	10.0%	13.3%	16.7%	20.0%	**230**
6.5%	-4.4%	-0.8%	2.9%	6.6%	10.2%	13.9%	17.5%	21.2%	24.8%	**240**
7.0%	-1.9%	2.1%	6.1%	10.0%	14.0%	18.0%	21.9%	25.9%	29.9%	**250**
7.5%	0.8%	5.1%	9.4%	13.7%	18.0%	22.3%	26.6%	30.9%	35.2%	**260**
	4000	**4500**	**5000**	**5500**	**6000**	**6500**	**7000**	**7500**	**8000**	
	Revenue per sq ft per annum (in INR)									

Source: First Global Research

Pessimistic Scenario | Realistic Scenario | Optimistic Scenario

As per our estimates, the retail companies will be able to justify such massive investments only in an optimistic scenario, with a combination of both high revenue per sq ft and higher margins, which to our mind amounts to wishful thinking. In fact, there is likely to be a trade-off between revenues and margins; and net results will be lower returns for investors. As stated earlier, retail companies may face mounting pressure on margins in the future. Pantaloon, which is the most diversified player at present, recorded an EBIT margin of 6.2% in H1 FY07 and expects a further decline in the coming years. Given the expected lower EBIT margin, we believe it will not be an easy task for the retail companies to generate a reasonable return for the investors.

> ***The retail companies will be able to justify such massive investments only in an optimistic scenario, with a combination of both high revenue per sq ft and higher margins, which to our mind amounts to wishful thinking. In fact, there is likely to be a trade-off between revenues and margins; and net results will be lower returns for investors…***
>
> ***… given the expected lower EBIT margin, we believe it will not be an easy task for the retail companies to generate a reasonable return for the investors***

There are very bleak chances for the retail companies to generate a reasonable return for the investors. Mounting pressure at the margins front may further pressure the investors' returns. Considering the low investor returns and high financial and business risk, we believe that there is definitely some mismatch between the pace of such massive investments and the expected growth in demand till 2011.

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**

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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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